Federalism and Decentralization's Effects on the Business Environment for Foreign Direct Investment

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Abstract

This study examines how the distribution of authority between national and subnational governments affects the stability of the policy environment experienced by foreign investors. I propose that national governments have stronger incentives to provide a stable environment for FDI compared to subnational governments. This is because national governments are legally bound to the bilateral investment treaties (BITs) they sign and as such must potentially bear the costs of international investment disputes, even when the dispute in question arose from an action by a subnational government. As a result, countries where power is relatively concentrated in the national government will have more stable environments than countries with greater levels of subnational autonomy. I test this hypothesis using data released by the World Bank Enterprise Surveys, and find that firms operating in unitary and centralized countries are more likely to report predictable and consistent interpretation of laws compared to firms in federal and decentralized countries. I also find that the positive stabilizing effects of BITs are greater in unitary and centralized countries.

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Introduction

In 1992, the US corporation Metalclad tried to build a hazardous waste landfill in the Mexican city of Guadalcazar. Metalclad was able to obtain a permit from the federal government, with assurances that the federal government would secure any further support required from the state of San Luis Potosi and the municipality of Guadalcazar. However, after Metalclad took over COTERIN, the Mexican company that owned the site, the governor of San Luis Potosi denounced the construction citing environmental concerns. The state and municipal governments attempted to block the landfill's construction and operation by denying Metalclad a building permit and challenging the legality of the federal government's agreement with Metalclad. In a strange turn of events, Guadalcazar was able to obtain a preliminary injunction barring operation of the landfill at the same time that federal agencies authorized Metalclad to expand the landfill site substantially. In the end, there was a state-wide decree establishing the landfill site as a protected natural area which effectively prevented the landfill from operating.

This case illustrates that a country's national government may not always be able to force subnational authorities to act in a way that is in line with national policies and regulations. This is because in many countries, the political system confers a significant amount of power and influence on subnational governments. Direct election of provincial governments are commonplace, as is devolution of policy authority. In general, when subnational governments are granted a substantial amount of autonomy, they have the power to shape and influence local economic conditions. The way in which these subnational governments use this authority can affect a wide range of issues, such as local hiring requirements and land issue permits, not to mention policy predictability and profitability (Eaton, 2010).

This paper examines the effect of such subnational policy authority on the business environment for foreign direct investment (FDI). I argue that the costs of harming FDI are larger for national governments than subnational governments, and thus national governments have a stronger incentive to provide a consistent and predictable business environment than subnational units do. However, in federal and politically decentralized countries where the national government has limited authority over its subnational units, it will be relatively more difficult for the national government to constrain its subnational units from expropriating investments. Therefore, we should expect that policy consistency and stability should be higher in unitary and politically centralized countries, where the national government retains strong control over its subnational units. I also argue that this will influence the efficacy of bilateral investment treaties signed by host country governments. While bilateral investment treaties provide a strong monetary incentive for national governments to prevent expropriation within their territories, their ability to do so will be contingent on how much authority subnational governments are given.

From a broader perspective, this study addressses the literature discussing the issue of federalism and decentralization and how they affect a country's economy. This question has long been a matter under debate. One longstanding perspective is that federalism prevents governmental tyranny and promotes economic growth. These studies generally focus on the constraints that federalism places on a government's ability to enact market-harming policies. Weingast (1995), for example, defines federalism as a system characterized by 1) a hierarchy of governments, each with a delineated scope of authority, and 2) institutionalized autonomy of each government. It argues that a federal system is market-preserving if it has these additional three characteristics: 1) subnational governments have primary regulatory responsibility over the economy; 2) a common market exists; and 3) subnational governments face a hard budget constraint. When these conditions are present, political institutions

can credibly commit the state to preserving markets by limiting the ability of the government to confiscate wealth, thus contributing to thriving markets and economies.

However, there has also been evidence to suggest that federalism and decentralization can have negative consequences for a country's economy. These studies typically focus on inefficiencies and divergence of preferences between government levels. Wibbels (2000), defining federalism as a system in which provinces are represented in the national legislative body and also have an elected legislature of their own, argues that developing countries with federal systems will be less able to implement macroeconomic reforms. This is because provinces face a free-rider problem amongst themselves regarding economic adjustment, and as a result provincial governments will have weaker incentives for adjustment than the national government. Others such as Cai and Treisman (2004) have argued that federalism leads to market distortion and erodes the central government's ability to implement welfare-enhancing policies, which results in weaker central law enforcement and lower welfare. Similarly, Fan, Lin and Treisman (2009) warn against the dangers of rent-seeking in decentralized systems, arguing that countries with a larger number of government or administrative tiers and a larger number of local public employees report higher frequencies of briberies.

This debate extends to the effect of federalism and decentralization on foreign direct investment. Jensen (2006), for example, defines political federalism as a system in which subnational governments do not have the primary responsibility of taxing and raising their own revenue, but are involved in legislation at the national level. He argues that in a federal system, the national government may have a preference toward maximizing national benefits at the expense of localized benefits. Taxing foreign investors benefits the national government in the form of higher tax revenues; on the other hand, the benefits of the investment itself are highly localized in the form of local job creation and higher wages. Therefore, we should expect subnational governments to constrain the national government from enacting policies that harm foreign investors. This is most effective in a federal system where subnational governments influence national policymaking. Jensen and McGillivray (2005) come to a similar conclusion, with the added finding that a federal structure is particularly effective in lowering political risk in less democratic systems, due to the underlying democratic deficit in such countries.

On the other hand, Kalamova (2008) has argued that political decentralization leads to decreased FDI into a country, due to coordination failures across levels of government as well as excessive bureaucracy and over-regulation. Kessing, Konrad and Kotsogiannis (2009) make a similar argument, citing federal countries' inability to commit to a low overall tax burden due to fiscal inefficiencies as a reason they are disadvantaged vis-a-vis unitary states in the competition for foreign direct investment.

My study speaks to this debate regarding the relationship between foreign direct investment and federalism/decentralization. I argue that when discussing the impact of federalism and decentralization on the business environment for foreign direct investment, it is important to take into consideration the international environment in which governments operate. This context should influence governments' preferences regarding treatment of foreign direct investment. National governments typically face powerful international constraints (in the form of potential international tribunals), that make them relatively reluctant to pursue policies that penalize or limit foreign capital. Subnational governments do not face similar constraints, and will be more likely to punish foreign capital when the need arises (for example, when anti-globalization sentiment is strong in the local community). This preference structure needs to be taken into account when debating the effect of federalism and decentralization. The following section presents this argument in detail.

Policy Stability for Foreign Direct Investment

Competition for foreign direct investment is a global phenomenon, involving all levels of government. FDI is seen as desirable because it generates capital and local employment opportunities. Governments endeavor to attract foreign investors in various ways, such as offering tax breaks and other fiscal incentive packages to foreign investors. A broader process of policy reform and liberalization of trade and investment policies may also accompany such efforts (Oman, 1999).

However, governments may also have incentives to penalize foreign investment and not infrequently do so, as this can provide short-term political gains if anti-globalization sentiment is high, and can also bring financial windfalls. Such actions are termed expropriation and include a wide variety of government actions that adversely affect the value of a property. Acts of "direct" expropriation, in which the investment is nationalized or taken by the government through physical seizure of assets or transfer of title, are the most dramatic and high-profile. This type of expropriation is now relatively rare.

On the other hand, "indirect" expropriation, denoting unpredictability in laws, or regulations that adversely affect investments, is quite pervasive (Asiedu, Jin and Nandwa, 2009). Indirect expropriation happens gradually using methods such as taxation, regulations, denial of due process, or delays and non-performance on the part of the government. Failure to maintain an appropriate legal, administrative, and regulatory framework conducive to FDI is also considered to be indirect expropriation (Reisman and Sloane, 2004). At times, even a government's pursuit of the public good can be perceived as expropriation by the investor. In one widely publicized case, the government of South Africa passed the Mineral and Petroleum Resources Development Act (MPRDA) in 2002, which included a clause stipulating that all South African mines must be operated under at least 26% black ownership. In response to this, investors from Italy and Luxembourg launched an arbitration claim, alleging that this "compulsory equity divestiture requirement" amounted to an indirect expropriation of their properties.[1]

Overall, expropriation is considered to be "one of the quintessential obstacles to foreign direct investment" (Kessing, Konrad and Kotsogiannis, 2009, p. 105), and this is particularly so when the host country is a developing country. Developing countries are considered to be higher risk because these countries generally have weaker legal systems and traditions than developed countries. However, while investors will always prefer lower risks of expropriation, the incentives of governments regarding expropriation will not be uniform across the board. The following section examines this idea.

[1] Dolzer and Bloch (2003) provide a cogent analysis of the current dilemma faced by governments, in which regulations can be construed as (indirect) expropriation to investors: "At a time when national policies concerning international economic relations are increasingly characterized by concepts aiming at structural adjustment, good governance and export-led growth, and when many countries find themselves in fierce competition for foreign direct investment, the era of straightforward formal expropriations of alien property seems to have come to an end. At the same time, however, the need for protecting certain public goods, be it in the areas of social cohesion or environmental protection, remains on the agenda of most, if not all, political actors. Against this backdrop, it does not seem unreasonable to assume that pressure on national governments – open or disguised – to protect domestic industries, the environment, or public health may encourage governments to regulate foreign investment, in itself or as part of the general economy, so drastically that foreign investors may be inclined to raise claims of indirect expropriation. The precise definition of what constitutes an expropriation is thus likely to continue to engender legal debates and disputes. This is even more so considering the growing number of bilateral investment treaties ('BITs')" (p. 155).

International Arbitration and Bilateral Investment Treaties

I argue that national governments have a stronger incentive to avoid expropriation than do subnational governments, due to the international context under which governments operate: namely, the possibility of international investment arbitration, which has recently become a significant concern for developing countries. Arbitration cases are initiated by foreign investors (nearly always from developed countries) against host country governments (the majority of which are developing countries). This dispute settlement method bypasses the host country's domestic court and judiciary systems. Instead, it proceeds under the auspices of an international institution – most often the International Centre for the Settlement of Investment Disputes (ICSID), but also occasionally the Stockholm Chamber of Commerce (SCC) or the International Chamber of Commerce (ICC) – or an *ad hoc* international arbitration panel pursuant to the rules of the United Nations Commission on International Trade Law (UNCITRAL).

The number of arbitration cases has increased exponentially since the 2000s. In the year 2015 alone, 53 new cases were filed with ICSID. What is more, the arbitral awards are frequently considerable sums. A recent study analyzed publicized cases and suggested that the mean award of ICSID arbitration cases is about $5.3 million, and the mean award of non-ICSID arbitration cases is about $20 million (Franck, 2011). Much larger awards have also been frequently publicized; for example, in early 2012, Exxon Mobile was awarded $908 million by an arbitration panel in a case against Venezuela. Another study estimated the average arbitration award against a developing country to be 0.53% of its annual government expenditure. Legal fees are no less a consideration, usually running into the millions and even tens of millions of dollars; at times it has even exceeded the actual amount under dispute (Gotanda, 1999).

The scope of issues challenged under arbitration cases have been widening as well. Though direct expropriations such as nationalizations have tended to receive the most global publicity, charges of indirect expropriations have become increasingly common over the years: "State conduct most frequently challenged by investors in 2015 included legislative reforms in the renewable energy sector, alleged direct expropriations of investments, alleged discriminatory treatment, and revocation or denial of licences or permits" (UNCTAD, 2016). The controversy surrounding this has not gone unnoticed, with one study noting that "terms commonly employed in bilateral and multilateral investment agreements, such as 'dispossession,' 'taking,' 'deprivation' or 'privation,' are also typically unaccompanied by clear definitions," and that "the definition of expropriation in international law is still very much in flux, and nowhere is this more evident than in the area of indirect expropriation" (Fortier and Drymer, 2004, p. 296). Failure to achieve a stable policy environment can thus potentially lead to an arbitration case for the host country government.

Interestingly however, though arbitration cases can arise from disputes between an investor and a subnational government, the defendant in such cases is invariably the national government. In international arbitration, the national government is held responsible for any loss of investment within its borders, even if a subnational authority was responsible for the action under dispute. Arbitration panels have been consistent in ruling that the national government must take responsibility for the actions of its regional and local governments (Schreuer, 2010). One famous such case was that of Methanex Corporation v. United States of America. Methanex, a Vancouver-based producer of methanol, submitted an arbitration claim under UNCITRAL for alleged injuries resulting from a California ban of the gasoline additive MTBE, of which methanol is an ingredient. Methanex contended that a Califiornia Executive Order and the regulations banning MTBE expropriated parts of its investments. The damages it claimed was $970 million. (A hearing on jurisdiction and admissibility was held in 2001, and in 2005 the arbitration tribunal ultimately

dismissed Methanex's claims, and ordered Methanex to pay the the United States' legal fees and arbitral expenses to the tune of $4 million.) We can see that the tribunal deemed it admissible that they bring a claim against the United States government, though the alleged act of expropriation itself stemmed directly from a California law.

National governments are, furthermore, burdened with shouldering the cost of arbitration and awards. The national government's responsibility requires that it pay any ensuing settlement fees or awards to the investor, in addition to shouldering its own legal fees. Herman (2011) notes that typically there is no clear mechanism by which the federal government can seek reimbursement of these costs from the regional government whose actions prompted the arbitration case. For example, when the Canadian province of Newfoundland and Labrador expropriated the assets of the US company Abitibi-Bowater, the firm launched an arbitration claim which was later settled for approximately $130 million. The province itself was not involved in the dispute, and so far as it is known the federal government has not attempted to recover the settlement money from the province.

National governments will therefore have stronger incentives to avoid subnational expropriation than do subnational governments. Moreover, these considerations for national governments are amplified when they have signed bilateral investment treaties (BITs). International arbitration claims can be launched on the basis of various different legal instruments, and these have included contracts between the investor and government, the host country's investment law, international treaties, and even customary international law. In practice, BITs are the most oft-invoked legal instrument – approximately two-thirds of all ICSID cases have been based on BITs. Currently, there are over 2,600 BITs worldwide, most of which were signed in the 1990s. Not only are they ubiquitous, but they also typically include a signatory's consent to submit any future dispute with an investor from the other state to an international arbitration panel, should the investor be inclined to pursue that option. Therefore, national governments' incentives to avoid expropriation will be even stronger when their countries have signed BITs.

How Federalism and Decentralization Affect Policy Stability

I have argued that national governments will try to avoid expropriation and pursue a stable environment for FDI. This incentive will be particularly strong when they have signed bilateral investment treaties. However, their ability to control the policy environment is not uniform across countries, and in fact will show a great deal of variation. I argue that federalism and political decentralization decrease a national government's power over its subnational units, thereby weakening its ability to achieve a consistent and predictable environment for foreign investors.

This argument raises a more fundamental question to be clarified: What are federalism and decentralization? As mentioned earlier, there is a considerable amount of existing research on the economic effects of federalism and decentralization. However, the terms are not consistently defined and measured across studies, and often confusingly overlap. For example, Treisman (2000*b*) distinguishes between fiscal and political decentralization, but makes no conceptual distinction between political decentralization and federalism; political decentralization is measured using the classification of federal countries from Elazar (1995). Kalamova (2008) even explicitly states that "Henceforth, we use decentralization and federalism as synonyms. Furthermore, institutional, administrative and political decentralization will be interchanged as well" (p. 2). To measure this blended concept, she uses the number of government administrative tiers as given in Treisman (2002). Kessing, Konrad and Kotsogiannis (2007) also use this variable by Treisman as a measure

of "vertical decentralization."

Jensen (2006), on the other hand, does distinguish between political federalism and political decentralization. Political federalism is defined as a system where "Subnational units do not have the primary responsibility of taxing and raising their own revenue but do have a hand in crafting national policy. Subnational units are involved... in legislation at the national level" (p. 107). By contrast, political decentralization is defined as a system in which "Subnational units are given autonomy over policy within their subnational territorial unit, short of taxing and spending their own revenue. Subnational units have no role in the crafting of national policy" (p. 108). While this distinction might be useful, his definitions do not seem to be widely used amongst other studies.

To clarify these conceptual ambiguities, I turned to the classification of decentralization developed first in Schneider (2003), which was further expanded by Norris (2008) to include a discussion of federalism. Norris lays out her agenda with the following words:

> To develop a global comparison, a classification of ideal types of vertical power-sharing is developed conceptually, based on two dimensions: the degree of fiscal, administrative, and political decentralization in the public sector and the type of constitutional rules governing the relationship between the national and subnational tiers. Formal constitutional structures in all nations around the world are classified as 'unitary states,' 'federal states' ... (p. 159)

In short, her study not only distinguishes between federalism and decentralization, but it also disaggregates decentralization into three aspects – political, fiscal, and administrative. My parsing of these concepts is rooted primarily in these discussions.

In Norris's classification, constitutions can be broadly divided into two categories: unitary and federal. A unitary constitution is one where "the national government is defined as sovereign over all its territorial units. The national government retains the authority and legitimacy to control the activities of subnational units even though some roles and administrative functions can still be devolved to lower tiers of government... In any case of conflict, however, the national government remains constitutionally sovereign so that executive decisions and laws passed by the national legislature cannot be overruled by lower units" (p. 168). Federal constitutions, on the other hand, are defined as those in which "each tier has certain specified areas of autonomy," which are "formally guaranteed, most commonly in a written constitution where disputes between tiers are usually resolved by an independent court" (p. 167).

Decentralization is disaggregated into three separate dimensions: administrative, fiscal, and political. According to Norris, "Administrative decentralization transfers bureaucratic decision-making authority and managerial responsibilities for the delivery and regulation of public services and for raising revenues from the central government to subnational tiers. This is the most basic form of decentralization" (p. 164).

Fiscal decentralization goes further than administrative decentralization, and involves the reallocation of resources to the subnational level, especially with regards to government expenditures and revenues. Schneider (2003) notes that "If resources have been ceded to subnational units, then central governments have, to one degree or another, less fiscal impact" (p. 36). To be clear, neither fiscal nor administrative decentralization are necessarily accompanied by the devolution of political authority. However, given that fiscal policies are crucial instruments with which governments pursue social stability and economic efficiency, shifting fiscal authority to subnational governments is a more significant form of power-sharing than delegating administrative responsibilities.

Norris argues that "the most radical type of vertical power-sharing involves *political decentralization*" (p. 166), which is an arrangement where "political actors and issues are significant at the local level and are at least partially independent from those at the national level" (Schneider, 2003, p. 39). It gives local actors a voice and venue through which they can pursue their interests. This can be done, for example, through the local election of a city mayor or state legislature. In politically decentralized systems, local matters are an important basis on which interests are formed, and political actors and parties orchestrate on a local level to compete over resources. As local politicians are elected rather than appointed by the center, in such systems the control of the national government over subnational authorities is significantly weakened.

As mentioned earlier, federalism and decentralization might seem indistinguishable at first glance, and they have often been used synonymously. However, they are distinct concepts which do not always accompany each other in practice. Norris recognizes this complexity: "In simple binary classifications, federalism is sometimes assumed to be equated automatically with decentralized decision making while unitary states are regarded as most centralized. In reality, the situation is more complex, however, as important variations can be observed" (p. 166). Simply put, it is not always the case that federal countries have decentralized systems, or that unitary countries have centralized systems. For example, Sweden is an example of a country with a unitary constitution but a decentralized system. In Sweden, the national parliament in Stockholm (Riksdag) remains sovereign. However, local elections happen at both the county and municipal level; the proportion of subnational expenditures is nearly 40% (which is even higher than some federal countries); and local governments administer a wide range of services, such as healthcare, education, social services, and public transport. Sweden is a clear case where the national government retains sovereignty over the subnational governments, but is also highly decentralized. On the other hand, Venezuela is an example of a country with a federal constitution but a relatively centralized system. It has a federal constitution and is divided into 23 states. However, the level of subnational expenditure is quite low, at only 3% of total government expenditure. Furthermore, state governors were historically appointed, with gubernatorial elections only beginning in 1989. Venezuela is a case where subnational governments have certain specified areas of autonomy, but the national government still retains a significant amount of fiscal control (and until recently, political control as well).

As we can see, federalism and the three dimensions of decentralization are distinct concepts. What is more, their reach and impact are not identical to each other. Administrative decentralization has the least amount of influence, as it focuses on bureaucratic management and does not necessarily imply any transfer of political authority. Political decentralization, on the other hand, is highly consequential as it creates local-level political actors and incentives, which could potentially diverge from the national government's preferences. Federalism also gives a significant amount of power to subnational governments, by establishing certain areas of autonomy which the national government cannot override. In short, while all these concepts involve transfers of power to subnational governments, they differ in their extent to which they weaken a national government's authority over its subnational units. Federalism and political decentralization involve a more substantial devolution of power compared to fiscal and administrative decentralization.

How will federalism and decentralization affect policy stability for foreign investors? I earlier argued that national governments will have stronger incentives to avoid policy instability compared to subnational governments, due to concerns of international arbitration. However, the national government's ability to intervene in subnational level actions should depend on the country's constitution type and decentralization level. National governments in unitary countries should have more control over subnational governments than in federal countries; similarly, national governments

in politically centralized countries should have more control over their subnational units than in politically decentralized countries. We can infer from this that in unitary states and politically centralized states, the national government should more easily be able to prevent expropriation by preventing subnational governments from changing or interpreting legislation in a manner harmful to foreign investors. Therefore, foreign investors should experience more consistent and predictable laws in unitary countries than federal ones; and in a similar vein, foreign investors should experience more consistent and predictable laws in politically centralized countries than decentralized ones.

Will administrative or fiscal decentralization also affect policy outcomes? Fan, Lin and Treisman (2009) mention "the problems of coordination and overgrazing in multi-tier structures" (p. 27), and show that "in countries with a larger number of administrative or governmental tiers, reported bribery was both more frequent and more costly" (p. 32). Inefficiency and corruption due to multiple levels of bureaucracy must surely be a concern for policymakers. However, administrative or fiscal decentralization do not affect the national government's level of control over subnational governments as much as political decentralization, so I do not expect them to have a significant impact on the level of policy stability for foreign investors. We thus have the following hypotheses:

> *1a. The consistency and predictability of rules and regulations for foreign investors should be higher in countries with unitary constitutions than in countries with federal constitutions.*
>
> *1b. The consistency and predictability of rules and regulations for foreign investors should be higher in politically centralized states than decentralized states.*
>
> *1c. The consistency and predictability of rules and regulations for foreign investors should not be affected by the host country's degree of fiscal decentralization or administrative decentralization.*

Furthermore, we can expect that BITs will magnify a national government's incentives to avoid charges of expropriation, as these treaties are the most widely invoked legal instrument behind arbitration claims. However, this is again dependent on the national government's level of control over its subnational units. National governments in unitary countries and politically centralized countries will more easily be able to abide by the terms of these treaties, increasing policy stability for foreign investors. This gives us the following hypotheses:

> *2a. Bilateral investment treaties should have a stronger effect on the consistency and predictability of rules and regulations for foreign investors in countries with unitary constitutions than in countries with federal constitutions.*
>
> *2b. Bilateral investment treaties should have a stronger effect on the consistency and predictability of rules and regulations for foreign investors in politically centralized countries than decentralized countries.*

Empirical Analysis

Dataset

To test the hypotheses, I use firm-level data produced by the World Bank's Enterprise Surveys. This data is built by surveying a representative sample of private firms from a selection of developing countries. The surveys are conducted through face-to-face interviews with top managers

Variable	Obs	Mean	Standard Deviation	Minimum	Maximum
Dependent Variable	1389	2.447	.959	1	4
Federalism	1389	.513	.500	0	1
State (Province) Elections	1250	1.32	.845	0	2
Subnational Expenditures	1209	16.899	13.285	1.742	45.794
Administrative Tiers	1117	3.493	.911	2	6
Bilateral Investment Treaties	1389	22.280	17.444	3	57
GDP Per Capita	1389	4.064	2.712	0.143	8.162
Latin America & Caribbean	1389	.459	.498	0	1
Senate Constituency	1389	.552	.497	0	1
Firm's Employees	1389	.00001	.00008	-9.69e-07	.002
Firm's Annual Sales	1388	.0005	.005	-3.72e-10	.202
Foreign Direct Investment	2627	2.739	12.951	-7.120	290.928
GDP	2779	118.044	397.869	.021	8909

Table 1: Summary Statistics

and business owners. Survey topics include a broad range of business environment topics including finance, labor, infrastructure, corruption, performance measures, and (crucially for this study) business-government relations. The typical number of interviews is 1200-1800 in larger economies, 360 in medium-sized economies, and 150 for smaller economies. The primary sectors of interest are manufacturing industries and service industries.

I take advantage of the fact that each firm's ownership composition is reported. As my argument centers on foreign direct investment, I use data of firms that report at least 10% of ownership by private foreign individuals, companies or organizations. (FDI is defined by the World Bank as "the acquisition of a lasting management interest – 10 percent or more of voting stock – in an enterprise operating in an economy other than that of the investor.") The firms are from 138 developing countries between the years of 2006 and 2016.

Dependent Variable

The dependent variable is a firm's response to the following statement: *"Government officials' interpretations of the laws and regulations affecting this establishment are consistent and predictable."* A firm's response is coded as follows: 1 is "strongly disagree," 2 is "tend to disagree," 3 is "tend to agree," and 4 is "strongly agree."

Independent Variables: Federalism and Decentralization

In order to test the effect of federalism I use a variable from Norris (2008), where political constitutions are classified as either federal or unitary, based on data derived from Griffiths (2005), Watts (1999), and Banks (2000). The coding is based on her definitions presented earlier. The variable is a dummy measure which is coded 0 when the country the firm operates in has a unitary constitution, and 1 if it has a federal constitution.[2]

[2]The original dataset codes unitary constitutions with a 1, and federal constitutions with a 0. I inverted the coding for ease of following.

	Federal	State Elections	Subnational Expenditures	Administrative Tiers
Federal	1.00			
State (Province) Elections	.57	1.00		
Subnational Expenditures	.43	.20	1.00	
Administrative Tiers	.12	-.22	.18	1.00

Table 2: Correlation Coefficients

To measure the effect of political decentralization, I use a variable from Beck et al. (2001). It codes whether state (or province) governments are locally elected: 0 if neither state executive nor state legislature are locally elected; 1 if the state executive is appointed, but the state legislature is elected; and 2 if both state executive and legislature are elected. When there are multiple levels of subnational government, the highest of these is considered to be the "state" level, and the lowest is considered to be the "municipal" level. Indirectly elected state governments are considered locally elected when the electing bodies are directly elected state bodies; however, they are not considered locally elected when the electing bodies are directly elected municipal bodies.

As a measure of fiscal decentralization, I use the percentage of subnational government expenditure in relation to total government expenditure. It should be noted that higher subnational expenditures do not always imply strong subnational control over fiscal policies. For example, in Austria and Germany, subnational governments have limited leeway in determining taxation, whereas in Sweden and Canada, subnational control over taxation policies is significant (Norris, 2008). Nevertheless, this is the most widely used measure of fiscal decentralization, due to its relative ease of measurement and data availability. This variable is extracted from Norris (2008), and is constructed from data from the World Bank.

The administrative decentralization variable is sourced from Fan, Lin and Treisman (2009), and provides the number of administrative tiers of government in each country. A tier is coded as a tier of government if the state executive body at that level is funded from the public budget, has authority to administer a range of public services, and has a territorial jurisdiction. As we can see from Table 2, administrative decentralization has a relatively low correlation level with the other variables.

Control Variables

The first control variable is the cumulative number of bilateral investment treaties signed by the national government of the country the firm operates in. I coded this variable using data from the United Nations Conference on Trade and Development (UNCTAD) and the International Centre for Settlement of Investment Disputes (ICSID). This variable is important to control for because national governments should presumably be more keen to avoid expropriation charges when they have signed many bilateral investment treaties. Based on my argument, however, it is unclear whether national governments in federal or decentralized countries will be able to enforce policy consistency. If this variable has an insignificant effect on the dependent variable, it might suggest that bilateral investment treaties are not always effective in increasing policy consistency, particularly when the country is federal or politically decentralized.

I also control for the economic development level of the country the firm operates in. This is measured by the country's GDP per capita (in constant 2000 US dollars), obtained from the World Bank's World Development Indicators. Studies such as Treisman (2000*a*) have shown that economic

development leads to higher quality government and less corruption. Therefore, we should expect this variable to be positively related to policy consistency.

The next variable codes the constituency of the senators in the country the firm operates in, again using data from Beck et al. (2001). If the constituency of the senators is the provinces (or states), this variable is coded 1; if the senate is appointed or elected on a national basis, it is coded 0. (If the senate is only partially elected through the constituencies, it is scored according to how the majority is elected.) I control for this variable because the influence that provincial governments have over national-policymaking could also affect the preference alignment between provincial and national governments, which in turn could affect policy consistency.

Using the World Bank's region classification, I control for whether the country is in Latin America or the Caribbean, as these countries have long had a complicated relationship with foreign direct investment. Traditionally, Latin American countries have had a relatively inhospitable view towards foreign investors. This is evidenced by the Calvo doctrine, developed by the Argentinian legal scholar Carlos Calvo, who held forth that "foreign aliens – like nationals – are subject to the laws and jurisdiction of the state where they do business or reside, including when they suffer harm or damage as a result of local disorder, political disturbances or civil war" (Calvo, 1870, p. 134). Thus when ICSID was established in 1965, almost all Latin American countries initially shied away from it. This was followed by a period of drastic policy change during the 1990s when Latin American countries joined the ICSID and signed BITs *en masse* (though some countries such as Mexico and Brazil still refused to ratify the ICSID convention). However, recent years have seen a reversal of this openness to foreign investment, which some have dubbed the revival of the Calvo Doctrine. In 2007, Bolivia became the first ICSID member ever to withdraw its membership, a move that was swiftly followed by Ecuador, Venezuela and Argentina. Eduardo Barcesat, chief legal advisor to Argentina's Treasury, was quoted describing ICSID as "a tribunal of butchers" that only rules in favor of multinational companies (MercoPress, 2013). Additionally, Venezuela terminated its BIT with the Netherlands in 2008, Bolivia denounced all its BITs in 2013, and other Latin American countries are said to be considering similar moves.[3] It seems safe to argue that many Latin American countries have deep-rooted ideological objections to FDI, with one commentator observing that "they are driven by a personal conviction that FDI, even if it does foster development and prosperity, is wrong, promotes imperialism, and thus deserves no effective protection" (Vincentelli, 2010, p. 423). To control for this unique character of the region, I include a dummy variable that is coded 1 if the host country is in the Latin American & Caribbean region (according to the World Bank classification), and 0 otherwise.

I additionally control for two firm level variables measuring a firm's political influence. The first is the size of the workforce employed by the firm. This variable is calculated by taking a firm's number of permanent full-time employees, and standardizing it by the size of the country's population. The second is amount of the total annual sales of the firm, divided by size of the country's GDP. These two variables should be related to a firm's influence level on the government. Workers' political votes can be used as a firm's bargaining tool, as can a firm's ability to make financial donations to campaigns (Zardkoohi, 1985). Politicians should be wary of antagonizing politically powerful firms through unpredictable rules and regulations. Therefore, I expect that these variables will be positively related to policy consistency. The firm-level variables are available in the survey data, and the data used to standardize these variables are from the World Bank's World Development Indicators.

[3]It should be noted that BITs typically have "sunset clauses" that protect investments anywere between 10-20 years after the treaty ceases.

Method of Estimation

The method of estimation I use is the ordered logistic regression. This regression supports models in which the dependent variable is an observed ordinal variable with an underlying latent continuous variable. The dependent variable in the data is an ordinal variable coded on a scale of 1 to 4, which is a measurement of firms' assessments of the government ranging on an unobservable continuous scale. Thus the use of the ordered logit model seems appropriate. I use robust standard errors allowing for correlation of observations among firms operating within the same country.

Additionally, since the data is structured as firm-level survey data, we need to take into account the sampling methodology utilized by the World Bank. The firms are selected through stratified random sampling, in which all firms are grouped within homogenous groups and simple random samples are selected from each group. (The strata used are firm employment size, business sector, and geographic region within a country.) Population estimates can be obtained by properly weighting individual observations, using sampling weights included in the survey data. Sampling weights, which denote the inverse of the probability that the observation is included because of the sampling design, account for the varying probabilities of selection across different strata.

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Federalism	-1.590***				-.177		
	(.605)				(.820)		
State (Province) Elections		-.910***				-.281	
		(.273)				(.415)	
Subnational Expenditures			-.081***				-.048**
			(.021)				(.022)
Administrative Tiers				-.023			
				(.689)			
*Federalism*BITs*					.-048**		
					(.022)		
*State Elections*BITs*						-.020*	
						(.011)	
*Subnational Expenditure*BITs*							-.0009*
							(.0005)
Bilateral Investment Treaties	.0001	.001	.013***	.005	-.003	.040*	.045**
	(.006)	(.006)	(.003)	(.005)	(.021)	(.018)	(.016)
GDP Per Capita	.0003***	.0003***	.00006**	.0002	.0002**	.0003***	.00007**
	(.0001)	(.0001)	(.00003)	(.0002)	(.0001)	(.0001)	(.00003)
Latin America & Caribbean	-1.323***	-1.258***	-.613***	-1.093**	-1.430***	-1.323***	-.556***
	(.305)	(.350)	(.194)	(.438)	(.273)	(.327)	(.130)
Senate Constituency	.247	-.462	1.255**	-.752	-.020	-.576	.690
	(.750)	(.612)	(.579)	(.654)	(.528)	(.477)	(.588)
Firm's Employees	-551.12	-790.618	461.184	1438.71	-53.008	-315.459	591.112
	(1179.424)	(1091.32)	(947.107)	(2370.03)	(993.870)	(991.677)	(900.795)
Firm's Annual Sales	-.822	-5.634	-2.773	-6.009	.058	-2.952	-3.776
	(6.539)	(24.343)	(6.849)	(30.624)	(5.821)	(22.435)	(6.760)

Standard errors clustered by country are in parentheses. ***p<.01, **p<.05, *p<.1.

Table 3: Dependent Variable = World Bank Enterprise Survey Question

Results

The results are displayed in Table 3. Looking at the first column, we can see that firms operating in countries with unitary constitutions are more likely to respond positively to the survey statement "government officials' interpretations of the laws and regulations affecting this establishment are consistent and predictable," and that this effect is statistically significant. The substantive effects are considerable. In a country with a federal constitution, the predicted probability that a firm will "strongly disagree" with the statement is approximately 0.34, "tend to disagree" is 0.25, "tend to agree" is 0.28, and "strongly agree" is 0.12 (holding other variables at their means). However, in a country with a unitary constitution, the respective probabilities are 0.11, 0.13, 0.37, and 0.37. We can see that in a unitary country, the probability that a firm will answer "strongly agree" to the question is over three times as high as a federal country. Moreover, the probability that a firm will answer "strongly disagree" is more than three times higher in a federal country compared to a unitary country. This supports hypothesis 1a, which argued that rules and regulations concerning foreign investors will be more consistent and predictable in unitary countries than federal ones.

We now turn to the effect of political decentralization. Looking at column 2, we can observe that the presence of state (or province) level local elections have a negative effect on a firm's response to the question of policy consistency. In a country with no state-level elections, the predicted probability that a firm will "strongly disagree" with the survey statement is approximately 0.09, "tend to disagree" is 0.11, "tend to agree" is 0.36, and "strongly agree" is 0.42. In a country with only state-level legislative elections, these probabilities are 0.18, 0.19, 0.38, and 0.23. In a country where both the state legislatures and executives are locally elected, the respective probabilities are 0.33, 0.25, 0.28, and 0.12. We can see that in a country with no state-level elections, the probability that a firm will "agree" with the survey statement is nearly double that of a firm in a country where both state executives and legislatures are elected. This supports my hypothesis 1b that political decentralization erodes the control that national governments have over subnational tiers, which should decrease policy stability and predictability.

Though fiscal decentralization was not expected to have an effect similar to that of political decentralization, we can see in column 3 that it does. As the proportion of subnational expenditures in the host country increases, the level of reported policy consistency decreases. At the lowest level of decentralization (6% of government expenditures at the subnational level), the predicted probability that a firm will answer "strongly disagree" to the survey question is 0.06, and the probability that it will answer "strongly agree" is 0.52. At the average level of decentralization (17%), these probatilities are respectively 0.16 and 0.25. At the maximum level of decentralization (46%), the probabilities are 0.65 and 0.04. As we can see, the predicted probability that a firm will answer positively to the survey statement decreases dramatically as the level of decentralization increases. This suggests that subnational expenditure levels might be a signifier for subnational government latitude, if more subtle than local-level elections or constitutionally guaranteed autonomy.

Administrative decentralization is not shown have a statistically significant effect (column 4), which supports hypothesis 1c. This suggests that an increase in the amount of bureaucracy is not, in and of itself, necessarily related to an increase in policy inconsistency, especially when it is not accompanied by a transfer of political power and resources to subnational units.

We now turn to the testing of hypotheses 2a and 2b, which posit an interactive effect between a host country's political system and bilateral investment treaties. Namely, I argued that bilateral investment treaties will be more effective when the national government is strong vis-a-vis its subnational counterparts. To test this I create three new variables: the first by interacting the federalism variable with BITs, the second by interacting the state-level election variable with BITs,

and the third by interacting the subnational expenditure variable with BITs. The results are presented in columns 5, 6, and 7. The numbers confirm the hypotheses: bilateral investment treaties are more likely to have a positive effect on policy stability when the country has a unitary constitution; these treaties are also more effective in politically centralized systems. The substantive results are notable. In a country with a federal constitution, the predicted probabilities of a firm's response change very little as the number of bilateral investment treaties signed by the national government increases. At the mininum number of BITs (3), the predicted probability that a firm will answer "tend to agree" or "strongly agree" to the survey question is 0.43. At the maximum number of BITs signed (57), this probability goes down to 0.38, which (somewhat surprisingly) suggests that policy stability actually *decreases* slightly as the number of bilateral investment treaties signed increases in a federal country. However, in a country with a unitary constitution, we observe the opposite effect. At the minimum number of BITs signed, the predicted probability that a firm will answer "tend to agree" or "strongly agree" to the survey statement is 0.50. At the average number of treaties signed (22), this probability increases to 0.69, and at the maximum number of treaties signed, the predicted probability is 0.89. As we can see, in a unitary country, bilateral investment treaties are linked to a very strong and noticeable increase in the predicted probability that a firm will answer positively to the question of policy consistency.

A similar interactive effect was observed between bilateral investment treaties and the presence of state-level elections. Specifically, bilateral investment treaties are more likely to positively affect policy stability when there are no state-level elections (as seen in column 6). In a highly politically decentralized country where both state legislatures and executives are locally elected, the predicted probability that a firm will "tend to agree" or "strongly agree" with the survey statement is 0.41 when the number of bilateral investment treaties is held at its minimum, and 0.40 when the number of treaties is at its maximum. Again, there is actually a very slight decrease in the reported level of policy consistency as the number of treaties increases. In comparison, in a country where only the local legislature is elected, the predicted probability that a firm will "agree" with the statement is 0.48 when the number of treaties is held at its minimum, and this probability increases to 0.72 when the number of treaties is increased to its maximum. Meanwhile, in a country where there are no state-level elections, the probability that a firm will "agree" with the survey statement is 0.55 when the number of treaties is at its minimum, and this increases to 0.89 when the number of treaties is at its maximum. As we can see, bilateral investment treaties have a strongly positive effect on policy consistency in politically centralized countries with no local elections, but this effect is unobservable in decentralized countries where state governments are locally elected.

An interactive effect was also shown between bilateral investment treaties and the proportion of subnational expenditures (column 7). At the lowest level of subnational expenditures (2%), the predicted probability that a firm will answer "strongly agree" to the survey question is 0.26 when the number of bilateral investment treaties is held at its minimum. This probability increases steeply to 0.76 when the number of bilateral investment treaties is at its maximum. When subnational expenditures is at its average (17%), the probability that a firm will answer "strongly agree" is 0.14 when the number of bilateral investment treaties is at its minimum, and 0.41 when the number of bilateral investment treaties is at its maximum. When the level of subnational expenditures is at its highest (46%), the probability that a firm will answer "strongly agree" is 0.04 when bilateral investment treaties is at its minimum, and 0.05 when bilateral investment treaties is at its maximum – a barely perceptible change. As we can observe, the effect of BITs decreases and eventually disappears, as fiscal decentralization increases, confirming a interactive effect between the two.

Given these findings, it is unsurprising that bilateral investment treaties were mostly found to have a statistically insignificant effect across the different specifications, in columns 1 through 3. Though we can see from the previous results that bilateral investment treaties positively affect policy stability in unitary and centralized countries, this effect is counterbalanced by their lack of influence in federal and decentralized countries. On balance, when the interaction variables are not included, bilateral investment treaties seem to show an insignificant effect on policy stability.

Of the control variables, GDP per capita and Latin America & Caribbean had the most consistent effects across the different specifications. GDP per capita has a positive effect on the dependent variable, showing that economic development generally improves policy consistency. In the first specification, at the lowest level of development (GDP per capita $143), the predicted probability that a firm will answer "tend to agree" or "strongly agree" to the survey statement is only 0.13. At the average level of development (GDP per capita $4065), this probability increases to 0.43; and at the highest level of development (GDP per capita $8162), the probability is 0.60. This indicates that a country's ability to maintain a stable business environment is affected by its development level, which could be due to less corruption in more developed countries.

Meanwhile, firms operating in the Latin America and the Caribbean region report experiencing less policy consistency compared to firms in other regions. The predicted probability that a firm in Latin America and the Caribbean will "strongly disagree" with the survey statement is well over twice that of firms in other regions. Moreover, a firm in another region is almost three times as likely to answer "strongly agree" to the survey statement than a firm inside the region. This could be due to resurgent economic nationalism in the region, as well as persistently high corruption rates.

The effect of the senate's constituency is not statistically significant in all specifications, but the limited evidence seems to point to increased policy stability when the senators' constituencies are the states (provinces). This could suggest that when states have influence over national level policies, the preferences of the states will be closer to the enacted policies than when senators are elected on a national basis, which in turn leads to higher levels of policy predictability and stability.

Surprisingly, the firm-specific variables regarding size of employment and annual sales do not seem to have a significant effect. This could be an indication that standardizing these numbers by total country population and GDP (respectively) is too crude a measure in estimating their political impact, especially if we want to approximate their local influence. Unfortunately, local population or gross state product data are not comprehensively available across countries.

Robustness Check: FDI Flows as Dependent Variable

If firms in federal countries and decentralized countries are less likely to answer that the policy environment is consistent and predictable, will this be reflected in actual FDI flows to host countries? As Kessing, Konrad and Kotsogiannis (2009) observe, FDI is often an irreversible investment: "For many types of FDI, and particularly so (by definition) for the type of investment for which there is a hold-up problem, capital installed is immobile once the investment is made and cannot simply relocate" (p.106). The creation of factories and machinery, not to mention a trained workforce, is a demanding undertaking; once established, they are difficult transport across national boundaries. Thus the responsiveness of investment flows might not be as strong as surveys simply administered to company staff. Testing this empirically would illustrate the mobility and sensitivity levels of foreign direct investment.

To investigate this question, I constructed a panel dataset, with 177 developing countries, between the years 1997 and 2016. The dependent variable is annual foreign direct investment flows

	(1)	(2)	(3)	(4)
Federalism	-2.413**			
	(1.144)			
State (Province) Elections		-1.234**		
		(.665)		
Subnational Expenditures			-.168*	
			(.101)	
Administrative Tiers				-.139
				(.700)
Gross Domestic Product	.024***	.026***	.026***	.020***
	(.002)	(.003)	(.002)	(.001)
GDP Per Capita	.188**	.284**	.232*	.103
	(.093)	(.134)	(.134)	(.152)
Bilateral Investment Treaties	.002	.006	.043**	.075***
	(.011)	(.014)	(.021)	(.017)
Senate Constituency	-.372	-.893	-.695	-2.230**
	(.597)	(.690)	(1.026)	(.871)
Latin America & Caribbean	.474	.070	.826	.095
	(1.243)	(2.204)	(1.427)	(1.755)

Standard errors clustered by country are in parentheses. ***p<.01, **p<.05, *p<.1.

Table 4: Dependent Variable = Foreign Direct Investment Flows

into a country (in billions of current US $). The independent variables and control variables are identical to the previous analysis (save the omission of firm-level variables). I also add one additional control variable, gross domestic product (in billions of constant 2010 US $), as larger countries are more likely to receive higher amounts of FDI. Since the dependent variable is continuous, I estimate a generalized least squares model with the standard errors clustered by country.

The results are presented in Table 4. Federalism, political decentralization, and fiscal decentralization all have negative effects on foreign direct investment flows. Looking at the first column, we can see that when the other variables are constant, the FDI flows to a federal country will be $2.4 billion lower than a unitary country. State-level elections also have a similar effect: a country where both the state legislature and executive are elected will receive approximately $2.4 billion less in FDI flows compared to a country with no state-level elections. Subnational expenditures affect FDI flows negatively as well: a 1% increase in the share of subnational expenditures is associated with an approximately $168 million decrease in FDI flows. Meanwhile, the number of administrative tiers in a country does not seem to have a significant effect on FDI flows. These results are supportive of my earlier findings. Not only are firms more likely to report a stable policy environment in unitary and centralized countries, but they are more likely to choose these countries as destinations for their investment. This suggests that the "hold-up" problem of FDI does not entirely override the desirability of a stable policy environment.

Discussion and Conclusion

This study has examined the effect of federalism and decentralization on the environment for foreign direct investors. There were two central findings. First, federalism and decentralization contribute negatively to a foreign investor's perception of the consistency and predictability of the host country's rules and regulations. I argued that this is because national governments seek to prevent subnational governments from harming foreign investment in order to avoid international arbitration, but their ability to do so depends on the political structure of the country. The second finding is that bilateral investment treaties do not have a uniform effect on the host country's investment environment, and rather that their effects are conditioned on the distribution of power between the national and subnational governments. Specifically, bilateral investment treaties are more likely to positively influence policy stability in host countries with limited subnational autonomy.

Theoretically and empirically, I made a clear distinction between federalism and the three dimensions of decentralization. The literature has often used the various terms interchangeably, which has resulted in some confusion. For example, usage of the terms "federalism" and "decentralization" synonymously has been a common trend. In other instances, studies have used the number of administrative tiers in a country to measure its degree of political decentralization. I argue that this is an imprecise measure of political decentralization, and that a more accurate measure would involve the presence of local elections, as is done by Schneider (2003). Given the *negative* correlation between a country's number of administrative tiers and the presence of local elections, using the number of tiers to measure political decentralization seems likely to mislead. I also tested the effect of subnational participation in national policy-making (measured by the constituency of senators), which was the definition of "political federalism" used by Jensen (2006), and found that it had limited effect on policy consistency or FDI flows. All this suggests that a careful examination of these concepts is necessary to avoid ambiguous conclusions.

My findings leave open several other avenues for research. Studies such as Elkins, Guzman and Simmons (2006) have argued that the spread of bilateral investment treaties is driven by international competition for foreign direct investment among host countries, and that countries are more likely to sign these treaties when their competitors have done so. What is not altogether clear here is whether national governments are aware of the effects of federalism and decentralization when signing bilateral investment treaties. This is an interesting issue that speaks to a larger question regarding the assessment by national governments of their ability to abide by the terms of these treaties prior to signing.

Furthermore, if federal and decentralized countries have less stable policy environments, are they more likely to be taken to arbitration by foreign direct investors? National governments of federal and decentralized countries might compensate for their relative lack of authority by signing fewer investment treaties, in which case they will not necessarily be subject to higher numbers of arbitration suits. However, if the primary driver of signing treaties is international competition, it may be that national governments of federal and decentralized countries did not sufficiently take their risk factors into consideration, and that this will be reflected in the volume of arbitration. These are questions I will be addressing in my upcoming research.

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