Terrorism, Counterterrorism Aid, and Foreign Direct Investment[1]

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Foreign investors generally refrain from entering countries with high political risks. As an often seen type of political risk, terrorism may deter foreign investors by creating an unsafe investment environment. This paper explores whether terrorism reduces foreign direct investment (FDI) inflows and argues that foreign investors adjust their information by observing whether the host country has the capability to deal with terrorism. Foreign aid from the United States used specifically for counterterrorism is an effective signal of a recipient's counterterrorism potential. Using two commonly used terrorism data sets and drawing upon a time-series cross-sectional data analysis, this paper finds that while terrorism can be an obstacle to FDI inflows, countries that receive more counterterrorism aid are less vulnerable to this adverse effect. It also shows that conflict-tied aid mitigates the negative effect of terrorism on FDI because it sends a similar signal to foreign investors.

Since the 1960s, foreign direct investment (FDI) has played an increasingly crucial role in the global economy. Today, almost every country around the world is a recipient of FDI. FDI inflows are conducive to economic development in recipient countries. As a result, many developing countries carry out reforms, such as tax reductions, in order to attract inward capital. In the FDI literature, an important finding is that both the economic and political environment in the host country influences the investment decisions of multinational corporations (MNCs). In particular, the presence of violence is a direct threat to the MNCs' operations since security is usually one of their main concerns. Terrorism, as a common type of political violence, should also be unfavorable to MNCs, even though some scholars argue that the shock of terrorism on FDI or on the overall economy is relatively small or even trivial (Enders and Sandler 1996; Shapiro 2003).

Because terrorism is not a welcome phenomenon to either governments or MNCs, countries must consider how to prevent or reduce the adverse effect of terrorism on investment. In the literature, many scholars believe that large or rich countries are less susceptible to terrorism's negative effects on FDI due to their ability to diversify and to attract foreign investors. In this paper, I argue for another possibility: countries that signal a commitment to combat terrorism to foreign investors through receiving counterterrorism aid are more likely to resist the negative impact of terrorism on FDI. By focusing on how aid conditions the effect of terrorism, this paper also adds to the debate on the effectiveness of foreign aid

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in combating terrorism (Azam and Delacroix 2006; Azam and Thelen 2008, 2010; Savun and Hays 2011; Young and Findley 2011).

To examine the effect of terrorism on FDI, I use terrorism data from the ITERATE database and conduct a time-series cross-sectional (TSCS) data analysis. To further test if this effect is conditional on a country's counterterrorism ability, I utilize data on US counterterrorism aid as a measure of a country's counterterror potential. The results show that terrorist attacks in a country discourage FDI inflows. This negative effect of terrorism on FDI is mitigated by the level of US counterterrorism aid received, but not by general aid. These findings are robust to an alternative measure of FDI, alternative data on terrorism, a smaller sample, and an alternative proxy for counterterror efforts. Although the argument that aid can condition the effect of terrorism on FDI is not new, this paper contributes to the literature by showing that only aid that is tied to counterterrorism or conflict prevention has this mitigating effect.

The rest of this paper is organized as follows. In the first section, I review the literature on the debate of terrorism's impact on FDI and briefly discuss the effect of foreign aid on terrorism. The second section discusses how counterterrorism aid can alleviate the negative effect of terrorism on FDI. The section afterward introduces the research design and data. The findings are presented in the fourth section. The final section concludes.

Terrorism, Aid, and FDI

The FDI literature reaches a consensus that political risks play an important role in reducing the attractiveness of a host country (e.g., Alfaro, Kalemli-Ozcan, and Volosovych 2008; Jensen 2008).[2] There are several sources of political risks, including expropriation risks, transfer risks, and violence risks (Jensen and Young 2008). Among these different types of political risks, violence is the easiest to observe. For example, countries plagued with civil wars, such as Chad, Burundi, and Democratic Republic of the Congo, are ranked very low in the World Bank's evaluation on the ease of doing business.[3] Empirical studies also show that political violence, particularly interstate conflicts, civil wars, and demonstrations, have substantial negative effects on FDI inflows (Schneider and Frey 1985; Nigh 1986; Blomberg and Mody 2005; Asiedu 2006; Li 2006).

Terrorism is a common type of political violence, so theoretically it should carry a similar effect to other types of violence. The literature on the terrorism–FDI relationship, however, has contrasting arguments. While some scholars believe that terrorism is detrimental to FDI, others argue that the effect is trivial. According to those who find a negative effect of terrorism on FDI, there are a few mechanisms through which terrorism may hurt FDI. First and most straightforwardly, terrorists often directly attack foreign firms (specifically their employees or their physical assets), which may drive those firms out of the host country and deter other firms from entering this country. In January 2013, for example, armed terrorists attacked a natural gas facility located in Amenas, Algeria, which resulted in 39 foreign workers killed. Foreign oil companies, such as BP and Statoil, soon withdrew their staff from Algeria and did not return the expatriate staff even after one year. In a recent paper, Powers and Choi (2012) discover a negative effect of overall terrorism on FDI, but after singling out terrorist attacks in which the targets are businesses, the authors find that only business-related events are negatively associated with FDI.

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[2] Political risks refer to the chance that governmental actions interfere with business operations. More broadly, these risks suggest that political environments constrain firms from operating normally (Kobrin 1979).

[3] See http://www.doingbusiness.org/rankings.

Second, terrorism may cause large-scale divestment or scare away foreign investors by affecting the environment where foreign firms operate. Terrorists may destroy infrastructure or other human and physical capital critical to foreign firms' operations. Terrorist activities may also hurt other aspects of the macroeconomy, including growth (Blomberg, Hess, and Orphanides 2004), trade (Nitsch and Schumacher 2004), and stock markets (Chen and Siems 2004; Eldor and Melnick 2004), which undermines the overall economy and lowers the economic outlook in a country. In other words, terrorism can change foreign firms' investment preferences by influencing not only their security concerns, but also economic prospects.

A third and indirect mechanism discussed in the literature is that the prevalence of terrorist attacks heightens the demand on the government to exert more effort toward counterterrorism. Counterterrorism, however, may require that the government monitor or limit private financial transactions to cut off the financial sources of terrorism (Li 2006), which may impede foreign firms' operations. Frequent terrorist activities may also lead to increasing government spending on security issues and decreasing spending on investment (Blomberg, Hess, and Orphanides 2004). These counterterrorism measures or policy changes carried out by the government may impose more costs on foreign investors and thus are unpopular to them. This point is supported by the Pew Global Attitudes Projects survey on 275 influential leaders in 24 countries. The survey shows that elites tend to believe that FDI will be hurt rather than helped by the war on terror.[4]

Some scholars, however, implicitly argue that terrorism might not scare away FDI because its impact on the total economic activities is relatively minor. They point out that terrorism can only destroy a small portion of the economy, and terrorist activities usually prevail in certain areas rather than nationwide (see Enders and Sandler 1996; Becker and Rubinstein 2004; Blomberg, Hess, and Orphanides 2004). Further, unlike other types of violence, which generally harass poor or unstable countries, terrorism actually occurs more often in developed countries. These countries are endowed with some dominant advantages that are favorable to foreign firms, so their ability to attract FDI may barely be affected by terrorism. Since terrorism rarely causes large-scale damage and is much more unpredictable,[5] it may receive less attention from foreign investors than other types of violence.

Similarly, scholars have contrasting views on the effect of foreign aid on terrorism. While some studies indicate the effectiveness of foreign aid in reducing terrorist activities (Azam and Delacroix 2006; Azam and Thelen 2008, 2010), Bapat (2011) shows that military aid may instead prolong terrorist groups' survival because the recipient country has an incentive not to destroy terrorism in order to keep receiving aid. Savun and Hays (2011), alternatively, argue that the effect of aid on terrorism hinges on the actions of the recipient country and the capacity of the NGOs that deliver it. Young and Findley (2011) further disaggregate aid by sectors and find that aid spent on education, health, and conflict prevention and

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[4] This survey investigates how opinion leaders view the 9/11 attacks and the subsequent war on terror launched by the United States. The influential people interviewed include individuals from five areas—politics, media, business, culture, and government. All the interviews were conducted in November and December 2001. The results show that 38% of the elites in the United States see the war on terror as harmful to FDI, whereas 12% see it as helpful and that 48% of the non-US elites see the war on terror as harmful to FDI while 22% see it as helpful. The research methodology and survey results can be seen at http://pewglobal.org/2001/12/19/america-admired-yet-its-new-vulnerability-seen-as-good-thing-say-opinion-leaders/1/.

[5] This unpredictability comes from two sources. First, one of the terrorists' goals is to cause widespread fear beyond the immediate victims (Hoffman 2006, 40), so most of the time terrorists prepare and act in secret. Second, terrorism arises due to various reasons, such as political or economic injustice and religious inspiration. Thus, it is more difficult for the government to foretell and prevent terrorist events. Forward-looking foreign investors may expect an interstate or intrastate war and thus avoid entering a country (Li 2006), but they may hardly anticipate a terrorist event.

resolution is able to reduce terrorism. Although the empirical results for the effect of foreign aid on terrorism are inconclusive, this literature suggests that, in order to examine the true effect of aid, we may need to focus on aid that is specifically tied to a certain field. Therefore, this paper pays attention to counterterrorism aid and conflict-tied aid rather than general aid.

The Mitigating Effect of Counterterrorism Aid

While proponents and skeptics have different arguments regarding the effect of terrorism on FDI, I side with scholars who believe that terrorism hurts FDI because terrorism's impact is direct and can be easily perceived by foreign investors. In fact, many leading executives of international businesses point out that terrorism is a threat that may influence their investment decisions (Kearney 2004, 2005). Evidence supporting a negative effect of terrorism on FDI can also be found in the existing studies. Enders and Sandler (1996) show that terrorist campaigns have a sizable effect on FDI inflows in two small countries—Spain and Greece, but the effect is only temporary. Lutz and Lutz (2006) focus only on Latin American countries and find that terrorism reduces inward FDI. Abadie and Gardeazabal (2008) draw upon a terrorism risk data set and find that, even after other types of risks are controlled, terrorism risks have a negative impact on FDI positions over GDP. Bandyopadhyay, Sandler, and Younas (2013) show that both domestic and transnational terrorism depresses FDI and that foreign aid can mitigate this negative effect, especially for domestic terrorism.

Indeed, it may not be surprising that terrorism has a negative effect on FDI, but there exists disagreement regarding what kinds of countries are immune to this negative effect. Due to the points I discussed in the previous section, scholars tend to believe that large or wealthy countries are more resistant to the impact of terrorism.[6] For instance, Blomberg and Mody (2005) discover a negative effect of violence on FDI. However, when they limit the subjects to only the developed world, the effect of terrorism becomes very small or even positive. Instead, some studies focus only on developing countries, which are supposed to be more vulnerable to terrorism shocks, and find that terrorism depresses FDI inflows (Al-Omar and El-Sakka 2009; Bandyopadhyay, Sandler, and Younas 2010).[7] Contrarily, Enders, Sachsida, and Sandler (2006) show that terrorism deters FDI inflows from the United States only in OECD countries, indicating that terrorists may tend to target US firms abroad and thus damage US interests in countries where attacks are most cost-effective.

In this paper, I argue that the key to understanding why some FDI recipients are less susceptible to the adverse effect of terrorism does not necessarily lie in the economic conditions. Instead, the counterterrorism ability the host country displays can alter foreign investors' assessments of this country. Specifically, foreign investors are both backward-looking and forward-looking. Past terrorist activities lower foreign investors' intent to invest in a country, but foreign investors adjust their information by seeing if this country shows a commitment to counterterrorism. If foreign investors believe that a country is well prepared to fight terrorism, they may not divest or hesitate to invest in this country, even if terrorist attacks prevail.[8]

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[6] See the discussion in Sandler and Enders (2008) and Gaibulloev and Sandler (2009).

[7] Another viewpoint contends that politically developed countries rather than economically developed countries are more capable of withstanding terrorism's impact (e.g., Tavares 2004).

[8] A classical example is Israel. Israel is renowned for having a powerful army and its specialty such as the conscription of women, so it has built a reputation of fighting hard for its national interests and of its outstanding military performance. MNCs that care about terrorist threats may feel that the Israeli government's commitment to counterterrorism and to the maintenance of security is very reliable. Therefore, even though harassed by terrorist attacks, Israel is attractive to international investors because the investors are confident in the country's defense capacity (Glozer 2006).

The question that follows is what signals a host country's commitment to counterterrorism. An apparent and straightforward signal is the counterterrorism aid a country receives, which carries a signaling effect to market actors. I argue that regardless of whether counterterrorism aid is effective in reducing terrorism or not, it signals the recipient country's capability or intention to combat terrorists to foreign investors. Foreign investors may believe that countries receiving more counterterrorism aid have a higher potential to maintain a secure environment or have a closer tie with strong donor countries that are more capable of fighting terrorism. Counterterrorism aid can also be a signal that the donor country, which is normally an influential actor, has a huge stake in the recipient country and therefore will make an effort to protect its interests there. The United States, especially, is the largest counterterrorism aid provider as well as the largest FDI exporting country. US investors will be more confident in a host country when they know that this country has a counterterror alliance tie with their home government, even though terrorism prevails.

In Pakistan, religious militancy and terrorism created an unfavorable environment for foreign investors in the 1990s. According to the World Bank's World Development Indicator (WDI) and the International Terrorism: Attributes of Terrorist Events (ITERATE) database, in 1994, Pakistan ranked 50th in terms of the amount of FDI received and 19th in terms of the cumulative number of terrorist attacks. The US-led war on terror after the 9/11 attacks changed the US–Pakistan relationship in a dramatic fashion, making Pakistan an important ally and recipient of counterterrorism aid from the United States (Epstein and Kronstadt 2012). In 2005, Pakistan received 7.4 million dollars of counterterrorism aid from the US government. While this assistance does not prove to be very effective in destroying terrorism in Pakistan (Kronstadt 2007), it restores investor confidence to a certain degree. In 2006, Pakistan ranked 16th as a terrorism-plagued country, worse than it was in 1994, but its inward FDI had increased ten-fold (4.27 billion dollars in 2006 versus 4.2 million dollars in 1994), while the global FDI has increased only five-fold. Momani (2004), in analyzing whether the US government took credit for the IMF loans to Pakistan, argues that Pakistan represents a case in which "[t]he Bush administration wanted to send the message that assisting the US war on terrorism would have a positive effect on countries' negotiations with multilateral institutions and benefit their economic situations. Specifically, an IMF agreement signals an endorsement of a country's economic policies and potentially ushers in added private investments." This suggests that the cooperation between Pakistan and the United States in the war on terror seems to provide Pakistan economic benefits and helps bring investors back to the country. Even though counterterrorism aid may not have a direct effect on terrorism, it can condition the effect of terrorism on FDI inflows because of the signal it carries.[9]

The idea that counterterrorism aid signals a country's counterterror potential is in line with the existing literature on the effect of external information on FDI inflows. This literature finds that connections with foreign actors can play a signaling role to private investors and effectively change their perceptions toward a host country. Gray (2009), for instance, shows that accession to the EU signals to foreign investors that a country's policy reforms fulfill EU standards and diminishes investors' risk assessments of this country. Garriga and Phillips (2014) show that

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[9] In addition to Pakistan, a few other countries that are US allies in the war on terror or that are the recipients of US counterterrorism aid have received rapidly increasing FDI in recent years. For instance, Nigeria is an important US counterterrorism partner after the 9/11; Cambodia has received US assistance in counterterrorism and peacekeeping since 1997. Both countries' inward FDI has increased at least eight-fold in the past decade. Although this is not direct evidence of the signaling effect, it suggests that countries' counterterrorism efforts with a powerful foreign country may be followed by economic benefits.

aid provides an informational effect to investors and helps draw FDI in post-conflict countries. This signaling effect of aid (or foreign connections in general) comes more substantively from the credibility of the foreign actors that build a relationship with the host country than from the host country itself. The same logic explains the mitigating effect of counterterrorism aid. Counterterrorism aid signals the recipient country's cooperative or patronage relationship with a powerful donor country in the field of counterterrorism and therefore provides additional information to foreign investors and lessens their concern about terrorist threats.

While foreign aid tied to counterterrorism or conflict prevention signals to foreign investors the recipient country's commitment, general aid may not have an identical effect. Indeed, it is likely that general aid indicates an intimate relationship with the donor country, thus stimulating inward investment, especially investment from the same donor country.[10] The literature on the aid–FDI relationship, nevertheless, produces mixed results. Some evidence exists that aid leads to increasing FDI in recipient countries (Schneider and Frey 1985) or in countries where the regulatory burden is high (Harms and Lutz 2006). Aid can also alleviate the negative effect of expropriations in high-risk countries (Asiedu, Jin, and Nandwa 2009). Karakaplan, Neyapti, and Sayek (2005), however, discover a negative effect of aid on FDI.[11] Selaya and Sunesen (2012) argue that the inconclusive findings may be driven by the inappropriate aggregation of aid data, which prevents researchers from examining the true effect of aid.[12]

Similarly, I argue that only counterterrorism aid, not general aid, has a mitigating effect for the terrorism–FDI linkage. While some studies find that aggregate aid can lead to a reduction in terrorism directly or indirectly (Azam and Delacroix 2006; Cassidy 2010), this influence, if any, is hardly appreciated by foreign investors because they cannot infer from general aid that the recipient country is committed to spending aid on counterterrorism efforts. Only when foreign aid is specifically used in the counterterrorism field would foreign investors be less concerned about terrorist threats, not only because counterterrorism aid may impose conditions, but also because it signals the collaboration between the donor country and the recipient country in fighting terrorism.

As I discuss above, one of the mechanisms through which terrorism hurts FDI is that counterterrorism activities may impede business transactions and may thus be unfavorable to foreign investors. Does this conflict with the argument here that counterterrorism aid has a helpful signaling effect? I argue that it is compatible because counterterrorism aid and counterterrorism measures are not necessarily the same thing to foreign investors. Counterterrorism measures are government policies implemented domestically that may impose additional costs on business transactions, and foreign investors may not trust the government's counterterrorism ability if no powerful foreign actors offer their support. Counterterrorism aid, on the other hand, is provided by foreign powers that are more capable of fighting terrorists, and aid-giving signals the host county's close ties with the powerful donors and the donors' involvement in the war on terror. Although counterterrorism aid is usually in a relatively small amount and may not have a direct effect on FDI, it can lessen foreign investors' concerns and therefore has a mitigating effect.

In short, even if terrorism usually hurts only a small part of the country, it may alter foreign investors' entire risk assessment of this country. Counterterrorism

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[10] Kimura and Todo (2010) call the effect of foreign aid on FDI from the same country the "vanguard effect." They find that only Japanese aid has the vanguard effect, followed by increasing FDI from Japan. Maizels and Nissanke (1984) also argue that foreign aid is provided to serve donor countries' investment interests.

[11] This negative effect is mitigated by good governance.

[12] They disaggregate aid and find that its effect on FDI is contingent on aid type: Aid invested in infrastructures helps attract FDI, but aid invested in productive sectors crowds out FDI.

aid received by the host country, however, can reduce investors' concerns. Observing that counterterrorism aid flows to a country, foreign investors are more willing to believe that the government's commitment to combating terrorism is credible, even though the country suffered from frequent terrorist attacks. Thus, this paper's two hypotheses are:

> **Hypothesis 1**: *Countries that suffer from more terrorist attacks are less likely to attract FDI.*

> **Hypothesis 2**: *Counterterrorism aid, not general aid, can mitigate the negative effect of terrorism on FDI.*

This paper has a similar argument and approach to Bandyopadhyay et al. (2013), which is the first to examine whether foreign aid can reduce the negative effect of domestic terrorism on FDI in developing countries. While in a similar vein by looking for a conditional effect of terrorism on FDI, this paper has a significant difference. The empirical analysis in Bandyopadhyay et al. (2013) focuses on general aid alone and looks at both bilateral and multilateral aid. This paper, however, argues that only aid specifically used on counterterrorism can condition the effect of terrorism, and empirically examines the conditioning effect of both types of aid. In fact, the formal model developed by Bandyopadhyay et al. (2013) shows that only aid tied to terrorism fighting increases the recipient country's counterterrorism measure, but general aid decreases it. A growing literature also pays attention to disaggregated aid and finds that aid tied to different fields may carry different effects on the outcome of interest (Bapat 2011; Young and Findley 2011; Selaya and Sunesen 2012). When turning to the association between foreign aid and terrorism, we should focus on aid that is specifically tied to terrorism fighting or, more generally, aid that is tied to security issues such as conflict prevention and resolution, which is the main contribution of this paper. The next two sections present an empirical analysis of the joint effect of terrorism and counterterrorism aid on FDI.

Research Design and Data

To investigate the effect of terrorism on FDI, I conducted a TSCS data analysis. The dependent variable is net FDI inflows (in constant dollars) in a country in a given year, and the data are from the World Bank's WDI database. I log-transformed the data to remove skewness. For negative values, I took the logarithm of the absolute values and re-introduced the negative sign.[13] The unit of analysis is country-year. The sample includes only developing (non-OECD) countries because they follow a different pattern in terms of attracting FDI from developed countries (Blonigen and Wang 2005; Powers and Choi 2012). A total of 114 countries are included in the analysis, and a list of those countries is shown in the supplementary appendix.

The key independent variable, *terrorism*, is the number of terrorist attacks that occurred in one country-year. I used data from the ITERATE data set, which contains only transnational terrorist events and is continuously updated.

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[13] In the FDI literature, at least four measures of FDI are used: the amount of FDI as a percentage of GDP (e.g., Jensen 2003; Blanton and Blanton 2007), the natural logarithm of FDI (e.g., Enders et al. 2006; Li 2006; Allee and Peinhardt 2011), net FDI inflows (e.g., Schneider and Frey 1985; Li and Resnick 2003), and FDI per capita (logged) (Busse and Hefeker 2007). They all make sense as long as the measurement corresponds to the concepts researchers want to capture. I used logged FDI because the goal is to know directly how terrorism affects foreign investors' decisions to enter this country and the subsequent amount they invest. Negative values are retained because they help us understand how terrorism may chase away FDI, but the results remain unchanged if negative values are coded as zeros.

I log-transformed this variable to remove positive skewness, but noted that the result remains unchanged without a log transformation. The potential problem of using the *number* of terrorist events is that it does not capture the differing magnitudes of terrorist incidents and does not address the issue of underreporting incidents (Frey, Luechinger, and Stutzer 2007). However, it is still preferred to other measures, such as casualties, because the latter may carry other information.

To test the argument that foreign investors adjust their risk assessment of the recipient country according to how much counterterrorism aid flows to this country, I used another key independent variable, *counterterrorism aid,* which is the logged amount of US counterterrorism aid a country received in a given year. To see whether the effect of terrorism on FDI is conditional on counterterror efforts, I included a multiplicative interaction term between *counterterrorism aid* and *terrorism.* If this variable is statistically significant, it means that terrorism and counterterrorism aid interactively determine the FDI inflows a country receives. The data on the US counterterrorism aid are taken from the US Overseas Loans and Grants, Obligations and Loan Authorizations Greenbook. I used the data labeled as "Nonproliferation, Anti-Terrorism, Demining, and Related" for this measure.[14] Granted, using this measure may not fully capture the sole effect of counterterrorism aid, because the data contain at least two other types of aid. This measure, however, excludes humanitarian aid and is therefore the closest measure on counterterrorism aid. In addition, it is used by other scholars as a proxy for counterterrorism efforts (Bapat 2011). It is more generic than counterterrorism aid, but if this variable is interpreted as "military aid" or "conflict-tied aid," we still have good reason to believe that it has a similar signaling effect to foreign investors.

The Greenbook provides data on counterterrorism aid beginning in 1986 in constant 2010 US dollars, so the time period under investigation is from 1987 to 2007.[15] I coded all the observations without data available as zeros because the Greenbook indicates that missingness means no aid was given to that country-year. In the sample, there are 97 countries that received US counterterrorism aid. Figure 1 presents the top 15 recipient countries, all of which had received a total of more than 15 million dollars.

In addition to counterterrorism aid, I examined whether general aid has a similar signaling effect to foreign investors. The data on general aid are from the WDI database. I used the net official aid from the United States, not only to be consistent with the counterterrorism aid that is solely from the United States, but also because other donor countries, especially Nordic countries, provide aid out of humanitarian concerns (Alesina and Dollar 2000), which may have nothing to do with the counterterrorism ability. I expected that only counterterrorism aid, not general aid, can curtail the adverse effect of terrorism on FDI.

Control Variables

I included several control variables. *Market size* is measured by the logged value of GDP. A larger market is supposed to attract more FDI. *Economic development* is measured by GDP per capita. Countries with a higher level of economic development often provide a more friendly and similar environment to foreign investors. In reality, most FDI flows horizontally among developed countries (Markusen 1995). *Economic growth* is expected to have a positive effect on FDI, as well, because high

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[14] Data are available at http://gbk.eads.usaidallnet.gov/.

[15] Almost all of the country-level data start in 1997, and the results remain unchanged when the time period under investigation is changed to 1998–2004.
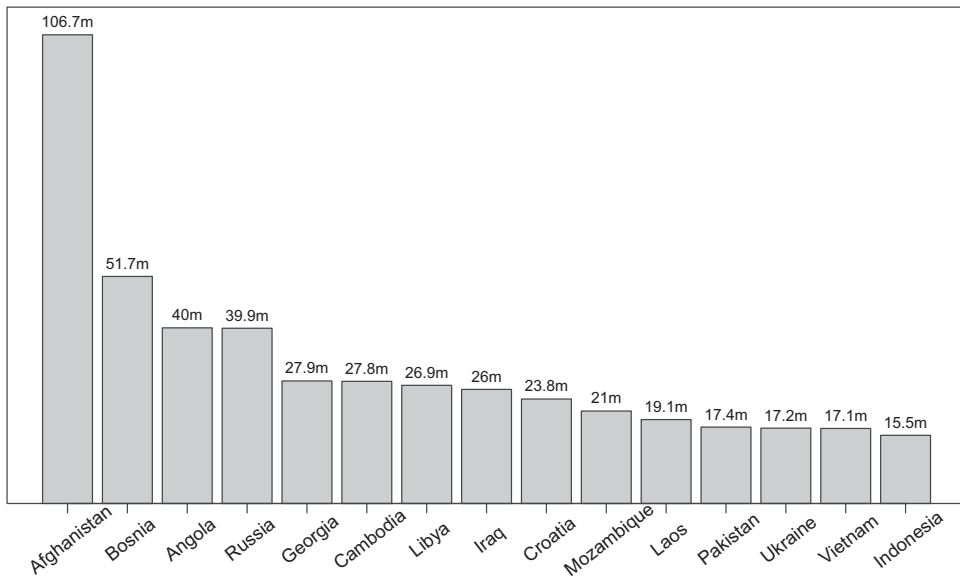
Fig 1. The Top 15 Recipients of US Counterterrorism Aid (1986–2006)

growth rates signal the potential of the economic development in host countries (Schneider and Frey 1985). *Trade* is the total amount of imports plus exports as a percentage of GDP. An open economy may be more receptive to FDI. *Exchange rate volatility* is the absolute deviation from the mean of the official exchange rate (that is, the local currency per US dollar) divided by the standard deviation. Larger volatility values represent more unstable exchange rates. The instability of exchange rates inhibits FDI by generating uncertainty about the expected profits firms can attain (Li and Resnick 2003). *World FDI inflows* represent the total amount of FDI (in billion dollars) in a given year. This variable is important since FDI inflows in one country are related to the total supply of FDI in the world. All of the data for these economic variables are from the WDI database.

Moreover, political factors may play a significant role in affecting FDI, as well. Specifically, democratic countries are found to be more attractive to MNCs because audience costs and a large number of veto players lead the executive to credibly commit to respect contracts (Jensen 2003, 2008), and because the protection of property rights makes democracies a favorable environment with low risks of expropriation (Li and Resnick 2003). I thus included *democracy* in the model specification. The data are from the Polity IV project (Marshall and Jaggers 2007), and the indices range from −10 to 10 with 10 as the highest level of democracy. *Regime durability* is another variable that may influence the uncertainty of the political environment. It is measured by the number of years since the last regime change. These data are also from Polity IV.

While this paper focuses on one specific type of political violence—terrorism, other types of political violence may have a similar deterrent effect on FDI. I thus included the variable *internal wars*, which is the total number of internal armed conflicts in a country-year. The data are from the UCDP/PRIO Armed Conflict Dataset (Gleditsch et al. 2002; Themnér and Wallensteen 2012). I also controlled for *oil production* (in thousand barrels) because oil abundance may affect both the inflows of investment and inflows of foreign aid. The data are from the US Energy Information Administration.[16] Further, one may argue that US

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[16] Available at http://www.eia.gov/cfapps/ipdbproject/IEDIndex3.cfm?tid=5&pid=53&aid=1.

counterterrorism aid is simply a proxy for US allies, so I included a dummy variable *US ally* to indicate countries that have alliance ties with the United States. The data are from the Alliance Treaty Obligations and Provisions data set (Leeds et al. 2002). The number of *economic sanctions* is also controlled for because a country may suffer from reduced FDI before the imposition of sanctions (Biglaiser and Lektzian 2011).[17] I used data on economic sanctions from Hufbauer et al. (2007). Finally, I controlled for *population* (in million people) because MNCs tend to enter developing countries to seek cheap labor (Dunning 1981).[18]

Statistical Model

The dependent variable is a continuous measure of FDI inflows, and thus, I used an ordinary least squares (OLS) regression with country fixed-effects.[19] The inclusion of country fixed-effects helps control for country heterogeneity and avoids omitted-variable bias. It also makes this model a within estimator, which allows us to examine how terrorist activities and counterterrorism aid interact to affect FDI inflows within countries. I estimated both classical and robust standard errors, and the results are not significantly different from each other. As King and Roberts (2013) argue, if the model is appropriately specified, both classical and robust standard errors will be approximately the same. So I believe that the model specification is correct and report only the classical standard errors. To avoid the simultaneity bias or the inverse relations, all the covariates are lagged one year behind the dependent variable.[20]

Findings

The results of the empirical analyses are presented in Table 1. In Model 1, I included all the control variables and *terrorism*. As can be seen, the effect of terrorism on FDI is negative and statistically significant at the 95% level, suggesting that terrorist activities have an adverse effect on FDI inflows, even after important determinants of FDI are controlled. Other things being equal, a 10% increase in terrorist attacks in the previous year is expected to reduce net FDI inflows by 8.8%.[21] This result supports the first hypothesis.

In the second column of Table 1, *US counterterrorism aid* enters the model. As can be seen, the addition of *US counterterrorism aid* does not substantially increase the model fit, as shown by the R-squared, and the effect of US counterterrorism aid on FDI is not statistically significant either. This suggests that counterterrorism aid does not have an individual effect on foreign investors' perception of a country. At first glance, this finding may seem odd because counterterrorism aid should serve as a positive signal to foreign investors and increase FDI. This result,

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[17] In the Pakistan example, one of the reasons underlying restored foreign investor confidence is the fact that the sanctions imposed on Pakistan related to nuclear issues were waived. Thanks to an anonymous reviewer for pointing out the importance of this variable.

[18] A problem is that population may be highly correlated with market size in the developing world. However, the results remain unchanged if this variable is dropped. The results also hold if other variables that have potential collinearity problems, such as *economic development* and *democracy*, are dropped. See the supplementary appendix for these results.

[19] The result of the Hausman test rejects the hypothesis that a random-effects model is consistent with the fixed-effects model.

[20] While some scholars in the FDI literature suggest including lagged FDI to deal with the autocorrelation problem (Aisbett 2007; Powers and Choi 2012), most of the FDI studies do not include a lagged dependent variable (e.g., Li and Resnick 2003; Büthe and Milner 2008; Allee and Peinhardt 2011). I followed this literature by excluding the lagged dependent variable. The results, however, are substantially similar when lagged FDI is included in the model, which are presented in the supplementary appendix.

[21] $-0.925 \times \log(1.1) = -0.088$.

Table 1. Effects of Terrorist Activities and Aid on FDI (from 1987 to 2006)

	Model 1	Model 2	Model 3	Model 4	Model 5
Terrorism	−0.925 (0.374)**	−0.920 (0.374)**	−1.070 (0.378)***	−0.947 (0.375)**	−0.930 (0.483)*
US counterterrorism aid		0.024 (0.052)	−0.011 (0.054)		
U.S. general aid			0.243 (0.094)***	0.008 (0.027)	0.008 (0.029)
Terrorism × Aid					−0.001 (0.025)
Market size	−3.342 (0.850)***	−3.369 (0.852)***	−3.400 (0.851)***	−3.911 (0.878)***	−3.910 (0.879)***
Development	0.059 (0.022)***	0.059 (0.022)***	0.060 (0.022)***	0.066 (0.025)***	0.066 (0.025)***
Economic growth	0.062 (0.034)*	0.061 (0.035)*	0.063 (0.034)*	0.068 (0.034)**	0.068 (0.034)**
Trade	−0.007 (0.013)	−0.007 (0.013)	−0.008 (0.013)	−0.009 (0.013)	−0.009 (0.013)
Exchange rate volatility	0.283 (0.344)	0.281 (0.344)	0.285 (0.343)	0.276 (0.344)	0.277 (0.344)
Democracy	0.276 (0.069)***	0.275 (0.069)***	0.280 (0.069)***	0.339 (0.072)***	0.339 (0.072)***
Regime durability	−0.020 (0.028)	−0.020 (0.028)	−0.019 (0.028)	0.036 (0.032)	0.036 (0.032)
Population	0.026 (0.015)*	0.026 (0.015)*	0.025 (0.015)*	0.021 (0.015)	0.021 (0.015)
Internal wars	−1.246 (0.591)**	−1.244 (0.596)**	−1.281 (0.596)**	−0.714 (0.610)	−0.711 (0.612)
Oil production	0.002 (0.001)**	0.002 (0.001)**	0.002 (0.001)**	0.002 (0.001)**	0.002 (0.001)**
US ally	1.158 (0.923)	1.209 (0.930)	1.129 (0.929)	1.245 (0.930)	1.246 (0.931)
Economic sanctions	0.298 (0.666)	0.320 (0.667)	0.328 (0.666)	0.581 (0.676)	0.581 (0.676)
World FDI inflows	0.002 (0.001)***	0.002 (0.001)***	0.002 (0.001)***	0.002 (0.001)***	0.002 (0.001)***
Number of observations	1,994	1,994	1,994	1,970	1,970
Number of countries	114	114	114	114	114
R-squared	0.2851	0.2852	0.2878	0.2862	0.2862
F-test		$p = .0099$		$p = .9551$	

(*Notes.* Standard errors are in parentheses. *$p < .1$; **$p < .05$; and ***$p < .01$.)

however, actually makes sense because counterterrorism aid itself, usually in relatively small amounts, is hardly able to increase a country's attractiveness to foreign investors. It only helps to mitigate foreign investors' security concern when this country is prone to terrorism, so it only has a conditioning effect, rather than an independent effect, on FDI.

In Model 3, I thus include the interaction between *US counterterrorism aid* and *terrorism*. As it shows, the coefficient of *terrorism* remains negative and statistically significant, and the coefficient of *US counterterrorism aid* is still statistically insignificant. The interaction term, moreover, is positive and achieves statistical significance at the 99% level. An *F*-test comparing Models 2 and 3 also indicates that these two models are significantly different from each other. This, on the one hand, means that the amount of FDI a country receives is affected by the interaction between terrorism and US counterterrorism aid. On the other hand, we can interpret the result as a conditional effect of terrorism on FDI (that is, conditional on counterterrorism aid). As the level of counterterrorism aid given to a country increases, the negative effect of terrorism on FDI decreases, supporting the second hypothesis.

Based on Model 3, I calculated the substantively meaningful marginal effects for terrorism and the standard errors (Brambor, Clark, and Golder 2006) and graphically presented the conditional effects of terrorism and the 95% confidence intervals in Figure 2. The rugs (that is, the hash marks on the *X*-axis) display the real data points of counterterrorism aid. Note that 85% of the observations have a value of zero. As can be seen, the effect of terrorism on FDI is negative and statistically significant when a country receives no counterterrorism aid, but is statistically insignificant when the level of counterterrorism aid is greater than zero. This suggests that the effect of terrorism on FDI is not constant; it is conditional on whether the host country receives counterterrorism aid. This also supports the argument that counterterrorism aid functions primarily as a signal, so that foreign investors care less about the terrorist threat as long as the host country is a counterterrorism aid recipient.
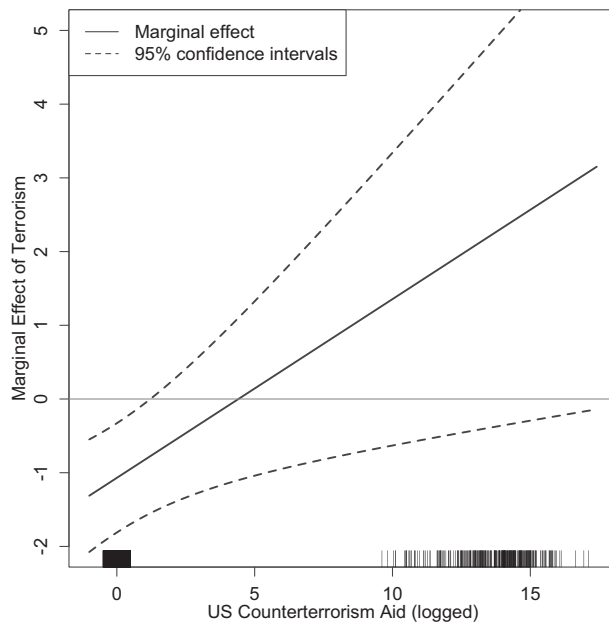

Fig 2. Marginal Effects of Terrorism on FDI Conditional on US Counterterrorism Aid and the 95% Confidence Intervals. The Rugs Show the Real Data Points
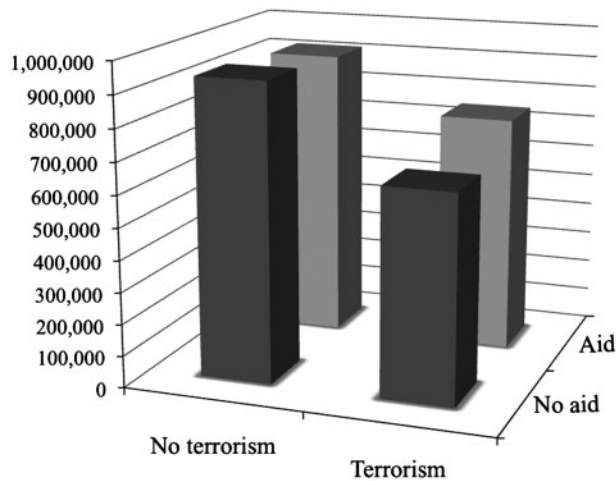
Fig 3. Predicted Amounts of Inward FDI by Whether Terrorism Appears and Whether Counterterrorism Aid Is Given

In Model 4 and Model 5, I replaced *US counterterrorism aid* with *US general aid.* As the results of both models show, general aid does not have a statistically significant effect on FDI inflows, and neither does its interaction with terrorism. The result of an *F*-test comparing Models 4 and 5 fails to reject the hypothesis that Model 4 and Model 5 are equal. In other words, adding the interaction term between general aid and terrorism does not improve the model fit. We need to single out aid that is specifically used on counterterror efforts to better understand the conditional effect of terrorism on FDI.

To illustrate the interactive effect between terrorism and counterterrorism aid, Figure 3 graphically presents the predicted amounts of inward FDI in four cases: a country immune to terrorism and receiving no aid (e.g., Taiwan in 2000), a country suffering from terrorism and receiving no aid (e.g., Syria in 1997), a country immune to terrorism and receiving aid (e.g., Madagascar in 2006), and a country suffering from terrorism and receiving aid (e.g., Georgia in 2001).[22] As can be seen, a country is predicted to receive the most FDI when there is no terrorist attack occurring or no aid given. A country that is immune to terrorist attacks and receives counterterrorism aid attracts a slightly lower amount of FDI, but the difference is statistically insignificant. Countries experiencing terrorist attacks receive substantially less FDI, as indicated by the two bars on the right. However, if a terrorism-plagued country receives counterterrorism aid, the amount of FDI inflows will be higher, suggesting that counterterrorism aid helps to bring back FDI when terrorism prevails.

In addition to the main findings, Table 1 shows that economic factors play a critical role in affecting FDI. Larger markets are less likely to attract FDI. This finding also appears in Büthe and Milner (2008). More developed countries, indicated by a higher level of GDP per capita, are more likely to receive inward FDI. Fast growing countries and countries with a larger population size receive more FDI. Democracies are better equipped to attract FDI, consistent with the findings in Jensen (2003). Like terrorism, internal conflicts have a depressing effect on FDI. Oil production has a positive effect on FDI, indicating the attractiveness of

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[22] I used the result of Model 3 to calculate the prediction. I set all the variables at the mean values and used the average values of the *terrorism* and *counterterrorism aid* variables for countries suffering from terrorism and/or receiving aid.

oil producing countries. Finally, global FDI has a substantial, positive effect on inward FDI, because every host country can expect more investment when the capital flowing in the global economy is larger.

Robustness Analysis

To verify the robustness of the results, I conducted a few additional tests. First, I used FDI as a percentage of GDP as the dependent variable. Although FDI/GDP represents a country's openness to or dependence on FDI rather than the real amount of FDI (Li 2009), it is a common measure in the FDI literature and is also used in Bandyopadhyay et al. (2013). I thus used this measure to check whether the findings are robust to an alternative dependent variable.

Second, I used conflict-tied aid as a proxy for counterterrorism efforts. As previously discussed, conflict-tied aid signals a country's intimate relationship with the donor country in terms of security building, so it is expected to reduce foreign investors' concern about terrorism, much like counterterrorism aid. Following Young and Findley (2011), I drew upon data from *AidData* (Tierney et al. 2011), and group aid whose purposes are related to conflicts, including security system management and reform, conflict prevention and resolution, land mine clearance, and reintegration and small arms and light weapons control. While this variable is more inclusive than the counterterrorism aid variable, it should have a similar signaling effect to foreign investors. This variable also includes aid not only from the United States, but also from other donor countries, which may be more relevant to the empirical analysis where the dependent variable represents FDI from all countries.

Third, I used terrorism data from an alternative source—the Global Terrorism Database (GTD), which is produced by the National Consortium for the Study of Terrorism and Responses to Terrorism and contains both transnational and domestic terrorist events.[23] I did not expect a separating effect of domestic terrorism from transnational terrorism. If the effect of counterterrorism aid is to signal the government's capability and commitment to fight terrorism, there should be no difference whether the government deals with domestic or transnational terrorism. Based on this understanding, I used pooled GTD data without disaggregating them.

Finally, one may argue that the relationship between aid and terrorism is endogenous because aid allocation may be a function of terrorist activities.[24] An endogeneity bias is not a problem here because both aid and terrorism are independent variables rather than the dependent variable.[25] It may be problematic if little variation exists in the interaction term between terrorism and counterterrorism aid, because the intuition suspects that only terrorism-plagued countries receive counterterrorism aid. While the data do not present a strong association between terrorism and counterterrorism aid,[26] I restricted the sample to only country-years in which counterterrorism aid was given. This way we can better capture the variations of counterterrorism aid within recipient countries. If countries harassed by terrorism coincide with countries that receive counterterrorism aid,

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[23] Available at http://www.start.umd.edu/gtd.

[24] This problem is well discussed and dealt within the literature on the aid–terrorism relationship (Azam and Delacroix 2006; Young and Findley 2011).

[25] In addition to aid and terrorism, there may be another source of potential endogeneity: the relationship between FDI and terrorism. Terrorists may choose to attack a country because of the presence of MNCs, and empirical evidence also shows that FDI attracts terrorists (Li and Schaub 2004). If this causal relationship exists, however, it implies a positive association between terrorism and FDI. My analysis, instead, indicates a negative one. So, if the endogeneity bias is present in the way that FDI is able to trigger terrorism, it only biases against my result.

[26] The correlation between the number of terrorist attacks and the amount of US counterterrorism aid is only 0.079.

we will not see a statistically significant coefficient for the interaction term because the terrorism variable will account for all the variation.

The results of the robustness analyses are reported in Table 2. Model 1 has FDI/GDP as the dependent variable, which, as previously discussed, has a different meaning from the net FDI inflows. The result, however, does not substantially deviate from the previous results. The effect of terrorism is negative but statistically insignificant, and the effect of US counterterrorism aid turns positive and statistically significant. Their interactive term, more importantly, remains to have a positive and statistically significant effect on FDI/GDP. This suggests that terrorism and counterterrorism aid jointly affect FDI.

Model 2 presents results when conflict-tied aid is used. The time period under investigation is from 1990 to 2007.[27] As the results indicate, terrorism is negatively associated with FDI, and this effect is conditional on conflict-tied aid. The positive and statistically significant interaction term between terrorism and conflict-tied aid suggests that conflict-tied aid has a mitigating effect for terrorism. As the level of conflict-tied aid a country receives increases, the adverse effect of terrorism on FDI decreases.

In Model 3 and Model 4 I used the GTD terrorism data instead. As can be seen in Model 3, terrorism, measured by the GTD data, has a negative and statistically significant effect on FDI. The interaction term between US counterterrorism aid and terrorism is positive and statistically significant, consistent with the findings in Table 1. Model 4 replaces US counterterrorism aid with conflict-tied aid, and the results are basically the same. While terrorist activities discourage inward FDI, US counterterrorism aid or conflict-tied aid can alleviate this unfavorable effect. These results provide strong support for my argument and indicate the robustness of the previous findings. It also suggests that aid tied to conflict prevention and resolution carries a similar signal to foreign investors.

In Model 5, I used a smaller sample, which includes only countries that received US counterterrorism aid. As its results show, terrorism has a negative effect on FDI within the recipient countries, but the effect is weaker if a country receives a higher level of counterterrorism aid indicated by the positive and statistically significant interaction term. This finding verifies the robustness of the previous results and indicates that they are not driven by the lack of variation within the interaction term. It also shows that it is not only *whether* a country receives aid that matters, but also *how much* counterterrorism aid is given that makes a difference.[28]

Conclusion

Foreign direct investment is suggested to benefit the recipient countries' domestic economy, and numerous studies have thus emerged to explore the determinants of FDI inflows. While many country-specific characteristics may affect FDI in an indirect way, violence can be a direct threat to MNCs. As a common type of political violence, terrorism should have a negative effect on FDI, as well. While foreign investors hesitate to enter terrorism-plagued countries, they may adjust their perception of these countries when host governments exhibit a stronger intention or capability to fight terrorists. Counterterrorism aid from the United States is an effective measure of the intention to fight terrorism, not only because it is directly

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[27] The *AidData* provides aid activities from the 1940s, but the conflict-tied aid data disaggregated from the *AidData* only have three data points before 1990, so I only use data beginning in 1990.

[28] I also conduct a few additional analyses, including dropping variables that may have potential collinearity problems, separating democratic countries and nondemocratic countries, using a dichotomous measure of counterterrorism aid, and including a lagged dependent variable. All the results are presented in the supplementary appendix.

Table 2. Effects of Terrorist Activities and Aid on FDI: Robustness Analysis

	Model 1	Model 2	Model 3	Model 4	Model 5
			(GTD database)		
	(FDI/GDP)	(ITERATE)			(Sub-sample)
Terrorism	−0.213 (0.241)	−1.398 (0.443)***	−0.482 (0.208)**	−0.558 (0.221)**	−29.605 (16.136)*
US counterterrorism aid	0.081 (0.034)**	−0.004 (0.041)	0.027 (0.057)		0.510 (0.568)
Conflict-tied aid				−0.025 (0.045)	
Terrorism × Aid	0.122 (0.060)**	0.083 (0.048)*	0.054 (0.029)*	0.040 (0.021)*	2.047 (1.156)*
Market size	−1.369 (0.543)***	−3.812 (0.941)***	−3.702 (0.937)***	−3.614 (0.940)***	−15.524 (3.934)***
Development	0.045 (0.014)***	0.068 (0.024)***	0.074 (0.024)***	0.073 (0.024)***	0.173 (0.078)**
Economic growth	0.122 (0.022)***	0.058 (0.034)*	0.054 (0.034)	0.056 (0.034)	−0.500 (0.151)***
Trade	0.022 (0.008)**	−0.022 (0.014)	−0.023 (0.014)	−0.021 (0.014)	0.026 (0.042)
Exchange rate volatility	0.311 (0.219)	0.323 (0.345)	0.334 (0.339)	0.315 (0.346)	0.292 (1.211)
Democracy	0.141 (0.044)***	0.269 (0.076)***	0.267 (0.076)***	0.269 (0.077)***	0.254 (0.397)
Regime durability	0.002 (0.018)	−0.023 (0.032)	−0.021 (0.032)	−0.016 (0.032)	0.143 (0.171)
Population	0.002 (0.010)	0.032 (0.019)*	0.032 (0.019)*	0.029 (0.019)	−0.049 (0.490)
Internal wars	0.042 (0.380)	−0.594 (0.652)	−0.516 (0.669)	−0.580 (0.671)	−1.828 (1.902)
Oil production	−0.001 (0.001)	−0.001 (0.001)	−0.001 (0.001)	−0.001 (0.001)	−0.010 (0.004)*
US ally	−0.968 (0.592)	0.701 (0.909)	0.900 (0.914)	0.750 (0.911)	−3.491 (2.373)
Economic sanctions	0.245 (0.425)	0.849 (0.678)	0.932 (0.681)	0.894 (0.680)	3.883 (2.383)
World FDI inflows	0.001 (0.000)***	0.002 (0.000)***	0.002 (0.001)***	0.002 (0.001)***	0.002 (0.001)***
Number of observations	1,994	1,752	1,752	1,752	288
Number of countries	114	114	114	114	83
R-squared	0.3678	0.2902	0.2897	0.2890	0.5590

(*Notes.* Standard errors are in parentheses. *$p < .1$; **$p < .05$; and ***$p < .01$.)

spent on counterterrorism measures, but also because it signals a close tie between the recipient country and the United States in the war on terror. This paper argues that US counterterrorism aid can alleviate the negative effect of terrorism on FDI.

I performed a TSCS data analysis on 114 developing countries, and the empirical results supported my arguments. Terrorism has a negative effect on FDI inflows, and this negative effect is mitigated by the amount of US counterterrorism aid given to a country. This result is robust to an alternative dependent variable, the usage of two commonly used terrorism data sources—the ITERATE database and the GTD database—and an alternative measure of conflict-tied aid.

This paper contributes to the literature on FDI, terrorism, and foreign aid. While some studies suspect that the influence of terrorism on the economy is relatively weak, the findings in this paper indicate an adverse effect of terrorism on FDI. While the empirical findings on the effectiveness of foreign aid are often mixed, this paper suggests that using pooled aid data may ignore important information. To better understand aid's impact, we should focus on disaggregated aid that is tied to a certain field. In the case of terrorism fighting, only counterterrorism aid or conflict-tied aid sends a signal to foreign investors and reduces their concern on the threat of terrorism.

The findings in this paper also provide important implications for both FDI recipients and aid donors. For governments that seek foreign capital, indeed, terrorist incidents may crowd out foreign investment and scare MNCs away, but a commitment to the maintenance of a secure environment for foreign investors may mitigate their security concern. When foreign investors receive the signal that a potential host country displays a strong will and capacity to battle terrorism, particularly in terms of receiving counterterrorism aid, their confidence in this country will increase making them more likely to bring in capital. For aid donors, while the effectiveness of aid in fighting terrorism is unclear, counterterrorism aid can at least bring substantial economic benefits to the recipient countries. In turn, powerful countries should continue to consider aid provisions a foreign policy tool they can employ to help improve the economies of developing countries they have an interest in allying with.

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Supporting Information

Additional Supporting Information may be found in the online version of thisarticle:

Appendix S1. Terrorism, Counterterrorism Aid, and Foreign Direct Investment.
Appendix A. List of countries that are included in the analysis.
Appendix B. Descriptive Statistics.
Appendix C. Additional Robustness analyses.
Table S1. Effects of Terrorist Activities and Aid on FDI: Additional Analyses.