Separate and Unequal:
Bilateral Investment Treaties and Property Rights in Developing Countries

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I. Introduction

The institutional environment has come to be seen by many in the field of development as the key to long-run economic growth. Good governance and the myriad institutions that define it will lead to lower corruption, greater rule of law, better education, and ultimately, economic development. Nowhere is the link between institutions and economic development more closely related than within the institutional environment for investment. Property rights—or the institutions that establish and enforce property rights—are vital for long-term economic growth. Investors, from small local businesspeople selling products in their local marketplace to large multinational corporations, will not fully commit their resources if they do not trust in the institutions that safeguard their property.

For foreign investors looking to enter countries with weak property rights environments and developing countries hoping to attract FDI, Bilateral Investment Treaties (BITs) ostensibly offer the perfect solution to weak property rights enforcement. BITs cover expropriation of property as well as indirect takings that are tantamount to expropriation, providing a secure legal environment for foreign investors. In effect, BITs create a separate—and superior—property rights environment for foreign investors that is not extended to host country investors. A number of studies have analyzed the potential for BITs to bring increased FDI to developing countries and come to differing conclusions. But FDI is meant to be a by-product of BITs. The main goal of these treaties is to protect the property rights of foreign investors in a host country—that is, the developing country that hosts the potential FDI—where extant property rights are unstable. An un-answered question, therefore, is the potential of the treaties to impact the

property rights environment in the host country more generally. That is what I address in this manuscript.

At first glance, it would seem that the increased FDI flows that BITs promise could be enough to overcome the potential for any negative side effects of the treaties. Further, if governments distinguish that foreign investors are more likely to invest in this more secure property rights environment, they may wish to extend the same privileges to their own investors, giving BITs a further positive impact—better property rights for all investors.

The flip side of this argument is rooted in an understanding of the determinants of property rights enforcement in developing countries. If, as I argue, property rights enforcement is determined through the distribution of power among interest groups, then creating a separate environment for foreign investors through BITs may have negative consequences for overall property rights enforcement in a country. Through BITs, foreign investors become insulated from the general property rights environment in a country. This insulation diminishes the incentives for foreign investors—strong proponents of greater property rights enforcement—to lobby for greater overall property rights enforcement, thereby reducing the incentives for political actors to enforce property rights for all investors. Without foreign investors motivating overall property rights reform, property rights enforcement for all investors is likely to stagnate or even decline. In the short run, BITs may be beneficial through their ability to attract greater FDI flows.[1] However, if the result is also a weaker long run property rights environment, there may be a tradeoff between short-run capital inflows and long-run economic growth.

[1] Though this point is hotly debated. See for example Tobin and Rose-Ackerman 2005,2007 and Neumayer and Spess 2005.

The paper proceeds as follows. Section II lays out the theoretical argument and plots the interactions between political actors and the decisions of interest groups to make political investments. Section III discusses the research design. Section IV concludes and discusses policy implications.

II. Argument

A. Property Rights Enforcement

Strong, well-enforced property rights environments enable individuals and firms to exchange and invest their resources, thereby increasing the overall rate of economic growth (1990, 1989). If better property rights lead to greater flows of investment, and countries seek investment for growth, then why do low- and middle-income countries not simply replicate the strong property rights systems of western capitalist societies? The simple answer is that they do. In many developing countries, property rights law precisely mirrors that of western countries. But most developing countries do not have the formal mechanisms in place to adequately enforce their property rights laws. Extant political economic theory on the emergence of good property rights environments focuses on institutional arguments. One set of arguments holds that separation of powers, or veto players with authority over policy change, are necessary and vital to a government's ability to make credible commitments to enforcing property rights (North and Weingast 1989). A divergent strand of the institutional literature claims just the opposite. That is, rather than separation of powers, only autocratic governments, insulated from opposition to reform, can credibly commit to property rights enforcement.

Empirically, we see examples of both of these arguments. Autocratic governments such as Chile and Singapore were able to bring about strong property rights

environments through insulating themselves from opposition to reform; democratic governments such as most members of the OECD were able to bring about credible property rights environments through constitutionally limited government.

Stasavage (2003) takes a first step towards helping us to understand why we see governments able to credibly commit to institutional enforcement under an array of institutional structures. He shows that regardless of the number of veto players, demand for well-enforced property rights among a controlling interest in government is necessary to achieve them. In a slightly different vein, Henisz (2000) studies the interaction between institutional constraints and economic growth. Similar to Stasavage, Henisz finds that it is not veto players in and of themselves that lead to a governments ability to credibly commit to property rights enforcement, but the preferences of the veto players that matter.

Both arguments take an important first step in understanding why countries are able (or unable) to establish credible commitments to property rights. Unfortunately, the preferences of political actors are left as a black box. In a manuscript on property rights enforcement I show that the preferences of political actors stem from the political investments made by interest groups, both domestic and foreign. Thus, it is the distribution of power across interest groups and their willingness and ability to influence political actors that determines the preferences of political actors, and therefore, the property rights environment in a country.

Because the costs and benefits of property rights enforcement are not evenly distributed, different interest groups will have divergent levels of concern over enforcement and varying abilities to organize for their interests. The willingness and ability of these groups to make political investments will be strongly influenced by the

political institutional structure of a country and the availability of substitutes for property rights—such as BITs.

The willingness and ability of interest groups to affect political actors' preferences over property rights is conditioned by a number of factors: the institutional structure of the country, collective action costs of interest groups, the availability of substitutes for property rights, and the goals of investors. The first element, the political institutional structure of a country—that is regime type, access to the political system, and the existing level of property rights enforcement—can both positively and negatively impact the capacity of interest groups to make political investments. On one hand, more democratic societies provide more access to the political system and channels for constituents to voice concerns. In democracies, policy makers are more constrained by competing interests, subject to a wider range of influences for reelection, and less subject to the demands of political and economic elites that may demand exceptions to property rights. At the same time, democracies have greater constraints (through greater numbers of veto players) on the ability of political actors to affect political change. While in many cases this equates to policy stability, divergent policy preferences among political actors can also lead to policy stagnation and an inability to reform weak property rights enforcement regimes (Tsebelis 2002 ; Buchanan and Tullock 1962).

Further, an important and understudied mechanism that affects this distribution of power is the availability of substitutes for property rights. Governments in developing and transition countries commonly offer either substitutes for their domestic property rights systems or investment incentives to foreign investors that specifically exempt them from the host country's institutional environment, while offering them stability through

institutions external to the host country. The next section of the paper deals directly with the most common substitute for property rights: BITs.

Finally, Different types of investors have different goals. Entrenched business elites prefer to limit competition through keeping enforcement levels low for other investors. SMEs may prefer the added benefits of strong enforcement, but with limited knowledge of those benefits, may prefer informality. Foreign investors are the most likely to seek better enforcement, but will seek exceptions where enforcement is likely to remain low. Because each type of investor has varied demands, they will also vary in their perceptions of the property rights environment. Thus, in any country, foreign investors, business elites, and SMEs may have completely differing perceptions of the domestic property rights environment.

Thus, to understand the level of property rights protection in any country, we must understand the complicated interactions between the institutional structure of the country, the distribution of power between interest groups, and a new element that I turn to now, substitutes for property rights.

B. BITs and Property Rights

Governments in developing and transition countries commonly offer investment incentives to foreign investors that specifically exempt them from the host country institutional environment and offer them stability through institutions external to the host country. These investment incentives include a host of strategies including host country investment incentives (such as tax breaks or legal stability agreements), private investor-state contracts that outline government commitments towards investors, and international

agreements that outline legal protections and guarantees for foreign investors (such as BITs and the investment chapters of preferential trade agreements (PTAs)).

One way to reduce the risk for foreign investors is to enter into treaties and arrangements with partner countries and international organizations. While a broad variety of international legal guarantees exist, BITs and their counterparts, the investment chapters of PTAs are used with the purpose of stabilizing some portion of the investment environment for foreign investors. Currently, these two mechanisms are the most important instrument for the international protection of foreign investment (UNCTAD 1998). BITs are presently touted by International Financial Institutions and donor organizations as the best means for attracting FDI to developing and transition countries. These treaties extend investment protection beyond that offered by the host country's domestic laws and often establish a presumption against the use of domestic institutions. The treaties outline host country obligations towards home country (or foreign) investors, which generally include a secure legal environment for the investor based on a third party legal system, as well as the establishment of mechanisms for dispute resolution, and the facilitation of the entry and exit of funds. Industrialized countries use BITs to secure additional and higher standards of legal protection and guarantees for the investments of its firms than those offered under national laws (UNCTAD 1989). BITs provide clear, enforceable rules to protect foreign investment and reduce the risk faced by investors (Rajan and Zingales 2003; Bhagwati 2004; Sachs and Warner 1995).

Governments use BITs to compensate for the political failure of being unable to provide credible commitments to property rights. At first glance, BITs appear to be an ideal solution to this political failure. That is, they are meant to enable governments to

credibly commit to foreign investors without changes to the institutional structure within the country.

International relations theory outlines a series of ways by which BITs may serve as commitment devices. The public nature of most BITs means that any violation of a BIT will be known to all potential investors and will likely deter future FDI flows (Lipson 1991). The main reason that developing country governments enter into BITs is to attract greater flows of FDI. Although simply signing a treaty may send a signal to investors that a country is willing to protect a home country firm's investment, a violation of a single firm's property rights without just compensation is likely to increase the perception of risk for all potential investors. Additionally, the design of the treaties themselves may be adequate to ensure compliance (Abbott and Snidal 2000; Simmons 2000). Almost all BITs and many investor-state contracts contain recourse to international arbitration—at the very least assuring significant legal fees for non-compliance. Beyond the public nature and of non-compliance with BITs, their international nature necessarily involves host country governments, rather than just the injured investor. Host governments are able to put pressure on the home country government to comply with the BIT (or the arbitration agreement) through means outside of the agreements. For example, during a dispute under the provision of the France-Argentina BIT, the French government tied the success of negotiations over compliance with the arbitration agreement to discussion with the IMF regarding restructuring Argentina's external debt (Ortíz 2006).

C. BITs and Interest Groups

At first glance, BITs appear to be an ideal solution to the inability of developing country governments to provide property rights enforcement. That is, they are meant to enable governments to credibly commit to foreign investors without changes to the institutional structure within the country.

If this is indeed the case, then BITs are likely to affect MNC's willingness to make political investments to strengthen the overall property rights environment. With recourse to international arbitration as well as the public commitments visible through BITs, foreign investors no longer have as strong a need for overall reform to the property rights environment and are not likely to involve themselves in the political process for reform. In more moderate cases, powerful foreign investors remain proponents of overall reform in countries, but if they have assurances through BITs, they will no longer be willing to make political investments to gain stronger property rights enforcement overall. With the advent of BITs, countries are able to offer property rights substitutes—that is, they are able to isolate foreign investors from the broader domestic property rights environment. If foreign investors care more about profit then about the institutional environment—which is undoubtedly the case—BITs are likely to mute foreign investor's demand for higher levels of property rights and their availability will make it less likely that foreign investors will make political investments to influence property rights protection.

BITs are likely to have a much smaller direct impact on business elites and SMEs, but may affect them indirectly through the general property rights environment in the country. Property rights substitutes may be available to elites through business synergies with foreign investors. In general, substitutes will be unnecessary as the status quo is

likely to be sufficient for the property rights requirements of elites. In cases where business elites accept substitutes through their relationships with foreign investors, these substitutes are likely to work in the same way for elites as for foreign investors, isolating them from the risk faced by smaller investors rather than moving towards reform of the overall system. SMEs on the other hand will never have access to BITs. Although those investors that do have access to BITs are generally not competing with SMEs, many SMEs see BITs as an unfair advantage for foreign or large investors. BITs are unlikely to directly affect SMEs perceptions of property rights; however, if they do serve to dampen political investments for property rights, they will negatively impact the general property rights environment.

Therefore the intuition is that, all else equal, we should see BITs having a positive effect on both foreign investors' and elites' perceptions of property rights, but a negative effect on that of small and medium investors. This conclusion, at first glance, may seem in opposition to political studies of the Free Trade Literature that find that if certain industries can be excluded from FTAs, political prospects for an agreement improve (Grossman and Helpman). In this case, by excluding a powerful interest group from the domestic environment, reform to the domestic environment becomes more difficult, as that reform is not conditioned by the BIT for all investors.

In a world without BITs, regardless of the nature of the domestic business sector, foreign investors will make political investments to gain a well-enforced property rights environment. Here we expect the state of property rights enforcement to be based on the distribution of power among interest groups and the existing institutional structure in the country. In a world with BITs, however, foreign investors are often removed from the

process of political investments, powerfully changing the nature of the distribution of power among interest groups.

The feedback loops between interest groups, institutions, and the overall distribution of power in a country leads to a series of hypotheses regarding property rights. More democratic systems may make political actors more responsive to a wider range of concerns. However, if less powerful groups (such as SMEs) are unable to act collectively, their concerns over property rights might not be heard. This leads to a series of hypotheses regarding democracy:

Hypothesis 1:
- *BITs will have a negative affect on domestic investors' perceptions of property rights enforcement.*

Hypothesis 2:
- *BITs will have a positive affect on foreign investors' perceptions of property rights enforcement.*

Each of these factors is likely to be conditioned on the availability of BITs in a country. That is, when BITs are available, foreign investors will be less willing to make political investments, muting the demand for and lowering the possibility of strong property rights enforcement. Therefore:

Hypothesis 3a:
- *Any impact of democracy on domestic perceptions of property rights will be conditioned by the inclusion of BITs*

Hypothesis 3b:
- *The effect of BITs on domestic perceptions of property rights enforcement will not depend on the level of democracy*

Hypothesis 4a:
- *The effect of democracy on foreign investors perceptions of property rights enforcement will be lessened by the inclusion of BITs*

Hypothesis 4b:

- *The effect of BITs on foreign investors perceptions of property rights enforcement will depend on the level of democracy*

III. Research Design

To test the theoretical implications more systematically, I employ a survey data set that measures investors' perceptions of property rights at the level of the firm. A number of measures of "property rights" exist. Existing studies of property rights complain that these measures do not measure the environment generally, but rather the perceptions of investors. However, if you consider the accepted definition of property rights: 1) the right to control resources, 2) the right to the income stream from the resources, and 3) the right to transfer the resources—we see that perhaps the best way to measure property rights is through investor perceptions of their rights over their resources. In other words, there is no true value of the enforcement of property rights as enforcement differs across investors, especially in developing economies.

To test the observable implications of this theory I need to estimate a model of the determinants of perceptions of property rights enforcement. Theories of property rights have emphasized a range of determinants, including the legal origin of the country, colonial heritage, income levels, and human development. Unfortunately, the weak nature of measures of property rights variables has resulted in very few empirical papers that test the determinants of property rights measures. Nevertheless, we can model the property rights environment using measures of the economic and human resource strength of a particular country.

I begin by estimating the following model:

$$y_{ic} = \beta_0 + \beta_1 \mathbf{b}_c + \beta_2 \mathbf{d}_c + \beta_3 \mathbf{G}_c + \beta_4 \mathbf{F}_{i,c} + \beta_5 \mathbf{S}_c + v_{i,c} \qquad (1)$$

Where domestic investor perceptions of property rights enforcement in country (y) depend upon the log of the number of BITs in force by the host country (b), the level of democracy (d), the interest group (or size/nationality of the firm) (g), a vector of firm-level characteristics (F), and some random error (v). Each of the variables is indexed by country (c) and firm (i).

Initially I estimated Equation (1) using ordinary least squares (OLS). However, this analysis combines information collected at both the level of the firm as well as that of they country. Because firms are nested within countries, ignoring the multilevel structure of the data would result in a series of statistical problems (Snijders and Bosker 1999). Thus, I use equation (1) as the first level in a multi-level or hierarchical model that explicitly deals with the nested nature of the data.

I model the country means as a function of the macro-level characteristics of the country, where S is a vector of country-level characteristics:

$$\beta_0 = \gamma_0 + \gamma_1 \mathbf{S}_c + u_{i,c} \qquad (2)$$

Variables and Data Sources

Dependent Variable

To investigate the effects of BITs and political institutions on domestic investors' perceptions of property rights I combine firm-level data from the World Bank's World Business Environment Survey (WBES) with country-level data from several sources. The WBES was designed to measure and evaluate business conditions in a large, cross-

regional set of countries. The WBES was administered to more than 10,000 firms in 80 developed and developing countries over a one and a half-year period from late 1998 through early 2000. The survey was administered to at least 100 firms in each country using a uniform methodology and parallel parameters for sample structure (Batra et al. 2002).

The survey asks a series of questions that correspond to my theoretical emphasis on enforcement of property rights. First, firms are asked to rate courts on the following statement for six factors:

"In resolving business disputes, do you believe your country's court system to be:"

a) Fair and Impartial
b) Honest/Uncorrupt
c) Quick
d) Affordable
e) Consistent
f) Decisions Enforced

Respondents are asked to rate each of these factors on a scale of 1 to 6 as follows:

1: Always
2: Usually
3: Frequently
4: Sometimes
5: Seldom
6: Never

Finally, respondents are asked to respond to the following question:

g) "I am confident that the legal system will uphold my contract and property rights in business disputes,"

with one being equal to fully agree and 6 equaling fully disagree.

While any of these questions might, by themselves, measure some of the investors' perceptions of the level of enforcement in the property rights environment, to make the best use of the WBES data I create an index of each of the factors to create a more comprehensive dependent variable. I create this index through principle component

analysis (PCA) which combines the seven variables into an index of weighted linear combinations of those variables. The factor loadings for each of the questions are a) 0.79, b) 0.76, c) 0.61, d) 0.57, e) 0.80, f) 0.63, and g) 0.58, respectively. Each of the included factors is highly correlated with the resulting index. I make to final modifications to the data for ease of interpretation. First, I standardize the resulting index to have mean zero and standard deviation of one. Second, I multiply the resulting index by -1 so that higher scores in the index equate to better property rights (rather than worse as in the original indicator). The variable is available for more than 6,500 firms in fifty-two countries.

Independent Variables

BITs (b)

Data on BITs are available from a listing published by UNCTAD that documents the parties to every bilateral investment treaty, the date of signature, and the date of entry into force. These data are available for every BIT of public record from the first treaty signed in 1959 between Germany and Pakistan through December 2000 (UNCTAD 2001). These are added to the number of FTAs signed by a country (with a high-income economy) that contain an investment chapter. To test the affect of BITs on property rights, I measure them in a variety of ways:

1) Total number of BITs *signed* with all countries
2) Total number of BITs *signed* with high-income economies (those most likely to have a foreign investment presence and to be users of ICRG risk analysis)
3) Total number of BITs *in force* with all countries
4) Total number of BITs *in force* with high-income economies
5) Log of total number of BITs *in force* with high-income economies—this is to measure the possibility of decreasing returns to scale for attracting investment.

While I examined the impact of all forms of BITs, for all estimations I use a count of the number of BITs in force between the host country and any high-income countries. I exclude low income BITs as their actual use is questionable. First, they do not seem to

attract a great deal of foreign investment. Second, it does not appear likely that the purpose of BITs signed between two low-income economies is an alteration of the property rights regime (Tobin and Rose-Ackerman 2005). Finally, the estimations changed minimally with the inclusion of all BITs or BITs that were signed but not in force.[2]

BITs are measured in each country at year *t-3* to account for the fact that BITs are likely to affect subsequent but not immediate perceptions of property rights enforcement.

Political Institutions (p)

The level of democracy is measured through the variable *polity*, available from the Polity IV data set (Marshall and Jaggers 2000). Polity is the difference between two indices—a negative one for autocratic characteristics, and a positive one for democratic characteristics—each of which is measured on a scale of 0 to 10. To make the coefficients easier to interpret, I converted the -10 to +10 index to 0 to 20. Polity is available for every country in the world from the 1800s through 2000. I measure it as an average over the years 1999-2000 except when data from one year was not available; in which case, the available years' data was used.

Interest Groups

I separate interest groups by the size of the firm and whether or not they are majority foreign-owned. The WBES categorizes firm size according to small firms (those with 50 or fewer employees), medium firms (those with 951-500 employees), and large firms (those with 501 or more employees). I grouped small and medium firms into one category, SME which contains firms with 500 or fewer employees.

[2] The results did not change when a variable measuring concurrent BITs or BITs in force 5-years earlier were used. Similarly, using signed BITs, BITs with all countries, and the log of BITs did not change the results in any of the specifications.

Firm-Level Characteristics (F)

To control for individual characteristics of firms that might affect the decision-making process, I include the firm's age and whether they are involved in the manufacturing or service industry versus other industries (such as agriculture or construction). Age is measured as the number of years the firm has been in operation. Industry is measured from a question asking which industry the firm is involved with and grouped into three dummy variables accounting for whether the firm is involved in manufacturing, service, or any other industry.

Country-Level Characteristics (S)

I control for country-level characteristics with dummy variables for continent and a measure of the absolute latitude of the capital of each country. In addition, I control for country-level economic characteristics that might affect investors' perceptions of the property rights environment: the log of the average level of income and the degree of openness of the economy. Income is measured as the log of a country's average per-capita GDP in constant 1996 US dollars at price-purchasing parity. Openness is measured as the ratio of exports plus imports to GDP. Both variables are from the *Penn World Tables* and are measured as an average over the years 1999-2000 except when data from one year was not available; in which case, the available years' data was used.

Further, the most likely reason for entering into a BIT is to address a weak property rights environment. I proxy for this environment with a measure of the health of the local economy, economic growth. Economic Growth is measured as per-capita GDP growth in constant 1996 US dollars at price-purchasing parity from the *Penn World Tables*.[3]

[3] To deal with the possibility of path dependence, I lagged growth from 1 to 5 years before the survey.

Finally, I eliminated all countries designated as high-income according to the World Bank's income classification system from the dataset.[4] I eliminate high-income countries from the data set because of the inherent differences high-income countries have for signing BITs. BITs signed by high-income countries are for the purpose of protecting their investors when they invest in risky environments and are not meant to attract FDI (the main purpose for low- and middle-income countries. More importantly, property rights in high-income countries are considered strong and well-enforced and BITs are not meant to serve as substitutes as they are in low- and middle-income countries.

After combining the data sets and eliminating observations with missing key data, my sample includes a maximum of 41 developing countries in all regions of the world and covers more than 4,000 firms (see appendix B). I estimate all of the models using instrumental variables, two-stage least squares, correcting for possible heteroskedasticity by using Huber (1967), White (1980) robust estimates of the variance and cluster the standard errors by country to provide more cautious estimates of the standard errors.

<<Insert Table 1 Here>>

Table 1 column (1) shows the relationship between BITs and investors' perceptions of property rights for the base specification. In column (1) we see a negative relationship between BITs and domestic investors' perceptions of property rights as well as democracy and property rights. However, neither of these relationships is statistically significant at the 90 percent confidence level, leading us to believe that neither of these variables has a direct relationship with property rights. The firm-level variables offer a

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None of these estimations was significantly different than the final estimation.

[4] For income classifications see: http://www.worldbank.org/data/countryclass/classgroups.htm

series of interesting results. SMEs have negative perceptions of property rights compared to those of large investors. The type of sector does not seem to have an impact on firms' perceptions of property rights, while the age of the firm has a strong, positive relationship. Income has a strong, positive relationship with domestic perceptions of property rights enforcement, while economic growth and openness to trade have insignificant relationships. Finally, Latin American and Eastern European Firms seem to have negative perceptions of property rights compared to those from Asia and Africa.

Equation (1) is useful for examining the independent effects of BITs and political institutions on perceptions of property rights. But, the theory leads us to believe that these effects may be conditional. To examine this possibility, I estimate the base model with a series of interactions (again modeling the country-level structure explicitly through a multi-level model identical to equation (2)):

$$y_{ic} = \beta_0 + \beta_1 \mathbf{b}_c + \beta_2 \mathbf{d}_c + \beta_3 \mathbf{G}_c + \beta_4 \mathbf{F}_{i,c} + \beta_5 (\mathbf{g\_size}_{i,c} * b_c) + \beta_6 (\mathbf{g\_foreign}_{i,c} * b_c) + v_{i,c} \quad (3)$$

Equation (3) is identical to Equation (1), but contains a series of interactions between a subset of firm characteristics (**F'**) and both institutions and BITs to enable us to understand the conditional relationship of these factors with firm size and ownership.

Column (2) of table 1 presents the results for equation (3). Once we have included an interaction with BITs, we see a strong negative relationship between BITs and domestic investors' perceptions of property rights regardless of the included interactions. The remaining variables retain their relationships from equation 1. It is always risky to put too much trust in coefficient estimates that are at best rough, but there is still value in examining the magnitude of effects, especially when they are interactive.

Figure 1 helps us to make sense of the interactions in equation (3); it shows the conditional effect of BITs of investors perceptions of property rights for foreign investors and SMEs, using unique coefficient estimates and standard errors generated from the coefficient estimates and the variance-covariance matrices from the regression in column (2) of Table 1. The solid lines indicate the conditional relationships while the dotted lines surrounding them are the 95 percent confidence intervals. We see that as the number of BITs increases in a country, foreign investor's perceptions of property rights increase while those of SMEs decrease. Figure 1 lends support to hypotheses 1 and 2, that is, BITs have a negative impact on domestic investor's perceptions of property rights, but a positive affect on those of foreign investors.

With an understanding of the contingent relationship between BITs and interest group on property rights perceptions, we turn to hypotheses 3 and 4 which predict a three-way relationship between BITs, interest group and democracy. To estimate this possibility, I re-estimate equation (3) accounting for the possibility of this three-way interaction:

$$\begin{aligned} y_{ic} = {} & \beta_0 + \beta_1 \mathbf{b}_c + \beta_2 \mathbf{d}_c + \beta_3 \mathbf{G}_c + \beta_4 \mathbf{F}_{i,c} + \\ & \beta_5 (\mathbf{g\_size}_{i,c} * b_c) + \beta_6 (\mathbf{g\_foreign}_{i,c} * b_c) + \\ & \beta_7 (\mathbf{g\_size}_{i,c} * \mathbf{b}_c * \mathbf{d}_c) + \beta_8 (\mathbf{g\_foreign}_{i,c} * \mathbf{b}_c * \mathbf{d}_c) + v_{i,c} \end{aligned} \qquad (4)$$

Equation (4) is identical to Equations (1) and (3), but contains three-way interactions between firm characteristics, institutions and BITs to enable us to analyze this contingent relationship.

Column (3) of table 1 presents the results including the triple interaction between firm type, democracy, and BITs. In each case, the individual and joint coefficients are

jointly significant. Once again, BITs have a negative independent relationship with property rights perceptions, but this relationship is dependent not only on the number of BITs in a country, but with its level of democracy. Additionally, all of the lower-order terms retain their relationships from earlier hypotheses. While interpretation of the interactive coefficient estimates is difficult because of the multiple interactions, we can still see from the coefficient estimates that the negative effect of BITs on property rights perceptions is contingent on firm type (a positive relationship for foreign investors, but negative for SMEs) as well as the level of democracy. Figures 2-5 show graphically these conditional effects. These estimates are generated from the coefficient estimates and the variance-covariance matrices from the regressions in Table 1 column (3).

Figure (2) examines the impact of democracy on *foreign* investors' property rights perceptions at various levels of BITs, holding all other variables at their means. While increasing levels of democracy always has a positive impact on foreign investors' perceptions of property rights, the degree of this change is highly dependent on the number of BITs in a country. For example, in a country with few BITs (one standard deviation below the mean), a move of 5 points on the polity scale (from 0 to 5) increases foreign investors perceptions from -.06 to 0.03, a positive increase of .09 perception points, while the same increase in democracy for a country with a high level of BITs increases perceptions from 0.06 to 0.07, an increase of only 0.01 perception points. This table lends support to hypothesis 4a; the positive relationship between democracy and foreign investors' perceptions of property rights is lessened by the inclusion of BITs.

Figure (3) examines the identical case to figure (2) for SMEs. Here we find support for hypothesis 3a, that is, the positive impact of democracy on domestic investors' perceptions of property rights is conditioned by the number of BITs. In this

case, while the slopes of the three lines are not significantly different from each other, the fewer BITs in a country, the more positive the perceptions of property rights.

Figures (4) and (5) reverse this relationship. Here, we look at the impact of BITs on foreign and domestic investors' perceptions of property rights at three different levels of democracy. In figure (4) we see that in more autocratic countries, increasing numbers of BITs has a strong, positive impact on foreign investors' perceptions of property rights, while for more democratic countries, increasing numbers of BITs has an insignificant impact on perceptions. That is, foreign investors feel more secure investing in democracies without BITs, but in autocracies they view their property rights as more secure under higher numbers of BITs. This lends support for hypothesis 4b. SMEs on the other hand have significant, negative perceptions of property rights that grow stronger the more BITs are signed, regardless of the level of property rights in the country. Figure (5) lends support to hypothesis 3b.

While the empirical results underline many of the hypotheses of the paper, a few examples will help to enrich our understanding of the theory. If the theory and results accurately reflect the way that institutions and the distribution of power affect property rights, we should see that in country with a large number of BITs foreign investors should have strong perceptions of the property rights environment while domestic investors' perceptions for the same country should be low. Three cases in point are Russia, Argentina and Indonesia. All three countries are well above average in terms of the number of BITs they have entered (measured as signed or in force and with high-income or all countries). All three have above average ratings by foreign investors, with scores at least one standard deviation above the average score for all low- and middle- income countries. At the same time, all three have average property rights enforcement ratings

by small and medium domestic investors well below the average for other low- and middle-income countries (again, at least one standard deviation below the average). At the other end of the spectrum lie Botswana, Belize, and Namibia. All three countries have stayed away from BITs, with any country. As of 2000, Botswana had no BITs in force, while Belize and Namibia each had one BIT in force (the average for low-and middle income countries is 8). At the same time, all three countries had very strong property rights enforcement ratings by their small and medium-sized domestic investors, yet low ratings by foreign investors.

The results in this section give us important insight into the way that political institutions and BITs both separately and together affect foreign investors' perceptions of property rights. From the empirical analysis, it seems to be the case that BITs, or substitutes for property rights for specific interest groups have a negative effect on property rights for domestic investors. While we cannot be certain of the causal mechanisms behind this interaction, it may be the case that governments are less willing to enforce the property rights environment for all investors when major players in the investment environment are already satisfied through other means.

Foreign investors seem to have opposing views of BITs and political institutions. I found support for the idea that substitutes for property rights for foreign investors improves those investors' perceptions of property rights. However, as countries become more democratic, the positive impact of BITs on foreign investors' perceptions decreases.

IV. Conclusion

This analysis offers a new argument and some evidence regarding the importance of institutions for establishing strong, effective property rights enforcement. I have argued that democratic institutions do help determine the emergence of strong property rights enforcement. However, they matter not because greater numbers of veto players with divergent preferences in and of themselves enable governments to credibly commit to property rights enforcement. Institutions matter because they shape the actions of interest groups—whose actions in turn shape the preferences of political actors.

A number of observable implications stem from this argument. In this paper, I test the importance of substitutes for property rights. I find that one common substitute for property rights, BITs, as measured by the number of Bilateral Investment Treaties in force has a strong, positive influence on foreign investor's perceptions of property rights. Further, while I confirm extant arguments of the importance of access to the political system and democracy for strong, well-enforced property rights, I find that the positive effect of democracy is muted by the presence of substitutes for property rights. Similarly, for domestic investors, I find that more democratic countries have better perceptions of the property rights environment for domestic investors. This relationship is contingent, however, on the availability of substitutes for property rights and on interest groups.

The empirical results in this paper should caution the use of BITs as a tool for attracting investment if they do indeed have this affect on the distribution of power among interest groups. At the same time, the results offer support to the growing literature on the benefits of good government for development; that is, as countries become more democratic, property rights protections may increase as well.

Understanding the emergence of strong, well-enforced property rights is a difficult task. Existing arguments for credible commitments to property rights are often conflicting or leave gaps in our ability to understand the underlying mechanisms for the emergence of strong property rights. The most important conclusion from this analysis is that if we focus only on institutional structures we will miss a key component necessary to understand the emergence of property rights and ensuing economic growth.

Finally, this study has important theoretical and policy-analytic implications. Theoretically, if we want to understand the emergence of strong, well-enforced property rights environments, we cannot look at institutions or interest groups in a vacuum but must understand how their interaction can lead to varied outcomes over property rights protections. In addition, we need to take a closer look at substitutes for property rights. If a tradeoff does exist in the short run between attracting foreign investment on the one hand and establishing strong property rights environments on the other, one should question the overall long-term effects of this tradeoff.

Table 1

Dependent Variable: Property Rights Perceptions

	Equation 1	Equation 3	Equation 4
BITs	-0.006	-0.003^^	-0.003^^
	(0.007)	(0.008)	(0.008)
Democracy	-0.007	-0.006	-0.009^^
	(0.009)	(0.010)	(0.011)
SME	-0.131***	-0.074^^	-0.114^^
	(0.035)	(0.060)	(0.239)
BITs*SME		-0.005^^	-0.003^^
		(0.005)	(0.015)
BITs*Foreign		0.005^^	0.017^^
		(0.005)	(0.015)
Democracy*SME			0.003^^
			(0.017)
Democracy*Foreign			0.021^^
			(0.015)
Foreign	0.033	-0.025^^	-0.314^^
	(0.033)	(0.069)	(0.226)
Democracy*'SME*BITs			0.000^^
			(0.001)
Democracy*'Foreign*BITs			-0.001^^
			(0.001)
Age	0.006***	0.006***	0.006***
	(0.001)	(0.001)	(0.001)
Service	-0.055	-0.054	-0.053
	(0.039)	(0.038)	(0.038)
Manufacturing	-0.024	-0.024	-0.022
	(0.035)	(0.035)	(0.035)
GDP_capita	0.283***	0.282***	0.278***
	(0.049)	(0.049)	(0.049)
Growth	0.023	0.024	0.022
	(0.022)	(0.022)	(0.021)
Open	0.0003	0.0002	0.0002
	(0.001)	(0.001)	(0.001)
Europe	-0.572***	-0.573***	-0.568***
	(0.134)	(0.133)	(0.126)
Asia	-0.158	-0.167	-0.172
	(0.161)	(0.159)	(0.159)
Latin America	-0.813***	-0.818***	-0.824***
	(0.133)	(0.133)	(0.133)
Constant	-1.526***	-1.560***	-1.490***
	(0.309)	(0.311)	(0.309)
N (firm)	7891	7891	7891

***indicates significant at .01 level; **significant at .05 level, *significant at .10 level
Heteroskedasticity consistent (robust) standard errors given in parentheses

Figure 2

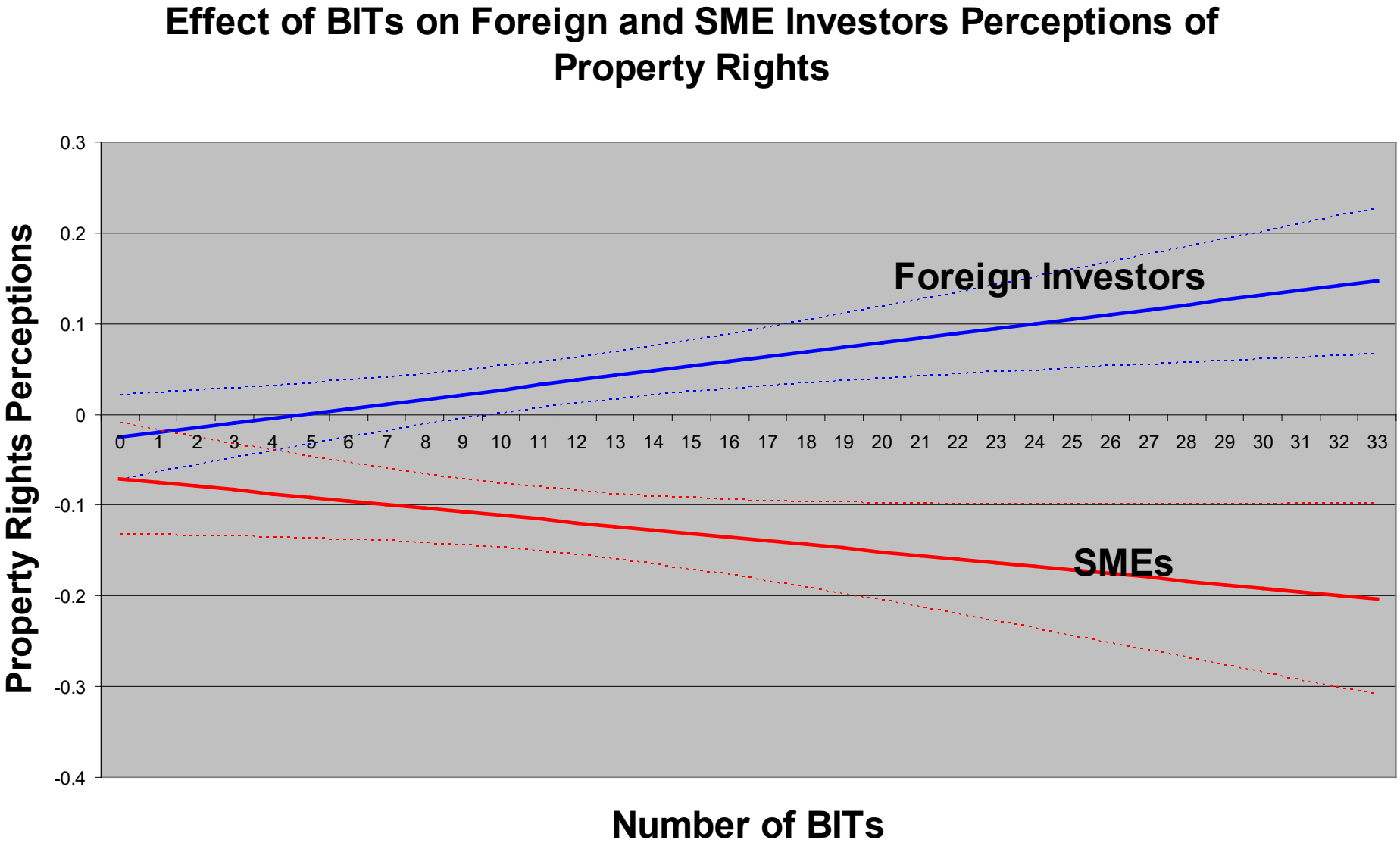

Effect of BITs on Foreign and SME Investors Perceptions of Property Rights
Property Rights Perceptions
0.3
0.2
0.1
0
-0.1
-0.2
-0.3
-0.4
0 1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30 31 32 33
Foreign Investors
SMEs
Number of BITs

Figure 3

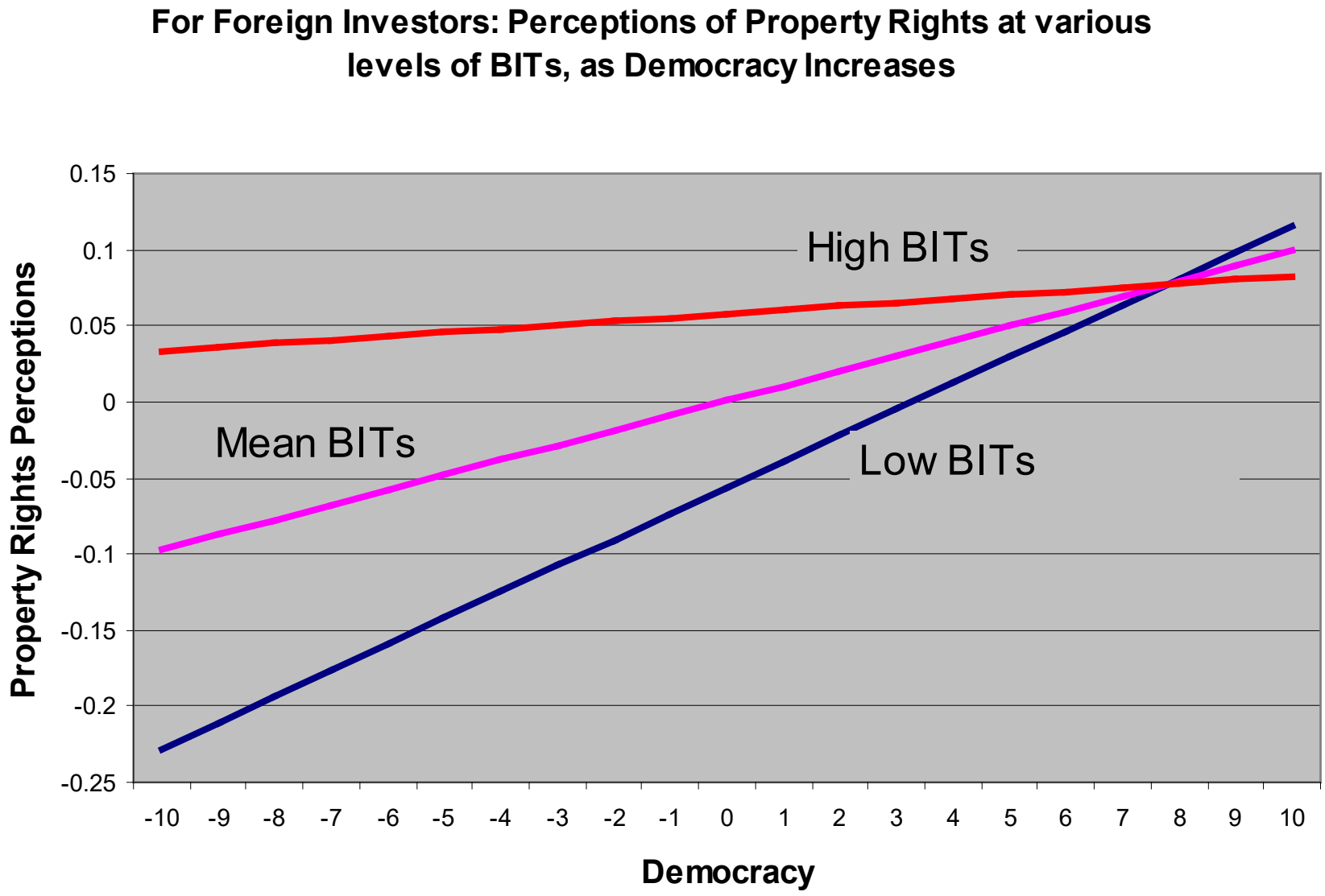

For Foreign Investors: Perceptions of Property Rights at various levels of BITs, as Democracy Increases
Property Rights Perceptions
0.15
0.1
0.05
0
-0.05
-0.1
-0.15
-0.2
-0.25
High BITs
Mean BITs
Low BITs
-10 -9 -8 -7 -6 -5 -4 -3 -2 -1 0 1 2 3 4 5 6 7 8 9 10
Democracy

Figure 4

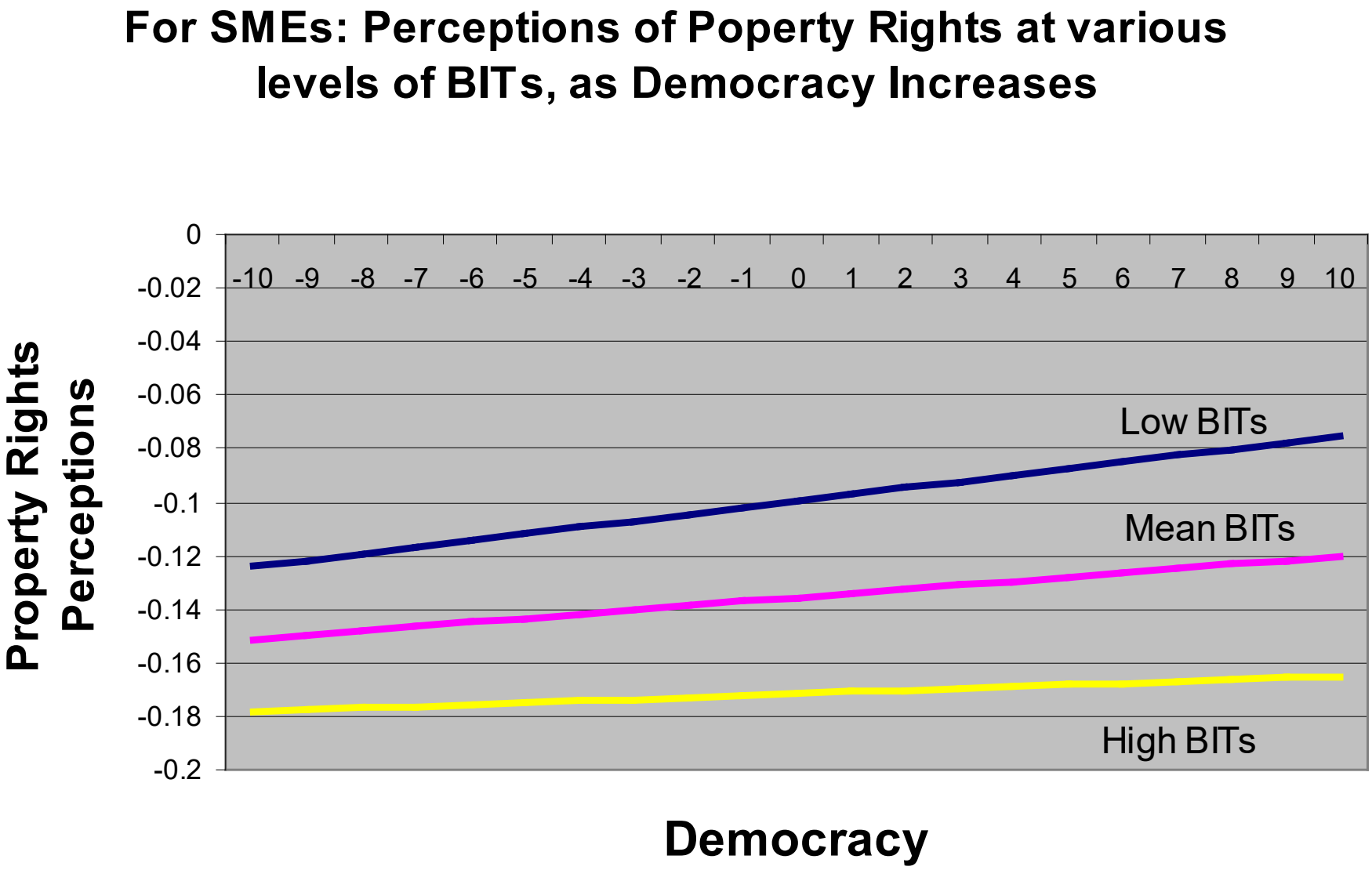

For SMEs: Perceptions of Poperty Rights at various levels of BITs, as Democracy Increases
Property Rights Perceptions
0
-0.02
-0.04
-0.06
-0.08
-0.1
-0.12
-0.14
-0.16
-0.18
-0.2
-10 -9 -8 -7 -6 -5 -4 -3 -2 -1 0 1 2 3 4 5 6 7 8 9 10
Low BITs
Mean BITs
High BITs
Democracy

Figure 5

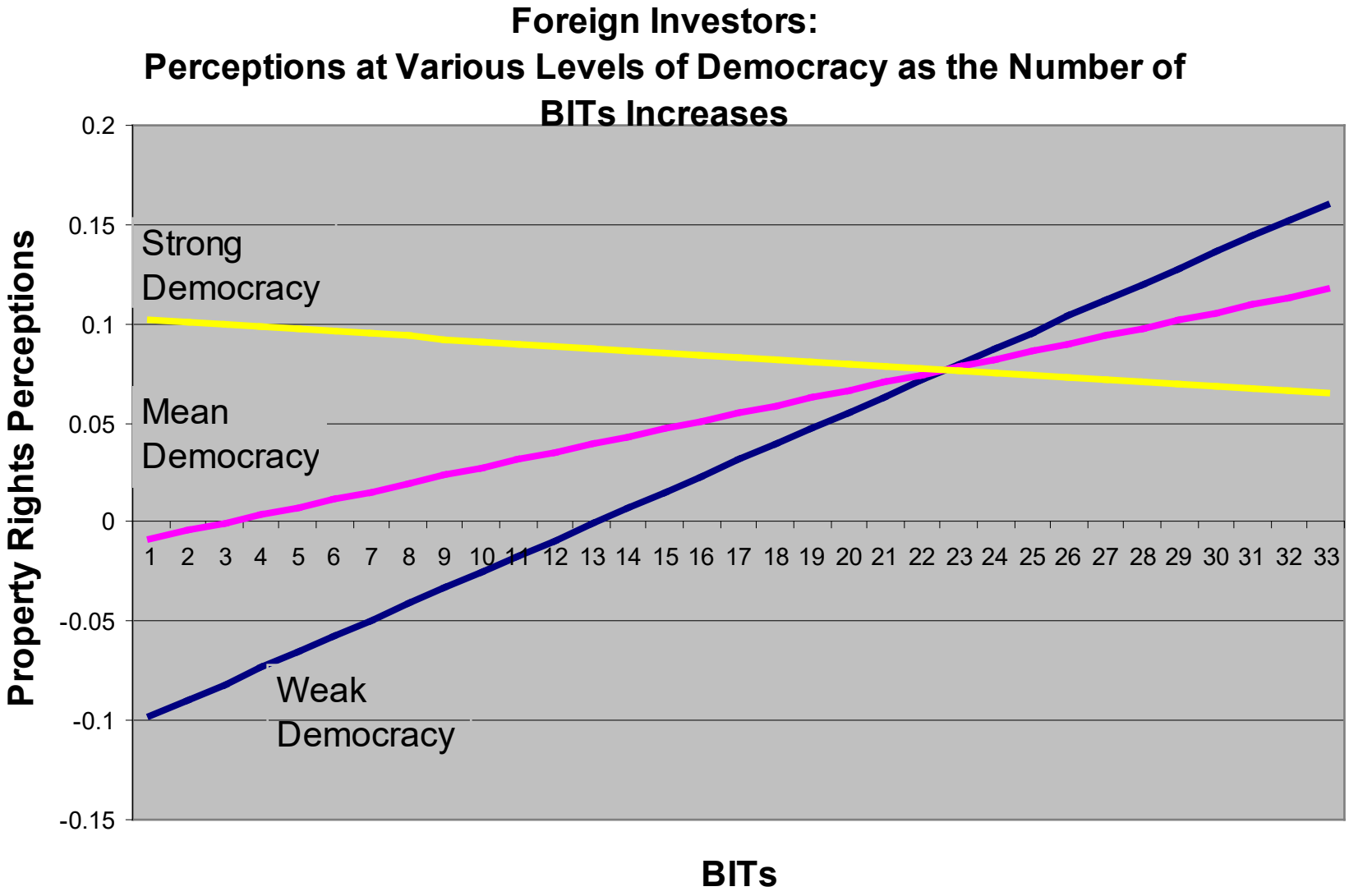
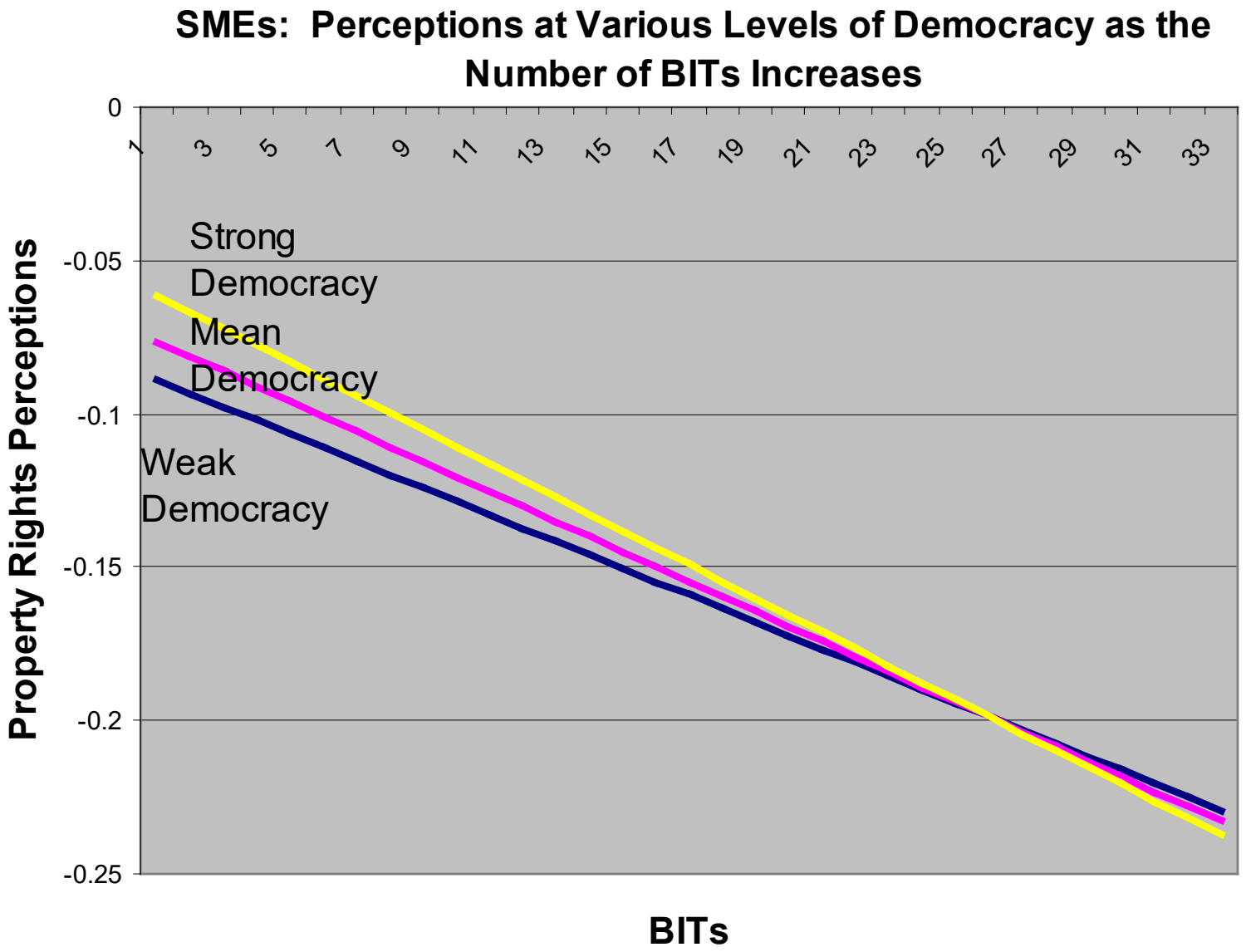

Foreign Investors:
Perceptions at Various Levels of Democracy as the Number of BITs Increases
Property Rights Perceptions
0.2
0.15
0.1
0.05
0
-0.05
-0.1
-0.15
Strong Democracy
Mean Democracy
Weak Democracy
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30 31 32 33
BITs

Figure 6


SMEs: Perceptions at Various Levels of Democracy as the Number of BITs Increases
Property Rights Perceptions
0
-0.05
-0.1
-0.15
-0.2
-0.25
1
3
5
7
9
11
13
15
17
19
21
23
25
27
29
31
33
Strong Democracy
Mean Democracy
Weak Democracy
BITs

Summary Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Perceptions	7891	-0.01	0.89	-2.36	2.52
BITs	7891	11.99	7.57	0	33
Democracy	7891	14.51	5.08	1	21.58
SMEs	7891	0.81	0.39	0	1.02
Foreign	7891	0.18	0.38	0	1
Age	7891	16.96	18.60	-14.62	193
Service	8998	0.41	0.47	-0.41	1.19
Manufacturing	7891	0.37	0.46	-0.28	1.08
GDP_cap	7891	7.15	1.06	4.60	9.99
Growth	7891	4.05	2.92	-2.79	10.36
Open	7891	69.06	32.02	17.20	193.83
Europe	7891	0.32	0.47	0	1
Asia	7891	0.17	0.38	0	1
Latin America	7891	0.23	0.42	0	1
Africa	7891	0.18	0.39	0	1

WBES Country List

Albania	Kazakhstan
Argentina	Kenya
Armenia	Kyrgyz Republic
Azerbaijan	Lithuania
Bangladesh	Madagascar
Belarus	Malawi
Belize	Malaysia
Bolivia	Mexico
Bosnia and Herzegovina	Moldova
Botswana	Namibia
Brazil	Nicaragua
Bulgaria	Nigeria
Cambodia	Pakistan
Cameroon	Panama
Chile	Peru
China	Philippines
Colombia	Poland
Costa Rica	Romania
Cote d'Ivoire	Russian Federation
Croatia	Senegal
Czech Republic	Singapore
Dominican Republic	Slovak Republic
Ecuador	South Africa
Egypt, Arab Rep.	Tanzania
El Salvador	Thailand
Estonia	Trinidad and Tobago
Ethiopia	Tunisia
Georgia	Turkey
Ghana	Uganda
Guatemala	Ukraine
Haiti	Uruguay
Honduras	Uzbekistan
Hungary	Venezuela
India	Zambia
Indonesia	Zimbabwe

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