Separate and Unequal:
Bilateral Investment Treaties and Property Rights in Developing Countries
(Preliminary and incomplete)

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I. Introduction

Bilateral Investment Treaties (BITs) are currently the dominant means through which investment in low- and middle-income countries is regulated under international law. Overall, the provisions of BITs are meant to secure the legal environment for foreign investors, establish mechanisms for dispute resolution, and facilitate the entry and exit of funds. BITs cover expropriation of property as well as indirect takings that are tantamount to expropriation. (Kishoiyian 1994, Schwarzenberger 1969, Walker 1956). In effect, BITs create a separate—and better—property rights environment for foreign investors, not afforded to domestic, host country investors.

Developed countries and their firms see BITs as providing valuable protection in often uncertain environments. Developing countries employ BITs as a means to attract inward investment. The protections to foreign investment are presumed to attract investment flows to developing countries that will lead to greater economic development. Developing countries hope that the treaties signal to foreign investors either a strong protective investment environment or a commitment that foreign investments will be protected through international enforcement of the treaty.

Research on BITs as has focused on their spread and their ability to attract FDI to host countries, but little work looks beyond their intended effects. If BITs are meant to attract FDI by changing the property rights environment for foreign investors, it is important to ask if they have any unintended consequences—positive or negative—for the host country. That is what this paper seeks to address.

At first glance, increased FDI flows in and of themselves could be enough to overcome the potential for any negative side effects. 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 posit, 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.

This paper show that the negative argument for property rights is in fact the case. If we gain a better understanding of the causal links determining property rights in a country, we see that insulating foreign investors from the general property rights environment has negative implications for overall property rights protection in developing countries.
The paper proceeds as follows. Section II lays out the theoretical arguments and plots the interactions between political actors and the decisions of interest groups to make political

investments. Section III investigates quantitatively a number of the observable implications that stem from the theoretical argument. Section IV concludes and discusses policy implications.

II. Theory

A. The Political Economy of Property Rights

Defining Property Rights

Property rights are defined in different ways in different societies. Nevertheless, Armen Alchian and Harold Demsetz's (1972) broad definition can serve to frame the issue. The authors define property rights as 1) the right to control resources, 2) the right to the income stream from the resources, and 3) the right to transfer the resources. Scholars of property rights agree that the definition of property rights is broad.[1] This leaves room for variation across and within legal systems. Variation within legal systems means that different types of investors within the same country are likely to have different perceptions of the property rights environment of that country. For example, within the same country, a foreign investor involved in an extractive industry will perceive the property rights environment quite differently then a small textile manufacturer or a large manufacturer related to the President. Thus, not only is it difficult to succinctly define property rights, it is also difficult to precisely measure them across countries.

Benefits of Property Rights

Ceteris Paribus, investors are more likely to invest in a strong, well-enforced property rights environment. Economic historians from Adam Smith to Douglass North have theorized that market economies depend on property rights to ensure the efficient exchange of goods between actors. Well enforced property rights systems ensure investors that they will directly realize any benefits from the use of their property, making investors not only more likely to invest, but to invest wisely and efficiently (Abbott 2000; De Soto 2000). Governments can directly gain from their commitment to a credible system of well-enforced property rights through greater levels of investment. Not only are the resources of the country put to their most efficient use, but, governments may claim a portion of the investment and subsequent growth through taxation (Firmin-Sellers 1995).

Recently, political scientists and economic growth scholars have tested the empirical relationship between property rights and economic growth and the evidence convincingly demonstrates a connection. [2] Overall, the evidence, both quantitative and qualitative,

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[1] See for example(Olson 1982; North 1990; Smith 1994)

[2] A number of scholars empirically demonstrate both a direct relationship between property rights and economic growth as well as an indirect relationship through improved asset allocation as well as enhanced labor and firm productivity. For example, in Firmin-Sellers (2003) study of property rights in Ghana, she found that the key to the state's economic success lay in the ability of the government to enforce property rights through its political institutions. Knack and Keefer (1995) offer evidence that "institutions that

demonstrates that weak property rights systems affect every segment of society: the wealthy and middle class shy away from investment and saving in a risky political environment; the government is unable to collect taxes on a substantial portion of the economy; finally, the poor are left with enormous amounts of "dead capital" (de Soto 2000).

Following on this broad statistical and theoretical work, the development community has, over the last few years, taken up the call towards better institutions in general, and property rights in particular. The World Bank, the IMF, and the many bilateral donors have made property rights reform a mainstay of their development programs.[3] Yet, regardless of this near universal push for property rights reform, in the majority of low and middle income countries in the world, we still do not see a trend towards better enforcement.

The Politics of Property Rights

This robust connection between property rights and growth has pushed many scholars to ask why some countries are able to credibly commit to the enforcement of property rights while others are not. Two divergent strands of research endeavor to answer this question: the literatures on economic and institutional reform. The literature on economic reform postulates that those governments best able to bring about property rights enforcement are authoritarian governments—those with strong enough states to insulate themselves from popular and interest group demands to maintain the status quo (Firminsellers 1995; Haggard and Kaufmann 1992; Fernandez and Rodrik 1991; Williamson 1994).

An opposing strand of literature calls the above reasoning into question. Instead of autocratic governments, the *veto players* literature claims that the emergence of constitutionally limited government—those with multiple veto players—are the best means for governments to credibly commit themselves to property rights enforcement, through restraints on their own power (North and Weingast 1989).

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protect property rights are crucial to economic growth and investment." Likewise, Goldsmith (1995), using cross-sectional data found a correlation between property rights and economic growth in low and middle-income countries. Claessens and Laeven (1995) find that countries with more secure property rights have higher growth rates through improved asset allocation. In a firm level study of political risk in developing countries, Borner, Brunetti and Weder (2005) found that "if political uncertainty is present, economically sound domestic investments are rare…institutional reform is therefore a crucial precondition for market-driven development that depends primarily on private sector investment." Torstensson (1994) found that "insecure property rights result in an inefficient allocation of investment funds and an inefficient use of human capital." Taking into account the time dimension of economic growth, David Leblang demonstrated that nations that protect property rights grow faster than those that do not. Stepping back to look at overall policies that affect not only overall growth, but also the incomes of the poor, Dollar and Kraay (2001) found that basic packages of good policies, within which property rights plays a vital role, raise overall incomes in developing countries and have an additional positive impact on the incomes of the poor. Likewise, Hall and Jones (1999) found that differences in government policy and institutions, with property rights playing a major role, equated to large differences in income across countries. Finally, but far from inclusively, Dollar, Hallward-Driemeier, and Mengistae (2002) in a series of countries and Dollar, Iarossi, and Mengistae (2006) in India find that at the level of the firm, the overall investment climate matters for a number of output factors including productivity, wages, and profit rates.

[3] See for example (2000)

Thus, we have two competing institutional arguments for government's ability to make credible commitments to property rights enforcement:

1) Autocratic governments are able to make credible commitments through their ability to insulate themselves from potentially powerful members of society who oppose strong, well-enforced property rights, and
2) Constitutionally limited democracies are able to make credible commitments because opportunistic policy changes will be more difficult under a separation of powers.

Empirically, we see examples of both of these arguments. Autocratic governments such as Chile and Singapore were able to bring about strong property rights 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 property rights enforcement under an array of institutional structures. In studying the same case as North and Weingast (1989), he shows that a system of checks and balances can provide credibility but it is neither a necessary nor a sufficient condition. Instead, he claims that we must take into account the partisan control of veto points, the number of issues involved and the delegation of policy. Stasavage 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.[4]

Stasavage's argument 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. If the important political economic question is how governments are able to credibly commit to property rights enforcement, then we need a better understanding of where the preferences of political actors come from. I argue that political institutions do play a role in the determination of the property rights environment in a country, but the degree to which they influence property rights enforcement is contingent on the willingness and ability of interest groups to support their preferred policies. One major determinant of the willingness of foreign investors to support better property rights in a country is the availability of substitutes for property rights.

The process that determines the preferences of political actors over property rights is complicated, but figure (1) provides a stylized overview. We see that the preferences of political actors are immediately determined by the political investments made to those

[4] In a slightly different vein, Henisz (Basinger and Hallerberg 2004; Oates 1972) studies the interaction between institutional constraints and economic growth. He finds that institutional constraints are strongly correlated with increased economic growth. Rather than simply measuring the number of veto players, Henisz takes into account the diversity of policy preferences of veto players. Thus, 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.

actors by interest groups. The important question then is: how and why do these interest groups choose to make political investments? I claim that the political institutional structure of a country and the availability of property rights substitutes affect the distribution of power among interest groups, which in turn determines interest groups' capacity to make political investments to influence property rights enforcement.

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.

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 the 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. I refer to these substitutes as "privatized investment incentives (PIIs)".

PIIs include a host of strategies including host country investment incentives (such as tax 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 Bilateral Investment Treaties (BITs) and the investment chapters of free trade agreements (FTAs)). Because of the importance of foreign direct investment (FDI) as a source of capital in these countries and the availability of PIIs, foreign investors play a particularly important role in this process. When PIIs are available, foreign investors, who would normally make political investments, will be less likely to do so. That is, one of the most important interest groups that would make political investments in favor of property rights enforcements no longer has an incentive to do so—and this could have a damaging impact on property rights enforcement for domestic investors. Thus, institutions are important determinants of property rights protection. Their importance stems not from their ability to directly affect credible commitments to property rights, however, but from the effect that they have over interest groups.

The primary implication of this process is clear: if the political investments of those opposed to reform plus the current benefits from a system of weak enforcement exceed the political investments of pro reformers plus the perceived overall economic benefits from reform, we are unlikely to see better property rights enforcement. What we need to understand are the mechanisms affecting the willingness and ability of interest groups to make political investments, and how those mechanisms interact. To evaluate how the effect of the interplay of each of these mechanisms on the enforcement of property rights, we must first define and understand each of the individual components: interest groups, political institutions, and PIIs.

[Figure 1 about here]

B. Political Investments and Preferences

In Figure 1, the most immediate determinant of the preferences of political actors is the political investments made to those actors. First, let us define political investments. Most commonly, they can be thought of as any contributions (monetary or non-monetary) made to political actors with the purpose of increasing the utility of the receiver. They include campaign contributions, political endorsements, contributions to local communities, and voter information (such as voters' preferences over and possible impacts of policies) or mobilization campaigns, among a host of other strategies. Political investments can be thought of as "lobbying," if the traditional definition of lobbying includes not just legal transfers of information and resources, but also the buying of influence and illicit transfers of resources. Political investments translate to support for the political actor to retain or gain power with the expectation that once in power, the political actor will then support the preferences of the interest group.

It could be that political actors' preferences over policies come from their own political positions—in other words, they are simply representing their own interests. For example, in the case of the glorious revolution in England, owners of government bonds directly controlled a veto point. The constitutionally limited government was able to bring about credible commitments to property rights because of their own interests in protecting property rights (Stasavage 2002). While this may be the case at times, more often veto points are controlled by political agents whose main objectives are to attain or maintain political office.

The political economy literature clearly demonstrates that the preferences of political actors are not determined through drives towards efficient economic and social outcomes, nor are they derived through a sense of right and wrong on the part of the actors. Governments and political actors maximize their utility through increased revenues or electoral success. Institutional change (in our case, establishing strong, well-enforced property rights) comes out of a government's ability to increase their utility through reform rather than maintaining the status quo (Riker and Sened 1991 Allio et al).

We can understand the necessary size and composition of these interest group coalitions in a similar way to the Bueno De Mesquita et al. (1999) institutional model of the democratic peace. In any polity, the selectorate is that group of citizens that participate in the selection of political leaders. The support (through political investments) of some subset of the selectorate—the winning coalition—is necessary for any political actor to attain or maintain office. Those interest groups that elect to make the requisite political investments (those that maximize the utility of the selected actor relative to other political investments) will have their interests represented. In the case of property rights, we must go beyond the selectorate as a domestic polity, and include outside interest groups with the ability and the willingness to make political investments for their cause (i.e. foreign investors). In other words, the preferences of political actors will mirror the subset of the selectorate that the actor believes to be the winning coalition. In addition to the political investments by interest groups, we must also understand the efficiency gains to the overall economy, political actors, and the average voter.

B. Interest Groups

A major challenge for this theory is to identify and to understand the motivations of the set of interest groups likely to have both the willingness and the ability to make political investments over property rights enforcement. The set of interest groups concerned with the enforcement of property rights in any country is vast. For example, consumers will favor the level of property rights enforcement that brings them the most economic gain; land holders care about better titling of their land so that they can expand and make capital improvements to their holdings; labor may see increased employment opportunities through better property rights that bring new investment projects. Yet if we are concerned with those groups that will make political investments to influence political actors preferences over property rights, the key is to understand which groups stand to gain or lose, and which are able or willing to organize over well-enforced property rights.

Business Elites

Most studies of the role of business in politics lump business elites into one catch-all category, usually encompassing powerful groups with strong ties to the political sector. While we could easily split the category "business elites" into hundreds of categories, it is useful, at the very least, to split them into two groups: *entrenched elites*, or those with long-standing ties to the business environment and *new elites*, whose power is often derived through economic reform. However, it is important to remember that not all entrenched elites have long-entrenched relationships with political agents, nor are *new* elites necessarily *new*.

Entrenched Elites

Entrenched elites are what we often think of when considering business elites, they are often family-led businesses that have built up their power over generations, they have long-standing ties to political elites (often with family members in power). Large and elite firms are less affected by poor property rights protection then smaller firms, and in most cases weak property rights enforcement gives elite firms an edge over smaller firms and potential entrants (Beck et al. 2005). When levels of property rights enforcement are low, entrenched elites are able to subvert the written legal institutions in their own favor. These elites tend to favor low enforcement of property rights laws to protect them from new entrants who are unable to compete against privileged firms in risky property rights environments. For entrenched elites, moves towards better enforcement are likely to equate to a loss of rents, privileges and greater competition (Glaeser et al. 2003; Sonin 2003).

New Elites

New elites tend not to have the long-standing ties to political elites of their entrenched counterparts. They are a large and growing force, especially throughout Latin America and Asia, where their political investments work mainly through networks and business associations that were formed to spur reform. They tend to be better- and often foreign-educated, making them more open to reform and to working with foreign investors. New elites benefit from continual market reform and property rights enforcement precisely because they lack the long-standing relationships with political actors that ensure entrenched elites of property rights protection.[5]

Small/Medium Domestic Investors (SMEs)

SMEs are the life blood of nearly all low- and middle-income economies. While data is often difficult to come by and varies widely by country, estimates generally claim that SMEs and informal sector activities in low- and middle-income countries account for 60 to 70 percent of GDP and over 40 percent of total employment (International Finance Corporation 2000; Frey 1989). SMEs have a great deal to gain from a reformed property rights system. Credible commitments to property rights provide collateral to potential investors for projects as well as greater incentives through reducing uncertainty and risk in the investment environment (World Bank 2005; North 1990; DeSoto 2000).[6] At the same time, SMEs may be opposed to property rights reform. Reform may bring greater competition to their industrial sector and, for many of the smallest firms, the benefits of formality do not outweigh the costs, with SMEs prefering to exist outside of the property rights system, regardless of the level of enforcement (Becker 1983) (ILO).[7]

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[5] New elites will not always be willing to make the political investments to secure better property rights enforcement. In many cases, they will be as opposed to reform as the entrenched elites. The most obvious case of new elites opposed to reform can be found in cases where economic reform creates “new winners”. This new group of elites benefits in the short term from initial reform to the overall economic system, but would lose out from overall reform to the system, including through strong, well-enforced property rights. These “new winners” in the former communist countries are a formidable interest group making political investments to retain the status quo of weak property rights enforcement, that helps these groups to retain their new, economically and politically strong status (Hellman 1998).

[6] Douglas North (1990) argues that inefficient property rights are “the most important source of both historical stagnation and contemporary underdevelopment in the Third World.” Hernando De Soto claims that property rights help people to borrow more easily and overcome the information constraints that enable markets to function efficiently.

[7] For example, Woodruff (1998) shows that institutional reform and trade liberalization in Mexico provided alternative sources for retail procurement of footwear, weakening the power of Mexican manufacturers over retailers.

Foreign Investors
In poor and high-risk environments, foreign direct investment (FDI) is one of the most important sources of investment funds and is seen as a primary means for increasing economic growth, making them powerful players within the domestic political sector. Foreign investors are, understandably, more willing to invest in countries with more stable property rights regimes. The uncertainty inherent in high-risk economies increases the cost of doing business and forces investors to insure against political and economic risk (Abbott 2000). Some MNCs may push for regulatory reform, but at the same time they may also seek to isolate themselves from the risk that other investors face and to obtain exclusive deals for themselves. While a foreign firm's investment decision is based primarily on the estimated return on the investment, firms actively try to influence the political environment to better suit the investment climate for the firm (Boddewyn 1988; Dunning 1980).

Overall
Thus, different types of investors have different goals. Entrenched business elites prefer to limit competition through keeping enforcement levels low for other investors, while emerging elites, while gaining power, may want to move towards a system of better connections. 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 through political investments for property rights, but will seek exceptions where enforcement is likely to remain low. The outcome in any country will first depend on the distribution of power between these groups, but at the same time will be a function of the feedback loops between the political institutional structure in the country, substitutes for property rights, and existing level of enforcement.

C. Distribution of Power

1. Institutional structure

Institutions are, quite obviously, endogenous to the study of institutional change. Path dependence as well as colonial and legal heritage certainly have some role in the current structure of any country's property rights system.[8] Party orientation and voter preferences[9] among a host of other institutional factors could affect the willingness and ability of interest groups to make political investments.

Democracy may indicate an increase in the number of veto players in the government. Veto players could create stability within the government, possibly improving investors' perceptions of property rights enforcement, but this would depend on the status quo environment of property rights enforcement in the country. That is, a country with a well-enforced property rights system would benefit from an increased number of veto players as this would lock-in the status quo of strong property rights enforcement. On the other hand, a country with a status quo of low property rights enforcement would not benefit from the stability of increasing numbers of veto players (Treisman 2000). India is a prime example of a democracy where the stability of checks and balances holds negative consequences for the property rights regimes. Bardhan (2000) maintains that in India, powerful groups use the democratic process to share the benefits of low enforcement of property rights among themselves.

Theory and evidence linking regime type to investor confidence is limited, but seems to point to a positive and direct correlation between democratic political regimes and investor confidence. More democratic societies provide more access to the political system and channels for constituents to voice concerns. Public policymaking is more exposed to a wider range of influences through more equal representation. Further, political actors 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 the status quo of low enforcement of property rights regulations (Li and Resnick 2003; Jensen 2003; Oneal 1994). As Milner and Kubota point out, democracy expands the size of the selectorate which could change its composition, and therefore, the preferred policies of the political actors.[10] For investor property rights protection, the concerned population in most countries is small, and it is likely to be even smaller in developing countries. Democracy is only likely to change the composition of the winning coalition within the selectorate when interest groups with the willingness and ability to join the selectorate become enfranchised.

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[8] Acemoglu et al. (2001) explain the quality of institutions (including property rights) in countries across the world with factors related to climate and other factors related to the mortality of settlers. La Porta et al.(1997; La Porta et al. 2000), and Beck et al. (2003) among others explain the quality of institutions with the colonial origins of the country.

[9] It is unlikely that individual voter preferences play a decisive role in political decision making over property rights enforcement for a variety of reasons. First, individual preferences can be easily manipulated by the concerned interest groups (Olson 1993). Moreover, popular interest in property rights is likely to be low, individual voters will almost never vote based on their preferences over property rights, and these popular preferences are likely to have little influence over policy decisions.

[10] (Milner and Kubota 2005)

Overall, therefore, democracy should not have a direct effect on investors' perceptions of property rights, but may have an indeterminate effect on the willingness and ability of investors' to make political investments. Therefore, I propose that the willingness and ability of interest groups to make political investments over property rights enforcement will be conditionally related to the level of democracy in the country, but this will differ depending on the type of investor, and as we see below, on the distribution of power between interest groups and on the availability of substitutes for property rights.

Interest Groups and Political Institutions

With an understanding of the role of political institutions in shaping preferences, we can return to our interest groups to better understand the interplay of these institutions with various interest groups. Regime type may work to directly impact the actions of actors (hence the dotted line in figure 1), but it is more likely to affect the actions of actors through its effect on the willingness and ability of interest groups to make political investments. If democracy equates to an expansion of the selectorate, then newly enfranchised interest groups may gain the ability to make political investments, thereby changing the preferences and the ensuing actions of political actors. Yet even with newly enfranchised groups, certain interest groups will remain unable or unwilling to make the necessary political investments to bring about better enforcement of their property rights.

SMEs are a large and unwieldy group that is not even well-defined ex ante when laws are inadequate and poorly enforced. The collective action costs for those suffering under inefficient systems might be too great to overcome, reducing pressure on the government for reform. Additionally, it is likely that a majority of potential investors and workers do not know or understand the potential gains from property rights reform and prefer to work under the status quo. The implication, therefore, is that democracy is unlikely to impact SMEs perceptions of property rights enforcement. That is, those groups without the willingness and/or ability to make political investments or who wish to remain outside of the formal system of property rights may not perceive differences in the property rights environment based on the political institutions of their country.

Emerging elites on the other hand work within the formal environment and usually have much to gain from property rights reform. Democracy may create opportunities within the political system for political investments towards better property rights environments. On the other hand, if emerging elites become early winners from reform they may make investments towards maintaining a system where they gain from a stagnant property rights environment. If emerging elites gain enough strength, political investments over property rights may be possible regardless of the type of government in power.

Business elites who favor maintaining the status quo of weak property rights enforcement may be the strongest political coalition, have the greatest ease of forming coalitions, and have strong holds over government leaders. In a number of cases political leaders own or have family members in the leading business groups as was the case in Indonesia under Suharto and pre-Sandinista Nicaragua (2000). Not only is it easier for elite business groups to make political investments based on their connections and resources but they are able to maintain these connections and resources through established contracts with political actors. Democracy and the enfranchisement of groups in favor of property rights reform may lead to an erosion of their privileges. Business elites will be better able to maintain their system of privileges under an autocratic regime where less powerful groups will have little ability to influence political actors. But even under democratic political systems, the existing advantages of business elites facilitate their ability to maintain their privileges through political investments.

Although *MNCs* may not have the usual political tool of the voting booth, they have influence over political actors in a number of respects. Because foreign investors are by their nature more mobile than domestic investors, fear of exit of an important financial resource makes political actors attentive to the interests of foreign investors[11]. Additionally, and perhaps more importantly, foreign investors can influence political actors directly through political investments such as campaign contributions, and transfers meant to directly influence the policy stance of political actors. Finally, large foreign investors often have free access to elite political actors when their firm represents a sizeable increase or share of overall investment in a country.

For foreign investors, unsure of the true situation within the country, democracy plays a different role. Several scholars argue that democratic institutions provide better property rights protection, policy stability, and lower political risks and, are therefore, more attractive environments to foreign investors (Jensen 2006; World Bank 2005). Investors look favorably on stability more than the actual institutional structure, but all else equal, profit margins far outweigh the political structure of the country in the decision to invest for foreign investors (Li and Resnick 2003; Keefer 1999). Thus, we would expect that ceteris paribus, foreign investors will prefer to invest in countries that have more democratic institutional structures, but again, the effect of democracy on foreign investors' perceptions of property rights will depend on the existence of substitutes for property rights for foreign investors.

Democracy may equate to greater access to the political system for previously alienated interest groups. Nevertheless, access to the political system will only equate to increased enforcement of property rights if those previously isolated groups gain the willingness and ability to make political investments to effect change. Both emerging elites and SMEs may gain the ability to make political investments under more democratic regimes. Their willingness to make political investments will depend on the characteristics of their group and the strength of other interest groups. Both groups should have better perceptions of the property rights environment under more democratic regimes, but this relationship will be contingent on the relative power of interest groups in the economy. Foreign investors and large business elites are more effective at overcoming collective action problems and, therefore, better able to make political investments vital to gaining their preferred level of property rights enforcement regardless of the institutional environment. Entrenched elites are more likely to have better perceptions of the property rights environment under more autocratic regimes, but their ability to maintain their privileged position under more democratic regimes will inform their preferences under

[11] A large literature examines the possibility of a race to the bottom in terms of factors that might influence a foreign investors' decision to enter or exit a country in favor of a competing country with more favorable tax, labor and other regulatory policies. Although no definitive proof exists of this "race to the bottom", countries actively change these policies in order to attract or retain these mobile factors of production.

democracies. Foreign investors are more likely to prefer the policy stability of more democratic regimes and are likely to be strong advocates for property rights reform regardless of the distribution of power between the remaining interest groups in a country. Their presence as a major force in political investments is likely to move any configuration of interest groups towards better overall protections of property rights enforcement. I turn now to an important factor that may alter the willingness and ability of foreign investors to make political investments for property rights reform, the availability of substitutes for property rights

2. Substitutes for Property Rights

A relatively new factor affecting the international investment environment, privatized investment incentives, are likely to have a significant impact on the distribution of power among investors. At the most basic level, PIIs offer a secure property rights environment to foreign investors, separate from that available to domestic investors. Under this separate and relatively secure property rights environment, foreign investors no longer have an incentive to offer political investments to political actors to secure the overall property rights environment for all investors. Without foreign investors offering political investments, the set of interest groups concerned with overall property rights enforcement is concentrated among SMEs and potential new elites A closer look at PIIs will illustrate their importance for foreign investors decisions over political investments and the overall domestic property rights environment.

Privatized Investment Incentives (PIIs)

The long, difficult, and expensive process of creating stable institutions has led many low- and middle-income governments to embrace an alternative method of attracting FDI which I call "privatized investment incentives."   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 Bilateral Investment Treaties (BITs) and the investment chapters of free trade agreements (FTAs)).

It may seem odd to claim that international legal agreements signed by sovereign nations or contractual obligations made by governments are designed to "privatize" the institutional environment. Yet this is just what some of their provisions do. International investment treaties and many contractual agreements provide for resolution of investor-host country disputes in international arbitration tribunals (such as the International Court for the Settlement of Investment Disputes (ICSID)) rather than within the judicial system of the host country. ICSID gives investors access to an arbitration process that cannot be refused by the host country and requires the host country to enforce the judgment of the tribunal as if it were a domestic judgment. Investor-state contracts stabilize taxes and investment policies so that general policy changes to the investment environment do not affect contracting investors.

International Investment Agreements (IIAs)

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 FTAs 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 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 PIIs may serve as commitment devices. The public nature of most PIIs, and BITs in particular 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 PIIs 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. 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 PIIs, 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 PII (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).

At first glance, PIIs 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 PIIs are likely to affect MNCs 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 PIIs, 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 privatized investment incentives (PIIs), they will no longer be willing to make political investments to gain stronger property rights enforcement overall. With the advent of PIIs, 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—PIIs 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.

D. Observable implications

The extant literature on political institutions and property rights enforcement reviewed earlier comes to conflicting conclusions on their relationship. The theory in this paper concludes that there is no direct link between institutions and property rights. Instead, institutions interact with the distribution of power among interest groups to affect the willingness and ability of those interest groups to make political investments. In turn, it is these political investments that have a direct effect on the level of property rights enforcement in a country.

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. Empirical Tests

The theoretical discussion leads to a set of hypotheses about the links between institutions, the distribution of power and property rights enforcement. Empirically, we lack the data to test the entire causal chain. However, we are able to test a series of direct and indirect relationships between institutions and substitutes for property rights on the one hand and property rights enforcement on the other. By testing the interior steps in the model through a series of interactions, rather than testing each link, I show that an indirect relationship does indeed exist between institutions and property rights. Further, I show that this relationship is contingent on the interest groups in the country as well as the availability of substitutes for property rights.

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. If we return to the definition of property rights from earlier in the paper, that is— 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 the economies that I study here.

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), a vector of country-level characteristics (S), and some random error (v). Each of the variables is indexed by country (c) and firm (i).

Initially I estimated Equations (1) using ordinary least squares (OLS). However, both the country-level economic characteristics may be endogenously determined. We may, for example, expect that in countries with higher levels of income and growth, investors have stronger perceptions of the property rights environment.[12] I therefore re-estimate the model using Instrumental Variables, Two-Staged Least Squares (IV2SLS), using separate models of growth and GDP for first-stage estimates for Equation (1). An ideal instrument would be highly correlated with the economic characteristics of a country, but uncorrelated with the average perception of property rights in that country. While most common instruments for GDP would not be suitable due to their high correlation with property rights measures, indicators of human development, the level of foreign demand for each country's exports and any supply side shocks are unlikely to correspond to investor's perceptions of property rights. I therefore use *Foreign Demand*,[13] *Oil Import Price*,[14] and the *Human Development Index* purged of its economic component as instruments for GDP and growth. The human development index purged of its economic component consists of measures of health and education. Countries with high levels of education and health tend to have higher income levels, though not necessarily higher rates of growth. On the other hand, a high level of foreign demand for a country's exports would likely indicate higher growth and income for that year. Similarly, oil import prices meant as a proxy for any supply side shocks would be likely to correlate highly with both income and growth. Each variable correlates with GDP and growth well above 0.5 and with property rights below 0.12. Theoretically and statistically, all three measures seem to serve as strong instruments for GDP and growth in the regression.

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:"

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[12] Similarly, we might expect that in countries with higher numbers of BITs, investors would have better perceptions of the property rights environment. While this is likely to be the case with foreign investors (those covered by BITs), nearly 80 percent of the data set is domestic investors without access to the property improving regimes of BITs. Therefore, it is unlikely that BITs are endogenously determined in this specification.

[13] Foreign Demand is calculated by averaging GDP across all nations for each year, but excluding nation *n*, and then weighting this number by the share of exports in GDP for nation *n*.

[14] Oil Import Price is measured by the nominal price of oil in local currency divided by the corresponding nation's GDP deflator

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 the log 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.[15]

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.

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.

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

Country-Level Characteristics (G)
Because country-level fixed effects would be too highly correlated with the number of BITs in each country, I control for country effects as best as possible 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.

Beyond these country-level characteristics that affect investors' perceptions, there is reason to believe that there is country-level heterogeneity that determines why some countries enter into BITs while others do not. While the nature of the data does not allow us to use fixed effects to account for this heterogeneity, I take two steps to alleviate some of the issues. First, the most likely reason for entering into BITs is to address poor property rights environments. 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*.[16] Second, I cluster the standard errors by country to adjust for intragroup correlation

Finally, I eliminated all countries designated as high-income according to the World Bank's income classification system from the dataset.[17] 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.

<<Insert Table 4 Here>>

[16] To deal with the possibility of path dependence, I lagged growth from 1 to 5 years before the survey. None of these estimations was significantly different than the final estimation.
[17] For income classifications see: http://www.worldbank.org/data/countryclass/classgroups.htm

Table 4 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 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:

$$y_{ic} = \beta_0 + \beta_1 \mathbf{b}_c + \beta_2 \mathbf{d}_c + \beta_3 \mathbf{G}_c + \beta_4 \mathbf{F}_{i,c} + \beta_5 \mathbf{S}_c + \beta_6 (\mathbf{g\_size}_{i,c} * b_c) + \beta_7 (\mathbf{g\_foreign}_{i,c} * b_c) + v_{i,c} \quad (2)$$

Equation (2) 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 4 presents the results for equation (2). 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 (2); 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 4. 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 (2) accounting for the possibility of this three-way interaction:

$$\begin{aligned} y_{ic} = {} & \beta_0 + \beta_1 \mathbf{b}_c + \beta_2 \mathbf{d}_c + \beta_3 \mathbf{G}_c + \beta_4 \mathbf{F}_{i,c} + \beta_5 \mathbf{S}_c + \\ & \beta_6 (\mathbf{g\_size}_{i,c} * b_c) + \beta_7 (\mathbf{g\_foreign}_{i,c} * b_c) + \\ & \beta_8 (\mathbf{g\_size}_{i,c} * \mathbf{b}_c * \mathbf{d}_c) + \beta_9 (\mathbf{g\_foreign}_{i,c} * \mathbf{b}_c * \mathbf{d}_c) + v_{i,c} \end{aligned} \tag{3}$$

Equation (3) is identical to Equations (1) and (2), but contains three-way interactions between firm characteristics, institutions and BITs to enable us to analyze this contingent relationship.

Column (3) of table 4 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 4 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.

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 4

Dependent Variable: Property Rights Perceptions

	Equation 1	**Equation 2**	**Equation 3**
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)
R-square	0.14	0.25	0.26
N	7891	7891	7891
J-Statistic			

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

Figure 1

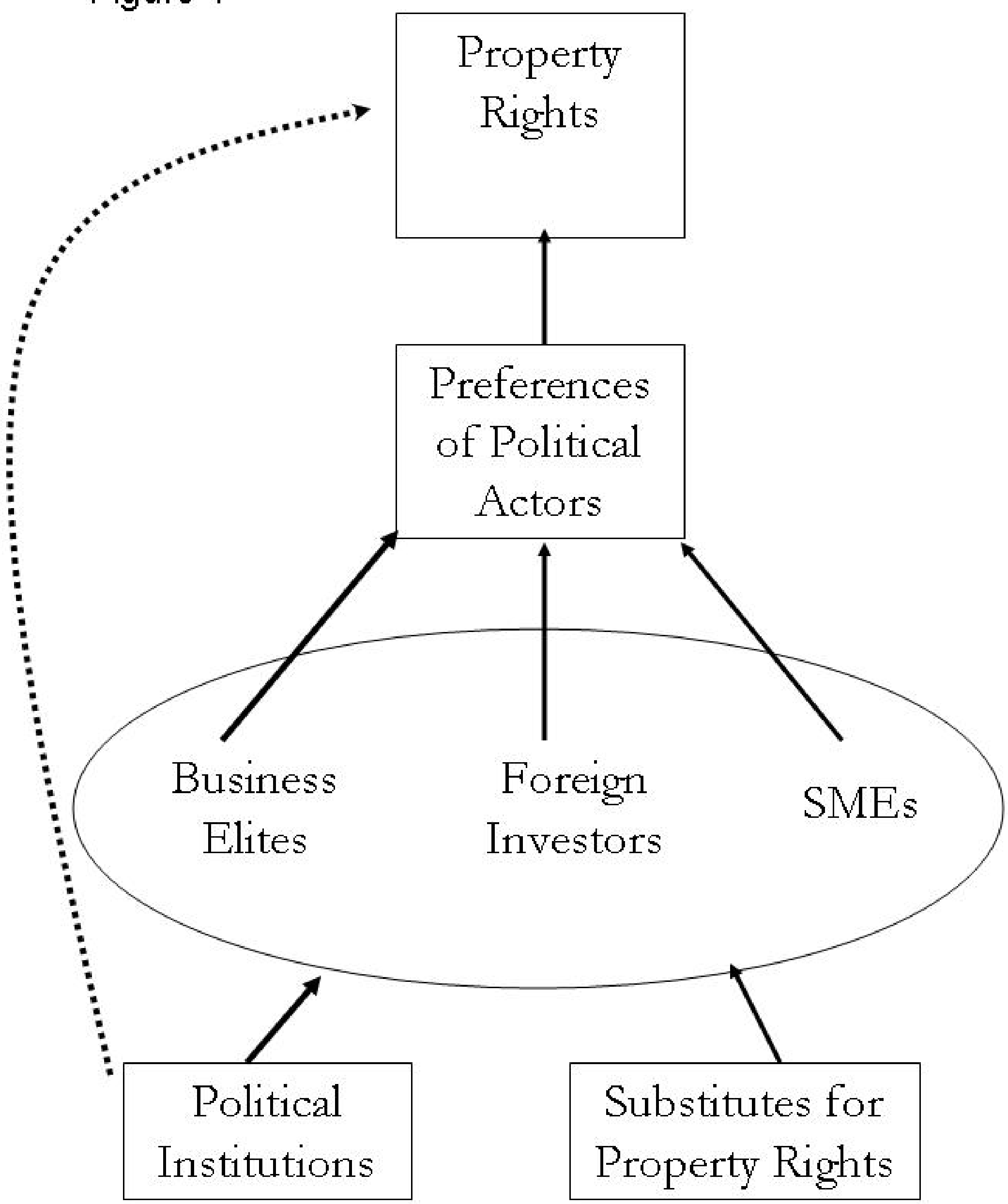

Property Rights
Preferences of Political Actors
Business Elites
Foreign Investors
SMEs
Political Institutions
Substitutes for Property Rights

Figure 2

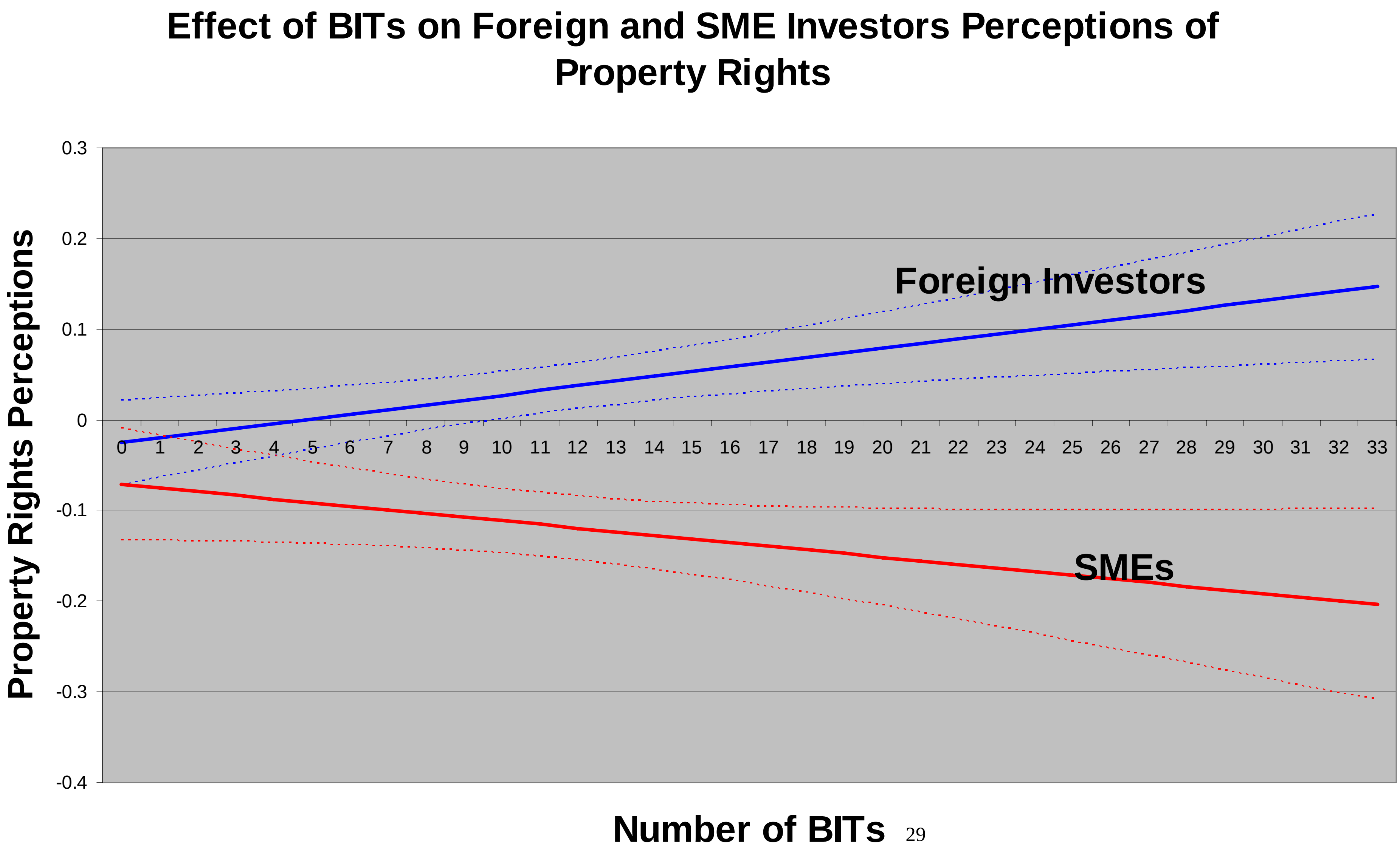

Effect of BITs on Foreign and SME Investors Perceptions of Property Rights
Property Rights Perceptions
0.3
0.2
0.1
0
-0.1
-0.2
-0.3
-0.4
0 1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30 31 32 33
Foreign Investors
SMEs
Number of BITs

Figure 3

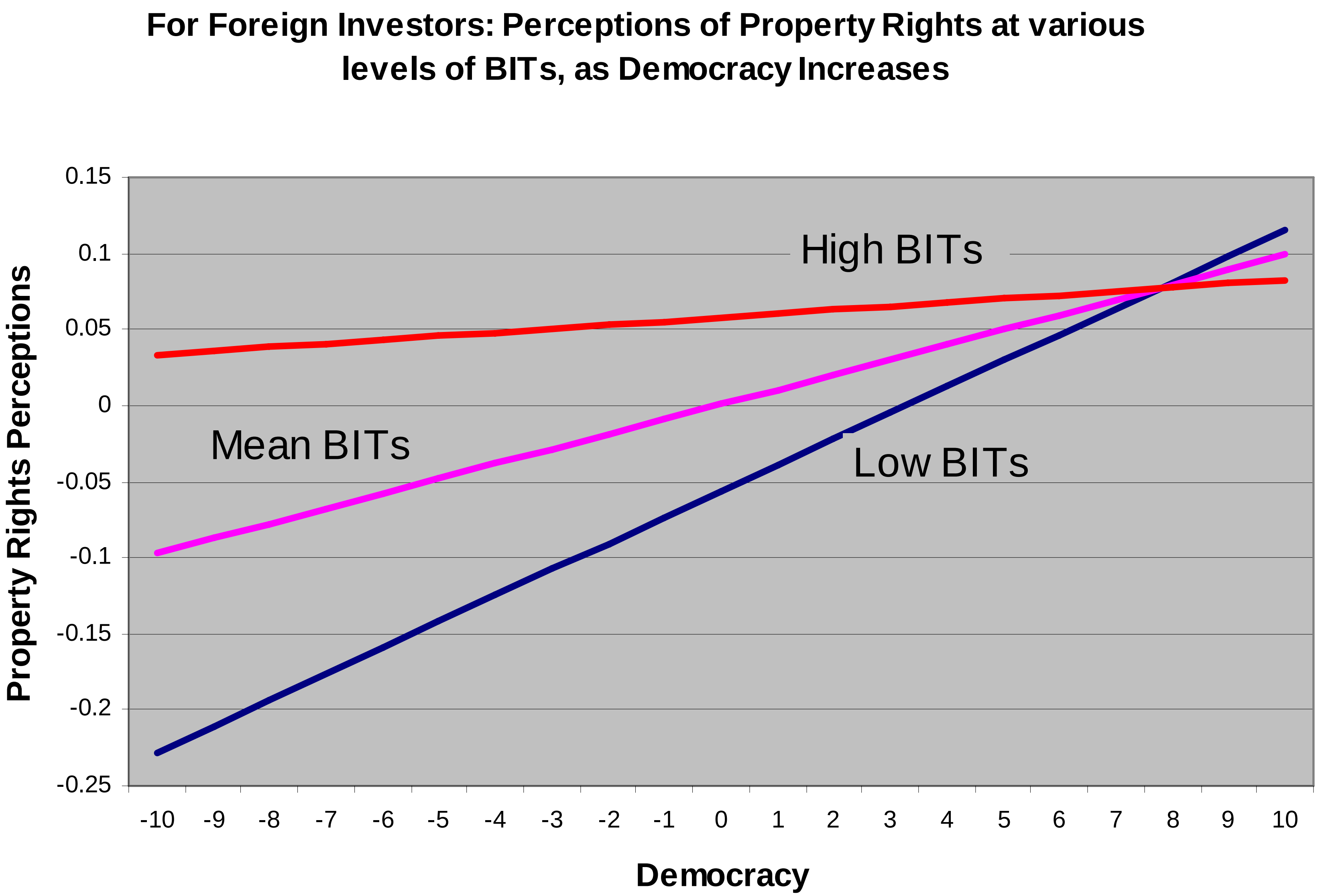

For Foreign Investors: Perceptions of Property Rights at various levels of BITs, as Democracy Increases
0.15
0.1
0.05
0
-0.05
-0.1
-0.15
-0.2
-0.25
Property Rights Perceptions
High BITs
Mean BITs
Low BITs
-10
-9
-8
-7
-6
-5
-4
-3
-2
-1
0
1
2
3
4
5
6
7
8
9
10
Democracy

Figure 4

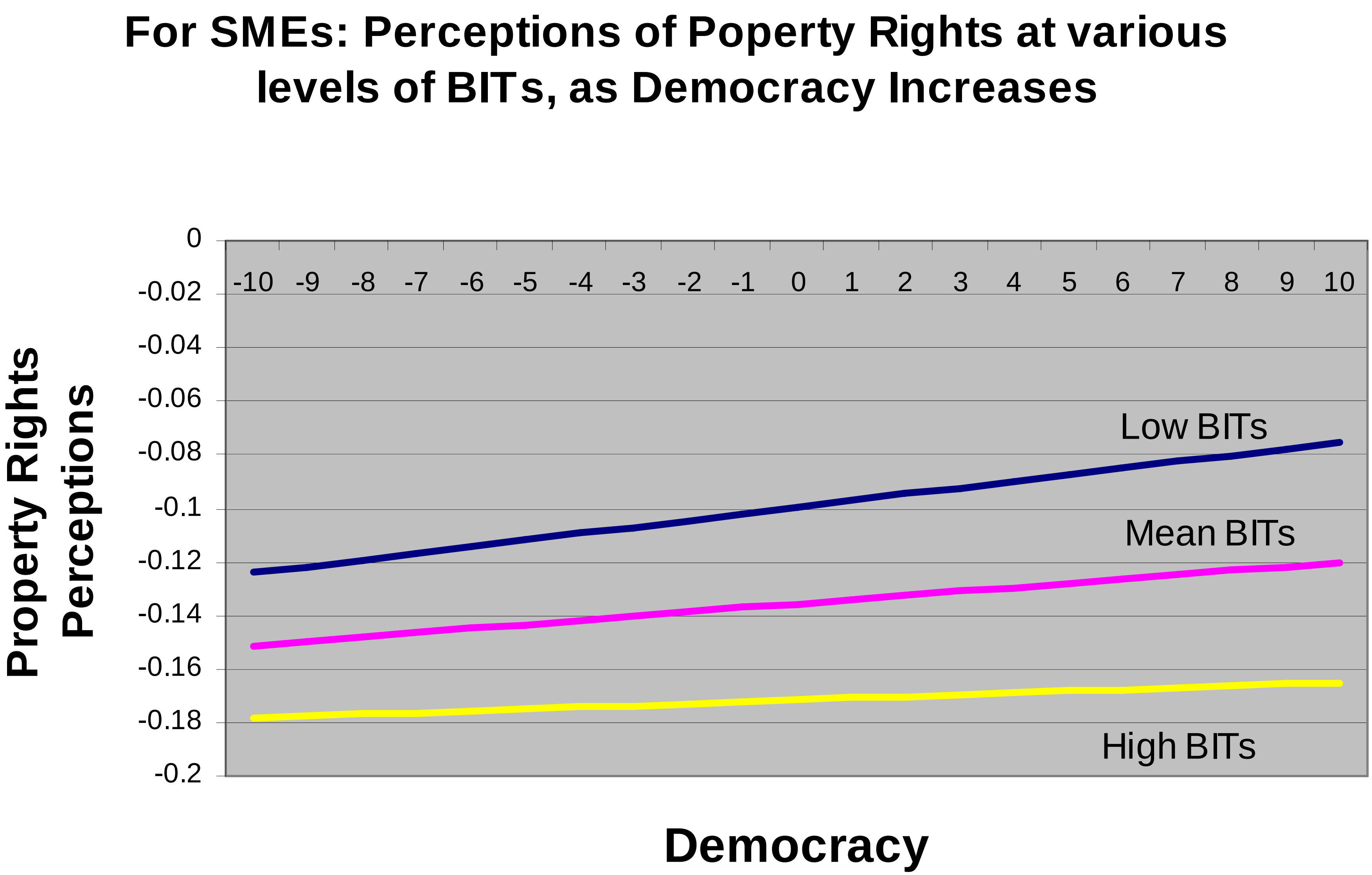

For SMEs: Perceptions of Poperty Rights at various levels of BITs, as Democracy Increases
0
-0.02
-0.04
-0.06
-0.08
-0.1
-0.12
-0.14
-0.16
-0.18
-0.2
-10 -9 -8 -7 -6 -5 -4 -3 -2 -1 0 1 2 3 4 5 6 7 8 9 10
Low BITs
Mean BITs
High BITs
Property Rights Perceptions
Democracy

Figure 5

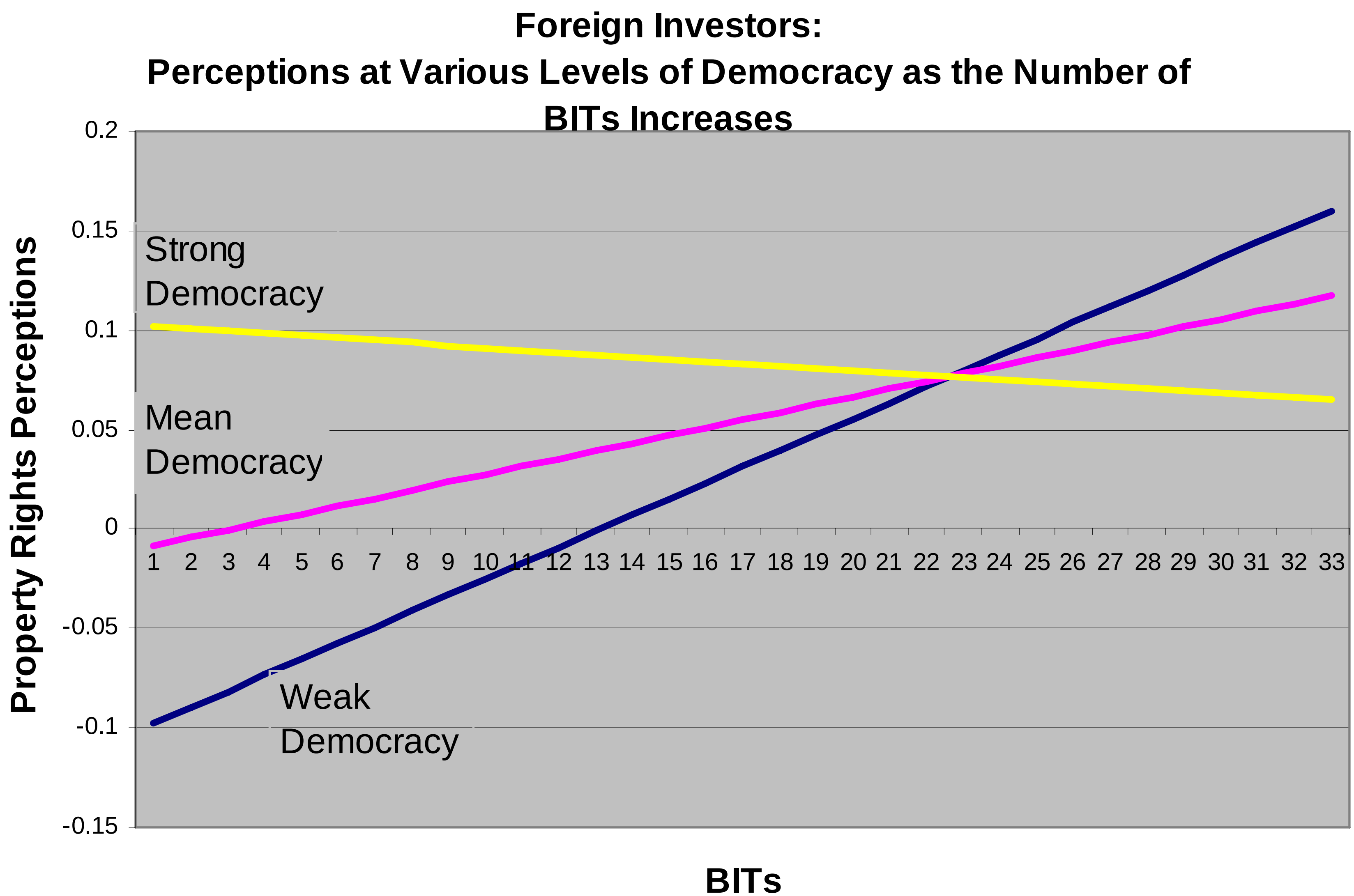

Foreign Investors:
Perceptions at Various Levels of Democracy as the Number of BITs Increases
Property Rights Perceptions
0.2
0.15
0.1
0.05
0
-0.05
-0.1
-0.15
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30 31 32 33
BITs
Strong Democracy
Mean Democracy
Weak Democracy

Figure 6

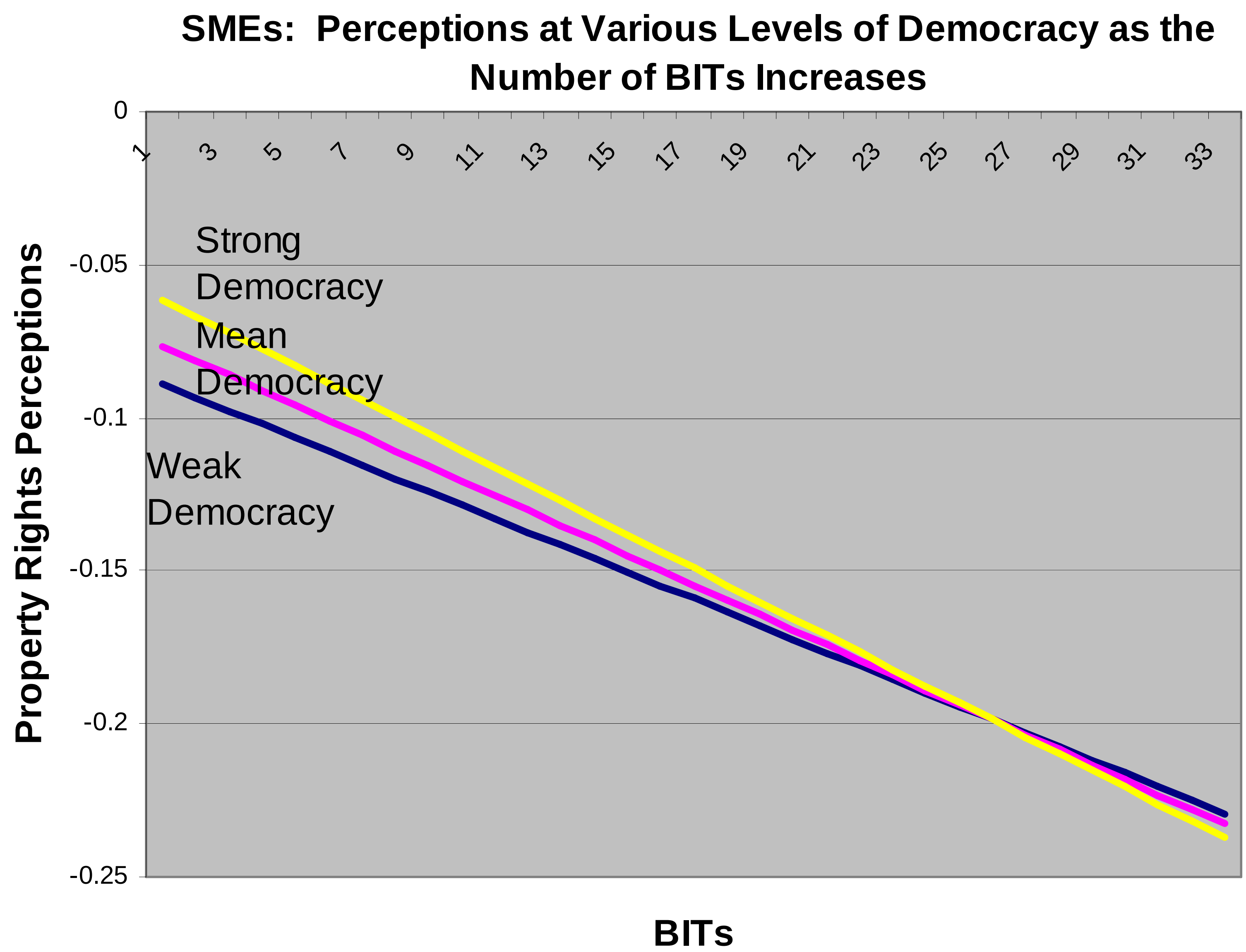
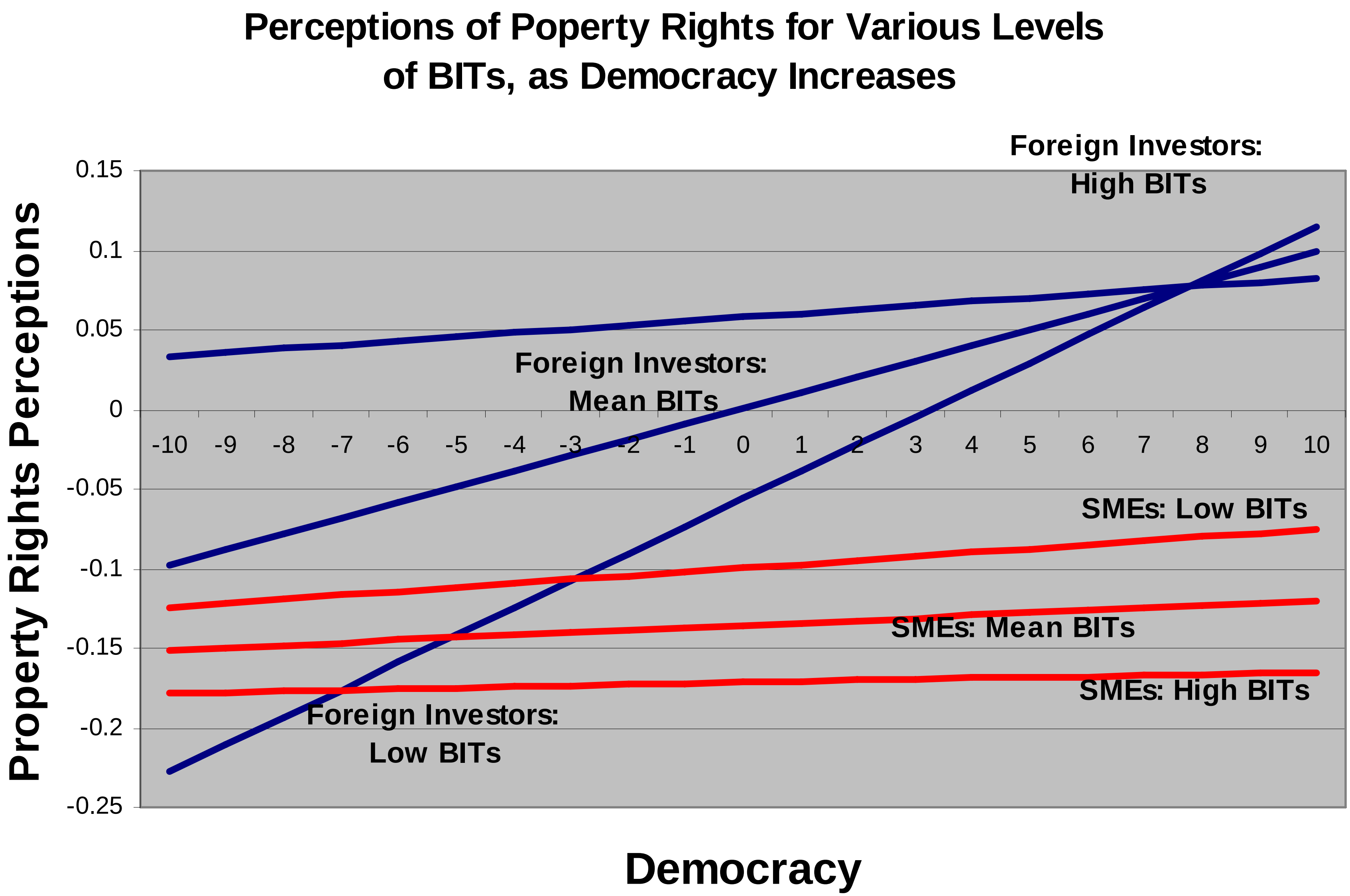

SMEs: Perceptions at Various Levels of Democracy as the Number of BITs Increases
0
-0.05
-0.1
-0.15
-0.2
-0.25
1
3
5
7
9
11
13
15
17
19
21
23
25
27
29
31
33
Strong Democracy
Mean Democracy
Weak Democracy
Property Rights Perceptions
BITs

Figure 7



Perceptions of Poperty Rights for Various Levels
of BITs, as Democracy Increases
Foreign Investors:
High BITs
Foreign Investors:
Mean BITs
SMEs: Low BITs
SMEs: Mean BITs
SMEs: High BITs
Foreign Investors:
Low BITs
0.15
0.1
0.05
0
-0.05
-0.1
-0.15
-0.2
-0.25
-10 -9 -8 -7 -6 -5 -4 -3 -2 -1 0 1 2 3 4 5 6 7 8 9 10
Property Rights Perceptions
Democracy

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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