BITs and Institutional Quality

Bilateral Investment Treaties are designed to increase investment flows to the signatory states. Section 4.2.1, reviewing the empirical evidence regarding BITs, revealed that some studies have found robust evidence that BITs indeed have a positive impact on investment flows. In addition, BITs might not only fulfil their stated purpose of attracting FDI but may also have external effects on domestic institutional quality. These external effects have been suggested to be either of a positive or negative nature. As the importance of institutional quality on economic growth has been emphasised by a number of authors, the question of an interaction between BITs and domestic institutional quality is of high relevance. This chapter addresses the question of the interplay between BITs and institutional quality using panel data in a fixed effects model. Specifically, we run regressions using the World Governance Indicators as the dependent variable over the time period 1996 to 2007 for non-OECD countries. The number of BITs and changes in domestic regulation in the field of investment are utilised as independent variables. The analysis further controls for GDP per capita, FDI inflows, trade openness, development aid and membership of the ICSID convention.

The chapter will proceed as follows: Section 6.1 introduces the competing theories, explaining why one might expect BITs to have a negative or positive impact on domestic institutions. Section 6.2 describes the model and the data that are used to test this impact and displays the results. Section 6.3 presents potential problems with regard to the results of the regressions. Section 6.4 discusses the results and presents a conclusion.

6.1 The Effect of BITs on Institutional Quality

6.1.1 Some Theory

What are the benefits of Bilateral Investment Treaties? The stated purpose of BITs is the "encouragement and reciprocal protection of investment." A number of empirical studies suggest that BITs accomplish this purpose. While FDI is, by now, generally associated with positive effects on economic development, it has been suggested that BITs might be detrimental to the welfare of developing countries who

---

466 See, e.g., Rodrik, Subramanian et al. (2004).
467 See, e.g., the US Model BIT or the German Model BIT.
468 See section 4.2.1.
find themselves in a prisoner's dilemma situation. This point was discussed in the previous chapter. The argument was that individually, developing countries can attract additional investment through the conclusion of a BIT. However, this investment constitutes merely a diversion from one developing country to another. As a group, developing countries would be better off without any BITs. This argument falls into the discussion of the problems and merits of institutional competition. Chapter 5 also pointed out that it has been suggested that FDI as such may have a negative or positive impact on certain government policies in the sense of a race to the bottom or a race to the top, e.g., in the area of tax policy. The preceding chapter tried to answer whether BITs support the negative or the positive aspects of institutional competition.

This chapter deals with a different, yet closely related issue, namely the specific impact of BITs on institutional quality. The analysis goes beyond the question of whether BITs can have immediate effects like a regulatory chill or the prevention of discriminatory government behaviour, but rather asks what effects BITs may have on institutional quality in general. Certainly, in the discussion presented below on the interplay between BITs and domestic institutions, arguments related to the theory of institutional competition will also play a role. However, the primary thrust of this chapter is a general and fundamental discussion on the causes of the quality of institutions. The BITs are in this context not analysed as being a direct manifestation of institutional competition, but rather as exerting a (mainly unintended) external effect on institutional quality.

The idea that the effect of BITs on institutional quality may be negative was first put forward by Daniels (2004). The author argues that the BIT "has systematically diverted the interests of potentially influential foreign investors from demanding the creation of good generalised laws and legal institutions, and has further encouraged them to enter into long term arrangements that impair the state's capacity to regulate effectively in the public interest and which further increase the risk of corruption and abuse." The argument rests on two pillars. The first relates to the well known importance of exit and voice in the political process as put forward by Hirschman (1970). Daniels asserts that in "Hirschmann's terms, the BIT enclave enables foreign investors to exit from domestic legal regimes and this, in turn, implies a withdrawal of their voice from the domestic debate over the need for, and character of, good laws.

---

470 See Basinger and Hallerberg (2004) and the literature mentioned therein. The authors themselves develop a model that implies that a race to the bottom will in many specifications not occur. See also Sinn (2003).
471 While the article of Daniels (2004) is only a working paper, it has been noticed and cited by other authors in the field. See, e.g., Franck (2007) and Dammann and Hansmann (2008).