EFFECTIVE LEGAL SYSTEMS AND FOREIGN DIRECT INVESTMENT: IN SEARCH OF THE EVIDENCE

AMANDA PERRY*

WHAT do we know about the role of legal systems as determinants of the location of foreign direct investment (FDI)? The short answer to this question is: not enough.[1] In recent decades, most governments have come to believe that FDI is an important source of the capital and technology necessary for economic development, and to seek new ways to induce foreign investors to locate within their jurisdiction.[2] Commentators and development agencies regularly argue or imply that FDI flows are to some extent determined by the effectiveness of the host State's legal system.[3] That is, it is suggested that the manner in which laws are implemented in a State can act as a deterrent or an attraction to potential foreign investors.[4]

There are well developed theoretical arguments why the effectiveness of legal systems should be a determinant of FDI (Part I). However, there is little empirical evidence to suggest that such a relationship actually exists; and there are existing theoretical arguments, including the concept of bounded rationality and the importance of informal business relationships, why any such relationship will be limited (Part II). In addition, there is good reason to expect that investors with different characteristics, such as size of nationality, will have varying degrees of sensitivity to the effectiveness of legal systems—a possibility which has generally been

* Lecturer, Department of Law, QMW, University of London, a.j.perry@qmw.ac.uk.
Thanks for assistance from Peter Muchlinski, Sol Picciotto and Amazu Asouzo.

1. Most fields of inquiry could benefit from more evidence. However, the immense implications (financial and moral) of lack of evidence in the field of development assistance was made clear by the former chief economist of the World Bank in a recent article on the IMF and the Asian Financial Crisis: "if we believed our policies were helping East Asia, where was the evidence? As a participant in these debates, I got to see the evidence. There was none." Stiglitz, "What I learned at the world economic crisis", *The New Republic* (April 2000) http://www.thenewrepublic.com/041700/stiglitz041700.html

2. See Stopford and Strange, *Rival States, Rival Firms Competition for World Market Shares* (1995); UNCTAD, *World Investment Report 1995: Trends and Determinants* (1995); UNCTAD, *World Investment Report 1998: Trends and Determinants* (1998); UNCTC, *The Determinants of Foreign Direct Investment: A Survey of the Evidence* (1992a) and *Formulation and Implementation of Foreign Investment Policies* (1992b); Meier, *Leading Issues in Economic Development* (1995), pp.247–251; and Todaro, *Economics for a Developing World* (1992), pp.397–400.

3. The term "legal system" is used here to describe all the institutions, including courts and bureaucracies, through which laws are implemented. It is not intended to refer to the content of those laws.

4. The role of legal systems as a determinant of portfolio investment is not addressed in this article.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

ignored by commentators (Part III). This article concludes that if legal reform aimed at attracting FDI is to be efficient and effective, then further research must be conducted into the existence and nature of any relationship between the effectiveness of legal systems and FDI flows (Part IV).

Throughout the article, reference is made to a study of the role of the Sri Lankan legal system as a determinant of FDI, conducted by the author ("the Sri Lanka study"). The Sri Lanka study was undertaken in 1997–1998 using 67 responses to a postal survey of foreign investors in commercial operation in Sri Lanka (Sri Lanka study survey),[5] and 35 semi-structured interviews with the wider Sri Lankan community (Sri Lanka study interviews).[6] Given its limited size and geographical scope, this study is used primarily to demonstrate the need to question the dominant theory relating to the role of legal systems as a determinant of FDI, and to suggest the routes which further research in this area could take.

I. LEGAL REFORM AND FDI

IN recent decades, the World Bank has led a resurgence of interest in the relationship between law and development. Regional development banks, such as the Asian Development Bank, and bilateral and multilateral aid organisations such as the Organisation for Economic Co-operation and Development (OECD) and the U.K. Department for International Development (DFID) are firmly committed, at least at a policy level, to the provision of funding and technical assistance for legal

5. In 1998, questionnaires were sent to the CEOs of each of the 402 companies in Sri Lanka which are offered extra incentives by the government because they are either export oriented, or are operating in a priority sector of the economy. Respondents were asked to describe their perceptions of the Sri Lankan legal system; to indicate whether they had made a pre-investment investigation of the legal system, had been surprised by the legal system, and would invest in hindsight of the legal system; and to indicate the impact (good, bad, variable or none) which they expected an "ineffective" legal system to have upon the value of their investment. Sixty seven usable questionnaires were returned. These are the (partially self-selecting) respondents upon which the Sri Lanka survey results reported in this article are based.

6. In 1997, the author conducted 35 semi-structured interviews in Sri Lanka with local and foreign business people, non-legal advisers, lawyers, NGO workers, diplomats, development workers and government officials. Interviewees were asked to comment upon issues surrounding the effectiveness of the Sri Lankan legal system, and the sensitivity of foreign investors to the legal system.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

reform programmes.[7] Like this article, development agencies understand the legal system to include all institutions and officials who are involved in creation and implementation of law, including courts and judges; bureaucrats; and politicians, in their capacity as makers and implementers of law.

With regard to the promotion of FDI in particular, commentators and development agencies argue that "as important as what rules say . . . is what they mean in practice. A pristine statute on investment that is unknown, unadministered and unenforced is ineffective."[8] For example, DfID proposed in 1997 that it should help developing countries to implement the "right domestic policies and conditions" such as "political stability, transparent and accountable government and the prevention of corruption," which "are crucial in order to attract and retain both foreign and domestic investment".[9] One commentator argued that Sri Lanka's failure to attract FDI "can only be explained" by the "relative conduciveness (*sic*) of the investment climate," which is made unattractive by a lack of certainty, transparency and stability.[10] Similarly, the former general counsel of the World Bank argued in 1995 that "a legal and regulatory framework . . . is a fundamental element in the stability and flexibility needed for the investment environment;"[11] the 1997 World Development Report concludes that perhaps the worst damage that a State can do to its prospects of investment is to cultivate an air of uncertainty;[12] and the Foreign Investment Advisory Service (FIAS) of the World Bank Group argues that ineffective legal systems "increase the withdrawal of investors who may have made a preliminary decision to commit to a country".[13]

7. Tshuma, "The Political Economy of the World Bank's Legal Framework for Economic Development" (1999) 8:1 *Social and Legal Studies* 75, p.76. See also Wälde and Gunderson, "Legislative Reform in Transition Economies: Western Transplants—A Short Cut to Social Market Economy Status?" (1994) 43 I.C.L.Q. 347; Webb, "Legal System Reform and Private Sector Development in Developing Countries" in Pritchard (Ed.), *Economic Development, Foreign Investment and the Law* (1996); World Bank Legal Department, *The World Bank and Technical Legal Assistance: Initial Lessons*, Policy Research Working Paper No. 1414 (1995); and World Bank, *World Development Report 1996: From Plan to Market* (1996) and *World Development Report 1997: The Role of the State in a Changing World* (1997).

8. European Bank for Reconstruction and Development, *Transition Report* (1996), p.101.

9. Department for International Development, *Eliminating World Poverty: A Challenge for the 21st Century*, White Paper on International Development Presented to Parliament by the Secretary of State for International Development, November 1997, para. 3.27.

10. Athukorala, "Foreign Direct Investment and Manufacturing for Export in a New Exporting Country: The Case of Sri Lanka" (1995) 18:4 *The World Economy*, 543, pp.544–548.

11. Shihata, *World Bank in a Changing World* (1995), p.234.

12. World Bank (1997), *op. cit. supra* n.7, at p.43.

13. Foreign Investment Advisory Service (FIAS), *Administrative Barriers* at http://www.fias.net/services/barriers.htm on 31 August 1999.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

Many States now seek assistance from development agencies to reform their legal systems with a view to attracting FDI.[14] This assistance is based upon the argument that investors are attracted to States which have effective legal systems; that an effective legal system is one which implements laws efficiently and predictably; and that reform of an inefficient and unpredictable (i.e. ineffective) legal system can help a State to attract FDI. At the root of this argument is the micro-level transaction costs analysis favoured by neo-institutional economics.

The argument that the effectiveness of a legal system can affect FDI flows appears to be based on the assumption that economic actors both *should* and *do* structure their activities in order to reduce transaction costs.[15] In theory, the role of laws and legal systems is to reduce those search and information, bargaining and enforcement costs associated with undertaking any transaction. However, legal systems are often unsuccessful in this regard.[16] Not only do legal systems fail to reduce transaction costs which exist in the market, but they themselves tend to impose additional transactions costs on economic actors.

First, transaction costs are said to arise through the inefficient enforcement of laws—for example, if court procedures are subject to delays, or bribes are required to lubricate bureaucratic decision-making. Followers of neo-institutional economics (including development agencies), argue that *efficiency* is best achieved where a State's laws are of good quality—that is modern;[17] and its courts and bureaucracies are

14. See the work of the FIAS which, for example, assisted Sri Lanka "in the development of a new institutional and procedural framework to attract foreign direct investment," and "in the preparation of an investment policy and institutional framework for foreign direct investment" in 1991 and 1993: FIAS, *op. cit. supra* n.13.

15. In the context of the choice between trade, licensing and investment, investors will choose to invest abroad—that is, to undertake transactions within the confines of a single economic unit, where such an "internalisation" of transactions results in lower costs than the alternatives of trade or licensing: Coase, *The Firm, the Market and the Law* (1988), at pp.6–7 and Hood and Young, *The Economics of Multinational Enterprise* (1979), pp.46–54.

16. Coarse, *op cit. supra* n.15 (1988), pp.6–7. See also Cooter and Ulen, *Law and Economics* (1997), pp.86–87.

17. Sherwood, Shepherd and de Sousa (1994) "Judicial Systems and Economic Performance" 34, *The Quarterly Review of Economics and Finance* 101–116, pp.101–105; Commission of the European Communities Directorate General for Economic and Financial Affairs (1993) *European Economy: Reports and Studies* No.2, 25–38, pp.25–32; Webb, *op. cit. supra* n.7, at pp.47–48; Shihata "Preface Good Governance and the Role of Law in Economic Development" in Seidman, Seidman and Wälde (Eds) *Making Development Work* (1999), p.xix; Shihata (1995), *op. cit. supra* n.11, at pp.234 and 590; and Guislan, *The Privatisation Challenge: A Strategic, Legal and Institutional Analysis of International Experience* (1997), pp.47–84.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

provided with adequate infrastructure, and trained and properly compensated staff.[18]

Second, transaction costs are said to arise through the unpredictable enforcement of laws—for example, if bureaucrats exercise discretionary powers in an arbitrary fashion, or judicial interpretations of laws are inconsistent. Followers of neo-institutional economics (including development agencies) argue that *predictability* is best ensured where laws are stable,[19] accessible[20] and clear;[21] the discretionary powers of the State (including its bureaucrats) are limited;[22] corruption is low[23] and powers are separated among branches of government,[24] in particular through the creation of an independent judiciary.[25]

In the context of international economic activity such as FDI, neo-institutional economic theory would predict that foreign investors will be attracted to States with "effective" (i.e. relatively low transaction

18. World Bank (1996), *op. cit. supra* n.7, at pp.94–95 and (1997), *op. cit. supra* n.7, at pp.7–8 and 99–100; Trebilcock, "What Makes Poor Countries Poor?: The Role of Institutional Capital in Economic Development" in Buscaglia, Ratliff and Robert (Eds) *The Law and Economics of Development* (1997), p.42; Sherwood *et al.*, *op. cit. supra* n.17, at pp.104–105 and 113; Stopford *et al.*, *op. cit. supra* n.2, at p.126; FIAS, *op. cit. supra* n.13; and UNCTAD (1995), *op. cit. supra* n.2, at p.277.

19. Flint, Pritchard and Chu, "Constitutional and Legislative Safeguards for FDI: A Comparative Review Utilising Australia and China" in Pritchard (Ed.) *Economic Development, Foreign Investment and the Law* (1996), p.104; Stopford *et al.*, *op. cit. supra* n.2, at p.222; and Shihata (1999), *op. cit. supra* n.17, at pp.xxiii–xxiv.

20. Stopford *et al.*, *op. cit. supra* n.2, at p.222. See also Trebilcock, *op. cit. supra* n.18, at p.40; Sherwood *et al.*, *op. cit. supra* n.17, at pp.104–105; and Commission of the European Communities Directorate General for Economic and Financial Affairs, *op. cit. supra* n.17, at pp.25–32.

21. Trebilcock, *op. cit. supra* n.18, at p.41; Sherwood *et al.*, *op. cit. supra* n.17, at pp.104–105; Stopford *et al.*, *op. cit. supra* n.2, at p.126; and Webb, *op. cit. supra* n.7, at p.48.

22. Tshuma, *op. cit. supra* n.7, at p.78; FIAS, *et al.*, *op. cit. supra* n.13; World Bank (1996), *op. cit. supra* n.7, at pp.93–97 and (1997), *op. cit. supra* n.7, at pp.8 and 103–106; Trebilcock, *op. cit. supra* n.18, at pp.30–31 and 41; Root, *op. cit. supra* n.22, at pp.139–149; Shihata (1999), *op. cit. supra* n.17, at p.xxii; Stopford *et al.*, *op. cit. supra* n.2, at pp.126 and 138; Stone, Levy and Paredes, "Public Institutions and Private Transactions: a Comparative Analysis of the Legal and Regulatory Environment for Business Transactions in Brazil and Chile" in Alston, Eggertsson and North (Eds), *Empirical Studies in Institutional Change* (1996), 95–128, pp.95–98; Clark "The Many Meanings of the Rule of Law" in Jayasuriya (ed.) *Law, Capitalism and Power in Asia* (1999), p.32; Pistor and Wellons, *The Role of Law and Legal Institutions in Asian Economic Development 1960–1995* (1999), p.53.

23. World Bank (1996), *op. cit. supra* n.7, at pp.93–97 and (1997), *op. cit. supra* n.7, at pp.8, 36 and 103–106. The World Bank argues that although predictable corruption (i.e. when the need for, and the results of, corruption are predictable) results in higher levels of investment than unpredictable corruption, it is still true that the highest levels of investment are found in countries where there is the lowest corruption.

24. Shihata (1999), *op. cit. supra* n.17, at p.xviii; and Trebilcock, *op. cit. supra* n.18, at pp.30–31.

25. World Bank (1996), *op. cit. supra* n.7, at pp.94–95 and (1997), *op. cit. supra* n.7, at pp.7–8; Gray (1998), *op. cit. supra* n.25, at pp.151–153 and (1999), *op. cit. supra* n.25, at p.63; Ratliff *et al.*, *op. cit. supra* n.24, at p.323; Clark, *op. cit. supra* n.22, at p.32; Root, *op. cit. supra* n.22, at pp.154–155 and Sherwood *et al.*, *op. cit. supra* n.17, at pp.104–105.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

costs), and avoid States with "ineffective" legal systems (i.e. relatively high transaction costs).[26] However, even if the effect of transaction costs is such that foreign investors *should* be attracted to states with legal systems which are "effective", there is little empirical evidence to suggest that they *are* so attracted. This lack of evidence, and some theoretical explanations for it, are explained in Part II.

II. EVIDENCE OF THE RELATIONSHIP BETWEEN LEGAL SYSTEMS AND FDI

A World Bank representative working on legal reform in Sri Lanka readily admitted in an interview that "one can never be sure" whether improvements in levels of FDI "can be attributed to legal reform or not. It is very difficult to know if law reform will have an impact, but to some extent, that thought is intuitive".[27] A review of existing literature reveals that, intuition aside, there is little empirical evidence to confirm that international economic actors do in fact pay significant attention to reducing their exposure to transaction costs endogenous to legal systems (Section A). Furthermore, there are good theoretical and empirical grounds to suppose that the impact of legal systems upon the location of FDI is likely to be limited by the capacity of foreign investors (Section B).

A. *Empirical Studies*

The scope and number of empirical studies which have touched upon the link between legal systems and the location of FDI are so great that no attempt will be made to summarise them all in this article. However, it is possible to note first, that such studies rarely make a direct attempt to address the role of legal systems as a determinant of FDI; and second, that the conclusions of such studies are inconsistent. These points can be illustrated by briefly examining a selection of existing work.

A substantial amount of research has addressed the growing importance of perceptions of political risk in the FDI decision making process.[28] Political risk is the "risk inherent in doing business in the . . . political environment of another country".[29] More specifically, it has been defined

26. Although this assertion is frequently made, commentators rarely take the time to spell out its theoretical roots in any detail, let alone to prove it empirically.

27. Interview 10. Similarly, Vandevelde acknowledges that the claim that BITs increase general economic prosperity is not supported by empirical evidence, but nonetheless contends that BITs do "reduce risk for foreign investors by stabilizing the legal framework within which the investment will operate": Vandevelde, "Investment Liberalization and Economic Development: The Role of Bilateral Investment Treaties" (1998) 36:3 Columbia Journal of Transnational Law 501–527, p.525.

28. See for example, those summarised in UNCTC (1992a), *op. cit. supra* n.28.

29. Kennedy, *Political Risk Management: International Lending and Investing under Environmental Uncertainty* (1987), p.3. See also Stopford *et al.*, *op. cit. supra* n.2 , at p.142.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

as the risk that a host state will "confiscate all or a portion of the investor's property rights located in the host country". These studies are of limited use in assessing the role of legal systems as a determinant of FDI, since "confiscation of property" is generally narrowly interpreted to occur only by the introduction of a new law, rather than by the failure to enforce an existing law, or the inconsistent interpretation of a law.[30] Furthermore, as the United Nations Centre for Transnational Corporations noted in 1992, political risk studies have not provided consistent results as to the relative importance of political risk as a determinant of FDI.[31]

Second, some studies have asked investors to rank the impact of various factors, including legal issues, upon their investment.[32] However, although these studies provide some evidence of the fact that investors report that legal systems may have a negative impact upon the value of an investment, they do not indicate to what extent this possibility actually affects the decision to invest in the first place.

Third, a cross-country study by Borner *et al.* has searched for correlations between economic growth rates and the political environment in a state. The study, which has exerted a good deal of influence over World Bank policy, showed a strong correlation between economic growth and the "political credibility" of a government. That is, it was found that higher rates of economic growth were experienced by those states in which the private sector perceives laws to be created and implemented in a predictable fashion.[33] This might be taken to suggest that both foreign and domestic investment levels will be improved where investors perceive legal systems to be predictable. However, it has been argued that these studies do not offer conclusive proof of the direction of causation.[34] Does economic growth cause political credibility or vice versa? Certainly, the study did not ask foreign investors whether their decision to invest in a host state was affected by the nature of the legal system.

A further study has examined the importance which foreign investors place upon particular aspects of the legal system. A survey of firms which

30. Comeaux and Kinsella, *Protection of Foreign Investment under International Law: Legal Aspects of Political Risk* (1997), pp.1–2 and 21–22.

31. UNCTC (1992a), *op. cit. supra* n.28, at p.43.

32. See for example a survey of 40 U.K. companies conducted on behalf of the non-governmental organisation World Aware and the Commonwealth Secretariat: Deol, *Promoting Investment in the Commonwealth: Survey of Responses from the UK Private Sector* (1998).

33. Borner, Brunetti and Weder, *Political Credibility and Economic Development* (1995). The study surveyed private sector perceptions of government in 28 developing countries. A further survey by Borner Brunetti and Kisunko of 69 countries was commissioned for the World Development Report 1997, and produced similar results: World Bank (1997), *op. cit. supra* n.7, at pp.32 and 43.

34. Messick, "Judicial Reform and Economic Development" (1999) 14:1, *The World Bank Research Observer* 117–136, p.122.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

had considered investing in Central and Eastern Europe showed that for nearly a third of them, uncertainty about environmental issues (i.e. liability, standards and costs) "was 'very important' in their decision not to further consider direct investment in any of those countries".[35] This survey provides some evidence that the manner in which laws are implemented is of importance to the foreign investment decision making process, but only in relation to environmental laws.

However, the Sri Lanka study casts doubt upon the role of legal systems as a determinant of FDI, at least in the case of Sri Lanka. The Sri Lanka study survey indicated that most foreign investors in the sample had not conducted a full investigation of the legal system before investing in Sri Lanka.[36] This suggests that for many respondents, the nature of the legal system cannot have been a determinant of the decision to invest in Sri Lanka. More importantly, although most respondents perceived most aspects of the Sri Lankan legal system to have characteristics which would cause it to be described as inefficient and unpredictable (and therefore ineffective) by development agency measures, 86 per cent of respondents reported that they would still have invested in Sri Lanka if they had known then what they know now about the legal system. That is, a knowledge of the fact that the Sri Lankan legal system was "ineffective" by the standard definition would not have prevented them from investing.[37]

There is an obvious need for a cross country study to identify how, when and why investors allow the nature of a host state legal system to influence their decision making. As will be shown below, any study is likely to discover that there is a substantial gap between how, when and

35. Klavens and Zamparutti, *Foreign Direct Investment Participation and Environment in Central and Eastern Europe: A Survey Report for the Environmental Action Programme for Central and Eastern Europe* (1995), pp.5–7. The study surveyed 77 firms which had considered investing in Hungary, Poland, and the former Soviet Union.

36. Only 43% of respondents had made a pre-investment investigation into the effectiveness of the legal system before investing in Sri Lanka, while 46% had made no such investigation. Furthermore, of those who had made a pre-investment investigation, more than half indicated that they had relied upon a superficial investigation of the content of laws, rather than the arguably more reliable method of consulting a foreign or local lawyer.

37. This may be either because those investors are not interested in the effectiveness of legal systems, or because those investors have a different understanding of what is an effective legal system. There is reason to doubt the accuracy of the dominant view of development agencies and commentators as to exactly what characteristics make a legal system efficient and predictable. For example, bureaucratic decision making which appears to be unpredictable to an American investor may appear to be perfectly predictable to a Taiwanese investor. This issue is explored further in Perry, "An Ideal Legal System to Attract Foreign Direct Investment? Some Theory and Reality", *American University International Law Review* (2000 forthcoming); and Perry, "International Economic Organisations and the Modern Law and Development Movement" in Seidman, Seidman and Wälde (Eds) *Making Development Work: Legislative Reform for Institutional Transformation and Good Governance* (1999) 19–32.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

why investors' decisions *are* so influenced; and how, when and why they would *wish* their decisions to be so influenced.[38]

B. *Limiting Factors*

Neo-institutional economics has itself pointed to two potential limitations on the role of legal systems as a determinant of FDI, both of which are associated not with the legal system, but rather with the foreign investors themselves.

First, foreign investors, like all economic actors, are affected by "bounded rationality". The "normative" approach to decision making offered by classical economics would suggest that a potential investor should, taking into account all the relevant information, make the decision which maximises their wealth. However, in reality investors are "navigating in a fog of risks and uncertainties whose hazards they can only surmise".[39] Although investors may intend to make rational decisions based upon the criteria of efficiency and wealth maximisation, their ability to do so is limited by "the computational capacity of the human mind".[40] Foreign investors may not be able to accurately assess the need to take account of factors such as the nature of the legal system in their decision making,[41] or to objectively assess the impact which the legal system will have upon their investment.[42] As a result it is investors' perceptions of the legal system, rather than the reality, which will have an effect on their decision to invest.

38. Not to mention the differences in how, when and why policymakers would like investors to take account of legal systems.

39. Gray, *False Dawn: The Delusions of Global Capitalism* (1998), pp.67–68. Aharoni notes that economic theory offered a good deal of advice as to how investors should decide to invest, but little evidence as to how they do decide to invest: Aharoni, *The Foreign Investment Decision Making Process* (1966), pp.8 and 36; and Coase notes that economists have little interest in or understanding of the institutions and individuals who make the choices, so that "the rational utility maximizer of economic theory bears no resemblance to the man on the Clapham bus, or indeed, to any man (or woman) on any bus": Coase, *op. cit. supra* n.15 , at pp.3–5.

40. Mercuro and Medema, *Economics and the Law: From Posner to Post Modernism* (1997), p.130. See also Langlois (Ed.) *Economics as Process: Essays in the New Institutional Economics* (1986), p.174.

41. Cooter, "The Rule of State Law Versus the Rule-Of-Law State: Economic Analysis of the Legal Foundations of Development" in Buscaglia, Ratliff and Cooter (Eds) *The Law and Economics of Development*, 101–148, p.102; Posner, *Overcoming Law* (1995), pp.442–443; and Zacharakis and Meyer, "A Lack of Insight: Do Venture Capitalists Really Understand Their Own Decision Process?" (1998) 13 *Journal of Business Venturing* 57–76, p.58. However, Aharoni argues that there is a direct and positive correlation between the availability of information, and the willingness of investors to make pre-investment investigations: *op. cit. supra* n.39, at p.80.

42. Stopford *et al.*, *op. cit. supra* n.2, at p.142. Knight, *Risk, Uncertainty and Profit* (1921), p.199.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

Second, to the extent that investors are able to collect and analyse information regarding the nature of legal systems in a potential host state, neo-institutional economists and others have produced evidence to suggest that some investors may not consider legal systems to be particularly important. In fact, many economic actors depend upon informal mechanisms, rather than the legal system, in order to structure and implement their economic activities.[43] It is therefore possible that some foreign investors might prefer to perform their economic activities with limited reference to the legal system of the host state, in which case the nature of a host state legal system might not be a determinant of FDI.

A number of studies have examined the use of informal mechanisms to deal with relationships among members of the private sector in a broad range of states. A 1962 survey of American businesses conducted by Macaulay found that many respondents did not lay down tight rules to govern their commercial relationships, rarely resorted to litigation or referred to legal agreements, and consulted lawyers only as a last resort.[44] Similarly, a study of Brazil found that local manufacturers prefer to use unenforceable orders in sales, rather than enforceable contracts, and had created informal mechanisms for dealing with credit enforcement, resulting in less than one per cent of initial non-payments being resolved in the courts.[45] Furthermore, commentators have noted that Japanese economic activity relies upon notions of community and "networks of trust"; Chinese (including Taiwanese) businesses rely on personal connections, "reciprocal obligations and long-term negotiating relationships"; Korean business people favour "co-operation" over more "legalistic relationships";[46] "African businessmen of Asian descent interact primarily with others from the same ethnic background" and finally, "Russian managers deal primarily with commercial partners who are familiar from the central planning days."[47] Finally, a 1996 survey of

43. See for example Gray, "Reforming Legal Systems in Developing and Transition Countries" in Seidman, Seidman and Wälde (Eds), *Making Development Work: Legislative Reform for Institutional Transformation and Good Governance* (1999) 61–66, p.62; Shihata (1995), *op. cit. supra* n.22, at p.xxi; and Stone *et al.*, *op. cit. supra* n.22, at pp.95–98 and 116–123. For the use of informal rules, rather than formal laws, see Ellickson, *Order Without Law: How Neighbors Settle Disputes* (1991).

44. Macaulay, "Non-contractual Relations in Business: A Preliminary Study" reprinted in Buckley and Mitchies (Eds), *Firms, Organisations and Contracts* (1996), 339–358, pp.344–355.

45. Stone *et al.*, *op. cit. supra* n.22, at pp.116–123.

46. Gray (1998), *op. cit. supra* n.25, at pp.169 and 183–185; see also Jones, "Capitalism, Globalization and Rule of Law: An Alternative Trajectory of Legal Change in China" (1994) 3:1 *Social and Legal Studies*, 195–221; Rajbhandary, "Protecting Trade Secrets through Family Business—A Case Study of Nepal" (1996) 16:4 *International Review of Law and Economics*, 483–490; and Winn, "Relational Practices and the Marginalisation of Law: Informal Financial Practices of Small Businesses in Taiwan" (1994) 28:2 *Law and Society Review*, 193–231.

47. Gray (1999), *op. cit. supra* n.25, at p.62.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

international joint ventures found that many investors avoid placing a great deal of detail into joint venture agreements. While most respondents to this survey felt that a formal joint venture agreement was "a critical element in defining the longer term relationship", providing "an essential building block in structuring the joint venture", others felt formal arrangements to be of less significance, stressing that "no agreements can work without the good will and dedication of both partners."[48]

Other studies have examined the use of informal mechanisms to deal with relationships between the private sector and the state. In these cases, the state is complicit in keeping relationships outside of the formal legal system.[49] It has been argued that in Asian states, large businesses have "extensive pre-emptive involvement" in the lawmaking process "that go beyond the well known phenomenon of lobbying in the West".[50] The relationship between the state and individuals in Asia has been described as an "informal", "voluntary and non-authoritarian" process of negotiation and guidance. Decisions are made on the basis of "a consensus of reciprocal expectations based on shared views of right and wrong" so that "positive law is often superfluous", and the formal legal system is of "marginal" importance.[51] In addition, the field of regulation has produced volumes of research detailing the extent to which regulators from all areas of the globe turn their backs on formal enforcement mechanisms for controlling the behaviour of the private sector, preferring to rely upon less formal systems of cajolement and negotiation.[52]

These studies indicate that private economic actors and States choose to use informal mechanisms for reasons of efficiency, or culture, or a combination of both. The decision to use informal mechanisms in preference to the legal system might not be justifiable on a transaction

48. Miller, Glen, Jaspersen and Karmokolias, "International Joint Ventures in Developing Countries: Happy Marriages?" (1996) International Finance Corporation Discussion Paper 29. See also Stopford *et al.*, *op. cit. supra* n.2, at p.93 on alliances between firms.

49. Jayasuriya, "Introduction: A Framework for Analysis" in Jayasuriya (ed.) *Law, Capitalism and Power in Asia* (1999), 1–27 p.10.

50. Pistor *et al.*, *op. cit. supra* n.22, at p.281. See also on Korea: Gray (1998), *op. cit. supra* n.25, at p.169; on the East Asian "tiger economies": Root, *Small Countries: Big Lessons: Governance and the Rise of East Asia* (1996), pp.170–171; and on the willingness of foreign investors to take advantage of these informal relationships: Stopford *et al.*, *op. cit. supra* n.*, at pp.13 and 135.

51. Kamarul and Tomasic, "The Rule of Law and Corporate Insolvency in Six Asian Legal Systems" in Jayasuriya (Ed.) *Law, Capitalism and Power in Asia*, 151–172, pp.151–173. See also Pistor *et al.*, *op. cit. supra* n.22, on the continuing disparity between Asian and Western states with regard to the use of discretionary, rather than rule-based, decision making techniques.

52. See for example Hawkins, who notes that "in pollution control the conditions under which formal intervention is deemed to be morally and organizationally permissible are very narrowly construed indeed": "Law as a Last Resort" in Baldwin, Scott and Hood (Eds) *A Reader on Regulation* (1998) 288–306, p.288.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

costs analysis. But this possibility is irrelevant for the purposes of a positive analysis of the role of legal systems as determinants of FDI.[53] Nevertheless, the impact of informal mechanisms, both generally[54] and specifically in relation to the role of legal systems as a determinant of FDI, has not been given more than superficial attention by development agencies. Commentators have fixed their attentions upon formal legal systems, and apparently assumed that the only important investors are those who value formal law. Indeed, the FIAS goes so far as to imply that investors who are happy to rely upon informal mechanisms for doing business are not "good" investors.[55] The economic grounds for this argument are not clear.

The implication of these studies for this article is that foreign investors may also prefer to structure and operate their investments with limited reference to the formal legal system of the host state. These investors can be described as *insensitive* to legal systems. Foreign investors may sometimes be prevented from operating informally, whether by the local community,[56] or by the state. However, investors who want to limit their interaction with the host state legal system, and who perceive that they will be allowed to do so,[57] are less likely to be sensitive to the effectiveness of legal systems.

Where investors are not sensitive to legal systems, no amount of reform to those legal systems will increase FDI flows. But can you tell which investors will be sensitive to legal systems and which will not? Are some investors more likely to be sensitive to legal systems than others? Part III examines the possibility that an investor's characteristics, such as size, nationality and export-orientation, might affect their sensitivity to the legal system of a host state.

53. See Campbell and Picciotto, "Exploring the Interaction between Law and Economics: the Limits of Formalism" (1998) 18:3 *Legal Studies* 246–278, p.253 on economists' frustrating habit of treating all social arrangements as transaction costs, rather than as arrangements which are "facilitative" of transactions, and without which transactions would not take place.

54. Stone *et al.*, *op. cit. supra* n.22, at p.104; Messick, *op. cit. supra* n.34, at p.120; and Tshuma, *op. cit, supra* n.7, at p.91.

55. FIAS, *op. cit. supra* n.13. FIAS argues that informal legal systems "can be a particularly strong deterrent for foreign investors who may not be politically connected, operate under strict internal corporate guidelines, or who do not have local partners to take care of a multitude of procedural obstacles and associated payments." It concludes that states with such legal systems "may lose the 'good' foreign investors they all attempt to attract".

56. Gray (1999), *op. cit., supra* n.25, at p.62.

57. In fact, the increased emphasis placed by states upon encouraging FDI may result in a corresponding increase in the willingness of states to allow investors to maintain a degree of independence from formal legal systems.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

III. CHARACTERISTICS OF THE INVESTOR AND SENSITIVITY TO LEGAL SYSTEMS

IN emphasising a micro-level transaction cost analysis of the relationship between legal systems and FDI, commentators have frequently ignored existing theoretical and empirical work on the political economy of multinational enterprises.[58] It is old hat to political economists that foreign investors locate their investment in those states which offer "locational advantages". If an investor determines that the most efficient way to produce Item A is to locate the production of that item in a state in which Raw Material B is available; and Raw Material B is only available, or most readily available, in State X; then the investor will locate in State X because it offers a "locational advantage" over other potential host states. If investors are sensitive to the nature of legal systems, then an effective legal system can be described as a locational advantage.

But political economists are also familiar with the notion that locational advantages are only half of the story. In fact, the decision of an investor to locate in a particular state is based not only upon whether that state offers a particular locational advantage over other states, but also upon the characteristics of the investor and, most importantly for this article, upon whether the investor has the characteristics (or ownership advantages) necessary to benefit from a State's locational advantages.[59] Where two potential host States have similar locational advantages, an investor may decide to invest in that State with which its home State has an "affinity", such as old colonial links, political alliances or a common language.[60] In these cases, an investor's nationality may offer ownership advantages which allow him or her to more effectively exploit a State's potential locational advantages. It is therefore the combined force of ownership and locational advantages which determine whether a firm will invest abroad, and if so, in which State.[61] If this is the case, then it is interesting to consider whether certain characteristics might render an investor more or less sensitive to legal systems.

The remainder of this Part explores the potential impact of size of investment, nationality and export-orientation upon investors' sensitivity to legal systems. It is assumed for the sake of argument that foreign investors are not constrained by bounded rationality, and that all

58. However, some authors have made detailed reference to the political economy of multinational enterprise when discussing the effect of the content of laws upon FDI flows. See Muchlinski, *Multinational Enterprises and the Law* (1995), Part 1; and Kofele-Kale, "The Political Economy of Foreign Direct Investment: A Framework for Analysing Investment Laws and Regulations in Developing Countries" (1992) 23 *Law Policy and International Business* 619.

59. Dunning, *Multinational Enterprises and the Global Economy* (1995), pp.57–61.

60. Caves, *Multinational Enterprise and Economic Analysis* (1996), pp.37, 46 and 52–53.

61. See Dunning, *op. cit. supra* n.59. See also UNCTC, (1992a) *op. cit. supra* n.2; Hood *et al.*, *op. cit. supra* n.15, at pp.44–47; and Coase, *op. cit. supra* n.15, at pp.6–7.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

investors have the same understanding of what constitutes an "effective" legal system.[62]

It should be noted that the Sri Lanka study was not designed with a view to testing the impact of investors' characteristics on the role of legal systems as a determinant of FDI. However, the sample nonetheless appears to be representative of the characteristics of wider population of foreign investors in Sri Lanka.[63] Therefore, the Sri Lankan study results can be taken to illustrate what is likely to be the position with regard to foreign investors in Sri Lanka, and the need for further research with regard to foreign investors in other countries.

A. *Size of the Investment*

The impact of size upon an investor's sensitivity to the nature of legal systems is difficult to predict. On the one hand, it could be argued that large investors are more likely to perceive themselves to have the negotiating power to get what they want from a host state, regardless of the nature of its legal system and/or to be able to insure themselves against the more extreme negative impacts of a legal system, such as expropriation. If this were the case, then large investors might be expected to be less sensitive to the legal system of a host state. This view is supported by Ratliff *et al.*, who argue that failures in the legal system hit "small and medium level businesses", whose "need for legal services is especially great because they cannot survive long delays and they lack experienced lobbies and broad contacts within the government that could help them get things moving." By contrast, "more established firms" (not a clearly separate category from small and medium sized firms) "have more flexibility to hold out, with their own rent seeking lobbies and more extensive ties to the government 'elite'."[64] Similarly, Vandevelde argues small and medium-sized firms are "relatively more risk averse" since they do not have the resources to self-insure against non-commercial risk.[65] However, these assertions have not been empirically validated.

62. See n.37 above.

63. Respondents presented a good sectoral representation of priority status companies with foreign investment: in four out of the nine sectors, respondents comprised over 20% of the existing population of such companies; respondents made up at least 10% of the general population in a further three sectors; and two sectors were poorly represented, since there were no respondents from the paper, paper product printing and publishing paper sectors, and only six per cent (2) of the non-metallic and mineral products sector was represented. The respondent firms also mirrored the general population of priority status companies in the characteristics of ownership nationality. In both the sample and the wider population, the most frequently represented nationality of ownership is Sri Lankan, followed by East Asian.

64. Ratliff and Buscaglia, "Judicial Reform: Institutionalizing Change in the Americas" in Buscaglia, Ratliff and Cooter (Eds) *The Law and Economics of Development* (1997) 313–340, p.323.

65. Vandevelde (1998b), *op. cit. supra* n.27, at p.526.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

On the other hand, small sized firms might perceive themselves to be best placed to avoid contact with the host state legal system. In addition, a smaller firm might be more able to rely upon informal mechanisms, if their business affairs are less complicated than those of large firms.[66] In this case, the hypothesis of the preceding paragraph would be reversed, and small investors might be expected to be less sensitive to legal systems.

Finally, it might be argued that a medium-sized investor is too big to hide from the legal system, but too small to have any clout. If this is the case, then it might be expected that medium-sized investors will be the most sensitive to the nature of the legal system, and the hypotheses of the preceding paragraphs would be modified accordingly.

The Sri Lanka study provided mixed results on this matter. There was general agreement among interviewees that smaller investors are less sensitive to legal systems, since they are less likely to get caught if they break the law, and do not have to consider their international reputation.[67] However, the survey of foreign investors revealed that larger companies (total investment at least US$2 million) were over two times more likely (63 per cent) to have conducted a pre-investment investigation of the legal system than smaller companies (total investment under US$2 million, 30 per cent). This may indicate either that larger firms are more sensitive to the nature of the legal system than small investors, or that larger firms are more able to investigate the legal system than smaller investors.

B. *Nationality of the Foreign Investor*

There is evidence to suggest that Western investors are more likely to be sensitive to legal systems than investors from non-Western, especially Asian, home states. It has been noted above that the relationship between the private sector and the state in Asia is far less formalised than in Western countries. As a result, it might be expected that investors from Asia will be less likely to be sensitive to the nature of formal legal systems than investors from Western countries, since the former will be more willing to rely on informal mechanisms.

For example, Althukorala notes that Western investors, who have thus far dominated the high-tech sector in Sri Lanka, "usually place a greater emphasis on political stability" when choosing host states. However, Asian investors, in particular from Korea and Taiwan, are beginning to gain international ground in high-tech manufacturing, and these investors "seem to place relatively less weight on political and policy instability"—a

66. Gray (1999), *op. cit. supra* n.25, at p.62.
67. Interviews 6, 9, 13, 16, 22, 23, 24, 26, 31 and 32.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

development which is "bound to have immense implications in the years to come for Sri Lanka" and other countries in the region.[68]

The Sri Lanka study provides further support for the contention that Western investors are more sensitive to the nature of legal systems. The majority of interviewees expressing an opinion on the matter agreed that an investor's nationality would affect how much importance they place upon the legal system.[69] Furthermore, interviewees displayed a remarkable degree of uniformity regarding the relative importance which different nationalities would place upon the legal system, reporting a descending sensitivity to legal systems for investors from the U.S., the U.K., other Western or European countries, South Asia, Japan, Singapore and other East Asian countries.

The broad consensus among the Sri Lanka study interviewees was that Europeans and Americans were the most concerned about the legal system, because they wanted to be in a position to follow the law. This was felt to be either because Western culture placed a higher premium upon the rule of law, or because the foreign investors were afraid of repercussions at home, whether from consumers or, in the case of U.S. investors, from the implementation of the Foreign Corrupt Practices Act. "Western investors from UK and US and Europe are more concerned about the rule of law, because they lay great emphasis on the rule of law at home. They are especially concerned with the issue of human rights, because there is pressure in their countries not to export capital to countries which have a poor human rights record."[70]

Where interviewees made distinctions between different East Asian investors, legal systems were consistently viewed to be of more importance for Japanese investors than for other East Asian investors. This view of Japanese investors as relatively law abiding may be helped by the fact that they have been investing in Sri Lankan joint ventures since the 1960s, and the countries share strong Buddhist connections. Three interviewees agreed that as a result of their cultural background, Japanese investors consider law to be sacred. On the other hand, two interviewees claimed that the Japanese lack interest in the legal system, because they prefer instead to rely upon mediation and negotiation, while "Westerners feel more comfortable accepting the decision of a court or arbitrator who is a third party, and the decision will allow them to move on." Opinion on South Asian investors was divided, with some interviewees expecting South Asian investors to be more concerned with the legal system than

68. Athukorala, "Foreign Direct Investment and Manufacturing for Export in a New Exporting Country The Case of Sri Lanka" (1995) 18:4 *The World Economy*, 543–564, p.562.

69. Interviews 1, 5, 7, 8, 13, 14, 15, 16, 18, 20, 21, 22, 23, 24, 27, 32 and 34.

70. Interviews 7, 8, 14, 15, 16, 18, 22, 23, 24, 27, 32 and 34.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

East Asians, and others indicating that they expected no appreciable difference.[71]

The Sri Lanka study survey of foreign investors supported the expectations of interviewees, revealing that firms with no Western investors were 12 per cent less likely to have conducted a pre-investment investigation of the Sri Lankan legal system (48 per cent) than firms with only Western investors, and firms with a combination of western and non-Western foreign investors (both 60 per cent). This may support the claim that Western investors are more likely to be sensitive to the nature of the legal system during the investment decision making process. Alternatively, it may indicate that western foreign investors are more likely to feel that they need to investigate the legal system, since it will be less familiar to them.

C. *Export-orientation*

Firms that are engaged in exports might be expected to have less interaction with the host state legal system than firms that intend to serve the local market. Imagine that Firm A seeks to manufacture a product in State X, for export and sale to buyers in State Y. Firm A will have contact with the legal system of State X at the points of entry and approval of the investment, importation of any inputs to the manufacturing process, manufacturing and export of the product, and exit of the investment from State X. By contrast, if Firm B seeks to manufacture and sell a product in State X, it will avoid contact with the legal system of State X at the export stage, but will have the increased burden of contact at the sales and after sales stages, including dealing with issues such as product safety, the settlement of debts and the enforcement of intellectual property rights. If this is the case, then export-oriented investors are likely to be less sensitive to the nature of host state legal systems since they will be less affected by the legal system.

Studies which have indirectly addressed this point have tended to support the contention that export-oriented investors are less sensitive to legal systems. One study found that fixed asset investors, who are by definition not export-oriented, are more worried than other investors about policy variability, since these are long-term projects requiring high capital input.[72] A 1970 study found that political and economic stability were of equally low concern to both exporting and non-exporting investors. However, non-exporting investors were notably concerned about "government guarantees that limited economic risk".[73]

71. Interviews 1, 5, 8, 13, 15, 16, 18, 20, 21, 22, 23, 24, 26, 32 and 34.

72. Omalu, *NAFTA and the ECT—Compliance with Implementation and Effectiveness of International Investment Agreements* (1998).

73. UNCTC (1992a), *op. cit. supra* n.2, at p.43.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

Similarly, some of the Sri Lanka study interviewees reported that exporting firms are less sensitive to legal systems. It was suggested that "investors who come to manufacture for export have no problems because their customers abroad pay them, and they generally don't come into contact with the legal system", except in relation to taxes. Exporters who do have legal difficulties may be able to avoid contact with the Sri Lankan legal system by using international or local arbitration, and although "it's more expensive ... everyone is more comfortable". By contrast, "companies in local trade are at the rough end", and they "frequently have unreasonable delays between delivery and payment".[74]

The Sri Lanka study survey of foreign investors supported the suspicions of the interviewees, indicating that non-exporting investors were more than one and a half times more likely (68 per cent) to have conducted a pre-investment investigation of the Sri Lankan legal system than exporting investors (39 per cent). This would seem to offer support for the contention that export-orientation is a characteristic which may have an impact upon the role of legal systems as a determinant of FDI.

IV. IMPLICATIONS

THE assertion that foreign investors are uniformly sensitive to the effectiveness of legal systems has not been proven to be true, despite constant repetition by development agencies and commentators. However, since "pessimism can only offer the empty consolation of being right",[75] it is time to pose the more optimistic question: how much does it matter? The response—as irritating for practitioners as it is reassuring for academics—is that the answer can only be found by conducting more research.

A. ... *for Researchers*

Two main themes which are likely to produce interesting research can be identified. First, the extent to which investors as a whole are generally sensitive to the effectiveness of legal systems—that is, whether legal systems can act as a locational advantage—is in need of empirical verification.

Second, there are empirical and theoretical grounds to suggest that the precise impact of investors' characteristics (such as size, nationality and export-orientation) upon sensitivity to legal systems merits further research. Special emphasis should be placed upon examining the role of investors' nationality in particular. If the global share of foreign investment emanating from Asian states continues to grow,[76] and Asian

74. Interviews 8, 15, 21, 25, 26 and 32.
75. Landes (1998) *The Wealth and Poverty of Nations*, p.524
76. UCTAD (1998), *op. cit, supra*, n.2, at pp.47–54.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

investors really are relatively insensitive to legal systems, then the argument for legal reform to encourage FDI will weaken. The possible impact of other characteristics could also be explored, such as the industrial sector, the location of investments within export processing zones, the intended duration of the investment, the existence of a local partner, and the degree of participation by foreign investors in the equity and management of the firm.

The lack of research in this area may be due in part to the general difficulties associated with assessing the determinants of FDI, whether or not they are related to the nature of the legal system.[77] Foreign investment decision making is a process of greater complexity and less rationality than traditional economics would suggest. This makes it difficult to study.[78] However, some brief suggestions can be made, based on the experience of the Sri Lanka study, for overcoming some methodological barriers.

First, in order to take account of the risk of foreign investor bravado, any study should attempt to triangulate the responses of foreign investors using a tool such as the Sri Lanka study interviews of the wider community. Second, any study should seek to track investors throughout the decision making process. That is, investors should be surveyed on their perceptions and experiences before, during and after the investment location is chosen. It is often very difficult to gain access to investors who are in the process of making investment decisions. But host states know who has approached their Board of Investment with preliminary inquiries, and they are therefore uniquely well placed to assist in tracking potential investors, as well as actual investors.

Finally, any such study needs to be approached with an open mind. This point requires emphasis because the very possibility that sensitivity to legal systems might be low, or might vary from investor to investor, is currently treated as counter-intuitive and even off-limits.

B. ... *for Host States*

The implications of this article for any state depend initially upon whether its pursuit of FDI is hot or lukewarm. States wishing to pay more than lip-service to the importance of attracting FDI could consider funding some of the research outlined above. Implementation of a survey such as that used in the Sri Lanka study would be genuinely affordable to any state which felt it had something to gain by improving FDI flows. Indeed

77. See UNCTC (1992a), *op. cit. supra* n.2, at p.59.

78. Aharoni, *op. cit. supra* n.39, at pp.15, 29–40 and 80. See also Stopford *et al.*, *op. cit. supra* n.2, at p.142.; and Buckley, *Foreign Direct Investment and Multinational Enterprises* (1995), pp.5–6.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

conducting a survey might in itself encourage foreign investors to feel that the host state cares about them.

Host states may be better placed than development agencies to stimulate research, to deliver access to the relevant information, and to implement any findings. Host states have everything to gain from getting an accurate picture of what foreign investors want. Unlike development agencies, states may be biased against creating a role for technical assistance (whether necessary or not) for which they then have to pay.[79] Furthermore, despite the fact that many prefer to view legal systems as separate from politics, the effectiveness of legal systems is a politically sensitive subject. Home- or regionally-grown research may be more likely to be given a hearing than the imported variety. The relationship between economic actors and legal systems clearly differs substantially from state to state, and ultimately it must be for each state to discover whether these differences are interesting or important.[80] In any case, most development agencies must, for political or legal reasons, stay outside of the realms of politics.

Whatever evidence is collected in the future regarding the relationship between investors' characteristics and their sensitivity to legal systems, the ability of a state to improve FDI inflows is likely be constrained by the characteristics of investors. Investors who are sensitive to legal systems will be attracted to states with effective legal system, whereas investors who are insensitive to legal systems will not be swayed. This has important repercussions for states, in relation to both their standing in the international competition for FDI, and their internal strategy towards FDI.

In the international competition to attract FDI, a state with an "effective" legal system will have an *absolute advantage* over states with ineffective legal systems in attracting those investors who are sensitive to legal systems. By contrast, a state with an ineffective legal system will have no absolute advantage in attracting investors, whether sensitive or insensitive. However, states with "ineffective" legal systems will have an internal *comparative advantage* in attracting foreign investors who are insensitive to legal systems, rather than in attracting those investors who are sensitive to legal systems.

So, the question for states with ineffective legal systems is whether their strategy should be to a) concentrate on their comparative advantage in

79. However donors and recipients of development assistance work within an intensely complex web of agendas—political and economic, national and international. It could be argued that a developing country with an irresponsible leadership might have an incentive to create as much need for development assistance as possible, in order to maximise the amount of foreign currency available for their misuse—but that is another article.

80. Consider the reliance on informality by the private sector in Asia, Africa and Eastern Europe, and by the state in Asia, as outlined in Part II(B) above.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press

attracting investors who are insensitive to legal systems, or b) reform their legal systems, so that they might have also have an absolute advantage in attracting investors who are sensitive to legal systems. This decision should rest upon a cost-benefit analysis—does the value of the "lost" (sensitive) investors exceed the costs associated with legal reform. If the answer is yes, then strategy "b" is advisable; and if the answer is no, then strategy "a" is advisable. Very tidy. But the question on the mind of any researcher with a taste for practical impact is whether states with ineffective legal systems are likely to have the political will to invest in making such a strategic decision. Practically speaking, the chances of developing states undertaking such research, in direct contravention of the dominant "intuition" of development agencies, are slim.[81]

C. ... *for Development Agencies*

Development agencies are promoting legal reform on the basis of limited evidence, and developing countries are unlikely as a result to have the financial or political will to test the validity of those projects. Therefore, it would seem that development agencies have two options—either support the research, or stop offering the advice. Legal reform in the absence of more information may be as likely to produce net costs, as it is to produce net benefits.

81. Although, if the World Development Report of 1999 is to be believed, the World Bank is about to usher in a new more sophisticated era in development, in which intuition might more readily be set aside in favour of fact: "a deeper understanding of development involves a recognition that sweeping beliefs are often incomplete, that layers of complexity are buried not far beneath the surface, and that wisdom is often contingent on the particular conditions of time and place.... In any given country, progress depends on a constellation of factors, and on shifts in their configuration that take place over time. What is required is to step beyond the debates over the roles of governments and markets, recognizing that they need to complement each other, and to put to rest claims that any particular policy intervention ... is the magic formula that will inspire development in all times and places." World Bank *Word Development Report 1999/2000* (1999), p.2.

https://doi.org/10.1017/S0020589300064654 Published online by Cambridge University Press