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Local Institutions, Foreign Investment and Alternative Strategies of Development: Some Views from Practice

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Local Institutions, Foreign Investment and Alternative Strategies of Development: Some Views from Practice

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This Essay summarizes the major insights gained from a panel discussion with legal practitioners about the relevance of local institutions to foreign direct investors. The Essay offers a critique of policy conclusions drawn from empirical studies that suggest a positive correlation between legal institutions and foreign investment flows. It points out that the data used in these studies are far too general to allow policy conclusions and that neither the data nor the policy conclusions are sufficiently attuned to the challenges or opportunities that foreign direct investment projects face on the ground. According to the results of the panel discussion, greater emphasis should be placed on the diversity of institutions that may support different investment projects and the local conditions and constituencies that are necessary for successful investment projects.

I. INTRODUCTION

Law matters for economic development, particularly for foreign direct investment. This statement forms part of the core consensus among policy advisors of developing countries, emerging markets, and transition economies. According to this new consensus, law plays a crucial role in the process of market-oriented development. The function of law is twofold: to define and enforce

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private rights, especially the rights of foreign investors, and to create the legal foundations for market-oriented reform, which alone can guarantee the basis for economic development, stability, and growth.

The statement that "law matters" is not entirely new. It figured prominently in the first law and development movement in the 1960s. This movement, however, came to a halt when financial resources dried up and the leading protagonists of the movement realized how little was known about law and legal institutions, particularly when and how they matter for socioeconomic development.[1]

However, in recent years, this vision of law has emerged again and spread increasingly around the world. Multilateral and bilateral aid institutions, including the World Bank, the International Monetary Fund ("IMF"), and the United States Agency for International Development ("USAID"), have spearheaded new "law and development" projects for countries in transition, emerging markets, and economies gripped by economic crisis. In addition, the Organization for Economic Cooperation and Development ("OECD") has developed codes of conduct based on corporate law for member states and transition economies, which are said to represent "best practices."[2] Once adopted and implemented by the law-receiving countries, these codes supposedly will foster economic development and growth.

Part II of this Essay offers a critique of the far-reaching policy conclusions drawn from recent empirical studies. Part III explains the motivation for using a panel discussion with practitioners to elicit new information and insights. Part IV summarizes the lessons learned from actual experience of practitioners involved in foreign investment projects. Part V sketches an agenda for future research on foreign direct investment and local institutions.

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1. David M. Trubek & Marc Galanter, *Scholars in Self-Estrangement: Some Reflections on the Crisis in Law and Development Studies in the United States*, 1974 WIS. L. REV. 1062; John Henry Merryman, *Comparative Law and Social Change: On the Origins, Style, Decline & Revival of the Law and Development Movement*, 25 AM. J. COMP. L. 457 (1977). For a critique of the critics of the first law and development movement, however, see Brian Z. Tamanaha, *The Lessons of Law-and-Development Studies*, 89 AM. J. INT'L L. 470 (1995).

2. ORG. FOR ECON. CO-OPERATION & DEV., OECD PRINCIPLES OF CORPORATE GOVERNANCE (1999), *available at* http://www.oecd.org/dataoecd/47/50/4347646.pdf.

II. IMPERFECT DATA AND POLICY CONCLUSIONS

Today there is much more empirical support for the claim that law matters for foreign investment. Nevertheless, new law and development initiatives that use these data to buttress their agenda are as problematic today as they were in the early 1960s. There are three main problems: (A) the data are poorly specified; (B) the concepts are incoherent; and (C) the promise of new reforms is rarely realized in practice. This Essay addresses these three problems in turn.

A. The Data Are Poorly Specified

The growing faith in the relevance of legal institutions relies, to some extent, on cross-country studies showing that institutional variables are statistically significant for promoting growth, trade, and foreign investment.[3] Most of these studies use cross-country data that capture the perceptions of interviewees (most of them foreign investors) regarding the "quality of legal institutions" on a given scale, where ten stands for "very good" and zero stands for "poor." These data typically identify only a few institutions. For example, the "efficiency" of the judiciary is frequently singled out. In addition, interviewees are asked about the scale of expropriation or contract repudiation by the government, the severity of corruption, and a general commitment to the rule of law.[4] Several studies also employ indicators for statutory law, but for many countries the available data address only a limited area of shareholder and creditor rights protection.[5]

B. The Concepts Are Incoherent

These studies suggest that countries with "better" legal institutions perform better economically. At the same time, however,

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3. Stephen Knack & Philip Keefer, *Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures*, 7 ECON. & POL. 207 (1995); Paolo Mauro, *Corruption and Growth*, 110 Q.J. ECON. 681 (1995); Shang-Jin Wei, *How Taxing is Corruption on International Investors?*, 82 REV. ECON. & STAT. 1 (2000); James Anderson & Douglas Marcouiller, *Insecurity and the Pattern of Trade: An Empirical Investigation*, 84 REV. ECON. & STAT. 342 (2001).

4. *See* Knack & Keefer, *supra* note 3. The authors developed the most widely used database on the basis of country risk assessments conducted by private consulting groups.

5. *See* Rafeal La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

these studies treat legal institutions as a black box. There is little conceptual clarity about what is meant by an "efficient judiciary," much less an account of the possibility that interviewees may have different understandings about what makes a judiciary "efficient." Is it speed, fairness, legality of conflict resolution, or something else? Furthermore, while the absence of government expropriation may be considered an obvious case, "expropriation" may come in many forms, including regulatory takings, some of which may be regarded as enhancing social welfare, even if they are disliked by the foreign investment community.

Another reason to question the mantra that legal reforms will benefit economic growth and development is that the policy conclusion rests on data that have little diagnostic or therapeutic power. Available information fails to elaborate on which institutions might be dysfunctional or what might cause their troubles. Moreover, they ignore the possibility that countries may have developed alternative mechanisms to resolve issues believed to be addressed by formal legal institutions in developed market economies.[6] Finally, policy conclusions derived from the data disregard the possibility that foreign investors have developed their own strategies to address their basic needs. These strategies may build on existing formal institutions, but may go far beyond them, even in countries with developed legal institutions.

C. *The Promise of the New Reforms Is Rarely Realized in Practice*

The difficulties of the earlier movement led its erstwhile proponents to sound the death knell of the first law and development movement.[7] Recent findings show that legal reforms that rely extensively on legal transplants do not necessarily promote effective legal institutions. As measured by the perception indices described above, countries that receive their law primarily from external sources by way of transplant tend to have inferior legal institutions, unless the countries take an active stance in adapting the transplanted law to domestic conditions or are otherwise familiar with it.[8] Other studies

6. These beliefs are increasingly undermined by a growing literature that investigates the relationship between formal and informal institutions, the role of social norms, etc. *See* discussion *infra* Part III.

7. *See* Trubek & Galanter, *supra* note 1.

8. Daniel Berkowitz et al., *The Transplant Effect*, 51 AM. J. COMP. L. 163 (2003); *see also* Katharina Pistor et al., *Law and Finance in Transition Economies*, 8 ECON. TRANSITION

have shown that the manner in which countries were colonized and the type of institutions established by the colonizers have had a long-term impact on the development of legal institutions, notwithstanding subsequent reform efforts.[9]

The new wave of market-cum-legal reforms has been even more disappointing. Across Latin America, market reform initiatives have been followed by crisis and instability, with few signs of sustainable growth. The most dramatic case of economic and legal reforms, hailed as highly successful only ten years ago, is that of Argentina. Similarly, liberalization efforts among the East Asian tigers, largely inspired by the IMF and other international financial institutions, have arguably exposed these highly successful countries to the risks that materialized in the crises of 1997 and 1998.[10] Finally, the extensive legal reforms conducted in transition economies over the past decade have not produced the desired outcome, as evidenced by the fact that many bemoan the lack of effective enforcement in the region.[11] These failures stand in sharp contrast to the developmental successes achieved in some of the countries most openly defiant of the new consensus, such as Malaysia in the aftermath of the financial crisis in Asia, or China, which has pursued a gradual reform policy in defiance of much of the conventional wisdom.

The net result is a lingering confusion over the appropriate content and scope of market-oriented reform, including the reform of legal institutions that are commonly associated with markets. At the very least, the record implies the need to question the reigning ideas surrounding legal reform. The importance of this subject is not solely academic. At stake are billions of dollars that will be spent on efforts to institute legal reform, and the hopes of hundreds of millions of people trying desperately to catch up to living standards in the West.

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325 (2000).

9. Daron Acemoglu et al., *The Colonial Origins of Comparative Development: An Empirical Investigation*, 91 AM. ECON. REV. 1369 (2001).

10. Some authors suggest that countries with "better" law on the books have been more successful in weathering the crisis. *See e.g.*, Simon Johnson et al., *Corporate Governance in the Asian Financial Crisis 1997-98*, 58 J. FIN. ECON. 141 (2000). Others, however, contend that the alleged dysfunctionality of domestic institutions in the affected countries reflected a mismatch between liberalization policies and local institutional arrangement, not an inherent weakness of these institutions.

11. For a critique of the "bad enforcement" argument, which redirects attention from failed reform efforts, see Joseph E. Stiglitz, *Keynote Address: Whither Reform? Ten Years of the Transition*, *in* ANNUAL WORLD BANK CONFERENCE ON DEVELOPMENT ECONOMICS 1999 27 (Boris Pleskovic & Joseph E. Stiglitz eds., 2000).

III. LEARNING FROM INVESTOR EXPERIENCE

In an effort to explore these issues, the authors of this Essay convened a panel of practitioners to participate in a foreign investment conference at Columbia Law School. Two ideas inspired this initiative. First, we recognized that the outpouring of foreign direct investment in recent years had extended to every country and region of the world economy, not merely those most closely following the favored policies of the new consensus.[12] Second, we thought that practitioners directly engaged in the structuring and management of foreign investment projects might have access to local knowledge, which often escapes academics and policy makers.

The fact that investors operate in countries that do not perform well on "rule of law" indices,[13] such as Russia, Vietnam or Indonesia suggests that there is more to the story than that which recently has been captured by the conventional "law matters" literature. There are many possible explanations for why investors will choose to invest in an environment with a weak legal infrastructure. The "why" is often determined by resources, such as oil, that are not available elsewhere. Other factors that motivate companies to invest are that the market may be too big to ignore, as in China and Indonesia, or that the companies' suppliers or buyers are already present in the market. Even if the "why" is primarily determined by non-legal factors, domestic institutions may play a role when deciding how to structure an investment project or in attempting to secure a greater share of future returns.

A further gap in the current understanding of investment patterns arises from the lack of detailed case studies. To date, much of the literature assembled considers only aggregate data and abstracts from the very legal and institutional arrangements that seemed to us crucial to understand. Given this lack of useful data, new insights likely could be drawn from the experiences of practical people engaged in real-world investment projects located in countries at the forefront of market reform. How do diverse legal and institutional settings impinge upon the process of foreign investment? Conversely, how do foreign investors respond to these various settings once they

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12. Among developing countries, China has been the leading recipient of foreign direct investment in the past ten years. *See* WORLD BANK, GLOBAL DEVELOPMENT FINANCE 87 (2003), *available at* http://www.worldbank.org/prospects/gdf2003; *see also* the United Nations Conference on Trade and Development, WORLD INVESTMENT REPORT 2002.

13. TRANSPARENCY INTERNATIONAL, CORRUPTION PERCEPTIONS INDEX 2002, (Aug. 28, 2002) *at* http://www.transparency.org. This index uses a 1-10 scale where higher numbers denote less corruption; Russia scores 2.7, Vietnam 2.4, and Indonesia 1.9.

have made the decision to invest in a market? This information is not available from studies that use aggregate data to analyze the statistical relationship between foreign direct investment flows and other factors.

To address these issues, six speakers with different regional expertise were invited as panelists. The speakers specialized in the following regions: Latin America, the Middle East and Africa, the former socialist countries of Eastern Europe, and the former Soviet Union. They also represented different industry sectors, including pharmaceuticals, oil, infrastructure projects, media, and food.[14] Most, but not all, of the panelists were lawyers by profession. Some were in-house counsels, while others worked as external legal advisors to companies. While by no means representative in a technical sense, the group was sufficiently diverse to avoid highly biased results.

The panelists received a broad checklist of the types of questions that would be raised during the discussion. These questions clustered around three themes:

(1) Strategic decisions and local institutions—i.e., analyzing how domestic institutions shape the decision to invest or not to invest;[15]

(2) Adapting and using local institutions after the fact—i.e., seeking answers to the role domestic legal institutions play once investors have made the decision to invest and are on the ground;[16]

(3) Globalization and diversity—i.e., trying to understand how the experience of investing in different

14. We would like to thank Kay Boulware-Miller, Mary Rose Brusewitz, André Madec, Mark Mansur, Elena Popovic, and Dan Price for their participation and for sharing their experience with us.

15. The following broad questions were included in this section: (1) Are concerns about legal institutions in the host country ever a defining feature when making investment decisions? (2) What weight do law and legal institutions carry in determining the decision of foreign investors (your firm or your clients) to enter a particular market? (3) What aspects of the local legal institutions are particularly relevant when making investment decisions? (4) How important are bilateral or multilateral investment treaties in mitigating any concerns about local legal institutions that you/your firm might have?

16. The following broad questions were included in this section: (1) Once a firm has made the decision to invest in a particular host country, how do domestic legal institutions in the host country determine the shape and scope of the investment? (2) How important are law and legal institutions as compared to other factors, such as political and economic stability? (3) Could you give examples of host country features (broadly defined) that have called for major adaptations of your original business strategy? (4) What have you found particularly useful in familiarizing yourself with the investment environment in a host country? (5) What have you found particularly useful in improving the investment climate for your firm or firms you have represented?

> environments has influenced the learning process of investors and may have shaped future investment strategies elsewhere.[17]

The questions were neither meant to bias the panelists nor to confine their comments to themes that interest only academics. Instead, the agenda sought to channel discussion to a broad purpose and to provide the practitioners with a roadmap connecting their own extensive experience to the topics of greatest concern to citizens, politicians, and legal academics.

Over the course of three hours of debate, the panel engaged in a wide-ranging discussion of the nature and variety of local legal institutions and their influence (or lack thereof) on the structuring and operation of foreign investment projects. In reflecting on their own experiences, the panelists did more than respond to the questions. They also introduced a new perspective on legal reform and on the complex relations among local institutions, foreign investment, and national projects of growth and development.

The remainder of this Essay describes the outcomes of the panel. The next Part summarizes five leading themes that emerged in the course of the conversation. The final Part suggests an agenda for further research based on an interpretation of these findings.

IV. LESSONS FROM THE PRACTITIONERS' PANEL

Five major lessons emerged from the discussion with the panelists, each of which is discussed below.

A. *The Conventional Program of Legal Reform Is Not a Prerequisite to Foreign Direct Investment in Developing Countries*

One of the pillars of the new consensus states that the rule of law, as it is conventionally understood, is both necessary and essential

17. The following broad questions were included in this section: (1) Have you had any experience with novel legal or business forms in developing or transitional markets? Please give examples. (2) Has experience with novel institutional arrangements changed the way you evaluate or approach new foreign investment opportunities? (3) Considering the different countries your/your client's firm invests in, how similar or diverse are your business strategies in each of these countries? (4) What efforts is your/your client's firm making in reducing institutional diversity, which may result in higher transaction costs? (5) How effective have these measures been?

to the process of foreign direct investment. But, as panelist after panelist affirmed, this element of conventional wisdom is true only in the most general, and hence trivial, sense. It is true in the sense that law, order, and regulation are better than chaos and crisis. It is certainly not true if taken to mean that a specific series of "rules of law," such as those identified and promoted as part of the Washington Consensus development program, is a prerequisite for investment.

To begin, law plays a minor role in the initial decision to enter a market. Why do foreign companies enter new markets? Although legal considerations may weigh heavily once a strategic decision is taken, legal concerns are not themselves the driving force in the initial calculation. Instead, other factors play a greater role, such as the importance of access to raw materials, the size and scope of the foreign market, or the geographical position of the target country in relation to other important markets.

If law, as a determinant of investment, plays only a minor role in the formulation of strategic initiatives, does it gain prominence once a strategic decision is taken and a project has been approved internally on non-legal grounds? The panelists also agreed on this point, but the position that they affirmed was distinctly at odds with conventional assumptions. Law, the panelists agreed, clearly played a crucial role in the structuring of an investment project, but no single set of laws or arrangements followed naturally from this concern. Instead, the kinds of laws that mattered varied from sector to sector and depended on the details of the particular investment project.

Consider a few case studies contributed by panel members. For the project finance attorney involved in a large-scale energy or construction project, local legal and regulatory arrangements were crucially important at every phase. The setting of basic tariffs, the dollar-indexing of local contracts, and the granting of access to import licenses and currency guarantees were important considerations in the structure of a project. Moreover, the nature and breadth of the interests involved meant that owners and managers needed to engage in a continuous process of dialogue and negotiation with municipal authorities, local suppliers, community groups, and business partners. No fixed set of legal entitlements could guarantee the economic conditions for the project's success or the goodwill or social acceptance required for both the project and the country to move forward.

However, the same assumptions may not hold true for other kinds of investment projects, such as the provision of a cross-border loan to a local bank, the formation of a licensing agreement, or the pursuit of a vulture investment in a pool of securities trading at a steep discount in the local market. In contrast to the energy project, these forms of investment present different issues, involve different relationships, and require different legal entitlements and support. For example, the bank loan raises questions about the nature of a country's currency regime and the part of its legal system that governs the enforcement of security interests. But it need not otherwise impinge on any vital social concerns, such as the interests of the local citizenry in securing access to affordable energy supplies or the interests of the local government in ensuring the development of municipal services.

As the preceding examples suggest, the concept that legal protection is required to support foreign projects is itself far too open-ended to generate a determinate model of legal reform. There is no direct correlation between foreign direct investment and the kinds of detailed legal arrangements that comprise a contemporary system of corporate or financial law. Instead, the question must be approached in a different way, through the examination of particular kinds of investment projects, the interests they raise, and the variety of legal forms and regulatory approaches available to support them.

The lesson may be generalized. The form and content of useful law will not only depend on the details of the project and the setting, but also on the particular strategy of institutional reform and the program of economic development adopted in a particular country. For example, a neo-liberal program of privatization will require one set of legal reforms, while a commitment to a more radically democratic form of market economy will require a different approach.

Two main implications flow from this set of examples. First, the question of what law matters cannot be answered in the abstract. Instead, the question can only be addressed if it is divided into several specific questions about the nature of the investment project, the setting in which it occurs, and the kind of development strategy pursued in a given country. Conversely, the justification of any particular set of legal reforms—whether or not intended to support the growth of foreign investment—must be viewed and evaluated in the context of a historically-specific development program, which is itself worthy of support.

B. The Conventional Program of Legal Reform and the Kind of Investment Associated with it May Be Detrimental to the Promotion of Growth and Development in Developing Countries

A second lesson flows directly from the first. While the panelists unanimously affirmed the priority of strategic considerations over conventional legal reforms, they were skeptical of the developmental claims traditionally associated with foreign direct investment. According to the new consensus, the new "best practice" legal reforms are both good in themselves and necessary as part of the larger project of market-oriented reform. Without good law or markets, economic development is itself imperiled, as foreign investors are held back from projects redounding to everyone's interests. The net result could only be characterized as a "lose-lose" situation in which the failure of conventional law reform retards the normal progress of global access, foreign transfers, and new technology, which are desperately needed in developing countries.

This line of thinking, however, seems to rest on a false assumption about the nature of foreign investment and its contribution to the development process. The rhetoric generally assumes that all forms of foreign investment are equally valuable and equally supported in the conventional framework of legal "best practices." However, as the earlier discussion suggested, the conventional view of investor protection is neither neutral among development paths nor uniformly good for growth and development. The panelists repeatedly stated that many of the most celebrated projects associated with the new reforms were also colossal failures. The most prominent example, which is discussed below, is the case of Argentina. Russia provides another example, where large-scale legal reforms have not produced the desired results.[18] Both the frequency and significance of failure—and the existence of unexplained success, in particular the impressive economic growth of China and more recently Vietnam and India—cast doubt on the conventional arguments made for the new reforms.

The challenge to the standard model manifests itself in many ways. First, there was a general skepticism among the panelists towards the neutrality of the orthodox model of investor protection. Similarly, the challenge was evidenced by the general anxiety about domestic constituencies left behind as foreigners pursued their

18. For a detailed analysis of the impact of legal reforms on financial market development in transition economies, see Pistor et al., *supra* note 8.

prerogatives with little input from local stakeholders or community organizations. Lastly, it was reflected in the concern expressed by some that the basic program of legal reform was of dubious value to local development and the initiatives most critical to it. Instead, many of the elements associated with the orthodox program of market reform were dismissed as favorable to foreign investors alone, rather than to local development.

Perhaps the most striking example of the failure of conventional reforms to promote sustainable economic development came in the course of a brief discussion of the Argentine privatization program. In the early 1990s, Argentina pursued a wide-ranging program of market-oriented reform, setting the standard for Latin America, in particular, and developing countries, in general. As one panelist reminded us, the country followed every precept of the new consensus. The financial markets were liberalized. State-owned companies were reorganized and sold through public tender. New codes of financial law and practice were established to aid new investment. Even the currency and cross-border investment regime established a model code of legal practice. Through the now defunct convertibility law, foreign purchases of peso assets and investments in local ventures could attract the same market confidence as an investment anywhere in the world. For a while at least, peso and dollar asset valuations could be treated with equal confidence. Foreigners were free to invest their dollars, and Argentina was the proud recipient of massive inflows of foreign capital.

Despite this exemplary program of institutional reform, the new Argentine economy and financial system proved to be anything but exemplary in practice.[19] The privatization of formerly state-owned enterprises introduced new sources of conflict and instability into the provision of basic services. Growth and efficiency gains were often far below agreed-upon targets. The reforms had been put in place to attract foreign involvement. However, to the dismay of local stakeholders and municipal authorities, the foreigners who came and the enterprises they developed fell short on a number of grounds.

Much has been made of the financial crisis to which Argentina would eventually succumb. This crisis clearly affected foreign investment projects. In the case of the larger projects, foreigners quickly found themselves with rights of uncertain value. Local

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19. Leslie Elliott Armijo, *Menem's Mania?: The Timing of Privatization in Argentina*, 1 SW. J.L. & TRADE AM. 1 (1994). On the failure of the Argentine model of reform more generally, see Dani Rodrik, *Trade Rout: Reform in Argentina, Take Two*, THE NEW REPUBLIC, Jan. 14, 2002, at 13.

services were in disarray. Tariffs, which previously had been granted as a benefit to induce investment, came into conflict with changing markets and the people affected by them. In addition, the very mechanisms through which foreign investment was granted also became roadblocks in the path of adjustment. Utility rates cast in stone became targets of popular anger, with politically-granted concessions undermining the prospects for further debate and the give-and-take required to ensure smooth functioning under conditions of economic uncertainty and increasing social disarray.

At the same time, new forms of investment began to emerge alongside the traditional projects. While the Argentine infrastructure projects floundered, a new generation of local initiatives, involving unorthodox financial arrangements and property rights, developed in the shadows of the traditional foreign investment projects. These more versatile community experiments stood in sharp contrast to the paradigm of foreign investment provided—and increasingly contested—under the aegis of market orthodoxy. Projects, such as the provincial energy cooperative which was organized on the outskirts of Buenos Aires, began to suggest an alternative approach to both law and foreign investment.

Three lessons stand out from this brief discussion of privatization and foreign investment. First, the conventional program of market reform has failed to provide the basis for stable, inclusive, and sustainable growth required by developing countries. Second, to a large extent, this failure can be attributed to a naïve belief in a particular style of foreign investment and a limited understanding of the institutions necessary to support foreign investment and ensure domestic gains from such undertakings. Third, notwithstanding the defects of the traditional program of economic and legal reform, countries were resilient. Left to their own devices, local groups and financial entrepreneurs could occasionally invent new forms of investment, navigate the local context, and channel resources to areas of commercial potential and social need. Although these approaches did not yet find sanction in the conventional categories of legal policy or economic reform, their presence was felt in practice.

C. The State Plays a Crucial Role in the Promotion (or Subversion) of Successful Investment Projects

The role of the state in economic development has been the subject of dramatically changing views over the past several decades. Proponents of the late development theory have long argued that the state plays a crucial role in promoting economic growth and investment, particularly in late-developing countries.[20] Since the mid-1980s, however, the role of the state has been downplayed in favor of markets. The prevailing ideology of economic reforms in Latin America and the post-socialist world has been "to get the state out."

As practitioners on the panel reminded us, this view is potentially one-sided. In light of the failed reform efforts in the past, the state has a key role to play in creating a favorable context for foreign investment. Especially in the Developing World, the government may need to act to promote socially beneficial investment projects. The state may need to act not merely as the provider of legal rules, but also as an economic agent in its own right, participating actively in the control of enterprise or as an investor and strategic partner in large-scale projects, involving both foreign and local capital.

Legal practitioners on our panel had no difficulty citing a variety of examples. Not all were benign—some cases suggested a lingering bureaucratic interference. This tendency was especially true in the former communist countries, where privatization had yet to take hold. However, there were also instances of helpful state involvement. Pharmaceutical companies needed to rely on the cooperation of local regulators to import and distribute foreign goods. Oil producers in Chad and elsewhere needed to rely on the state's efforts to prepare the infrastructure and create a socially useful safety net. Still other projects relied on a direct joint venture with the state. Telecommunications projects in Mexico, Argentina, and Brazil depended on the state to retain control rights, provide tax and tariff exemptions, and actively support and fund the development of local systems.

How should the variety of government roles be interpreted? For some on the panel, the participation of the state in the process of production was always unfortunate. However, for others, the aforementioned experiences elicited a different response. For these panelists, the participation of the state in foreign investment projects could provide a necessary and needed corrective to the work of independent private agents. Perhaps the government should not be confined to the roles of facilitator and legal provider. Perhaps it could

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20. The late development theory was first formulated by Alexander Gerschenkron. *See* ALEXANDER GERSCHENKRON, ECONOMIC BACKWARDNESS IN HISTORICAL PERSPECTIVE 5 (1962). It is reflected in the work of Amy Amsden, Robert Wade, and others. *See* ALICE H. AMSDEN, ASIA'S NEXT GIANT: SOUTH KOREA AND LATE INDUSTRIALIZATION (1989); ROBERT WADE, GOVERNING THE MARKET: ECONOMIC THEORY AND THE ROLE OF GOVERNMENT IN EAST ASIAN INDUSTRIALIZATION (1990).

also serve in a broader capacity, reconciling the conditions of foreign investment and the conditions of local development.

In the eyes of the legal practitioners at the Conference, there are two competing visions of the role of government in foreign investment. Under one view, the state should adhere to its traditional function consistent with the ideology of conventional market reform. However, under another view, the state could and should perform a number of roles left open in the course of foreign investment. The state could undertake these roles, neither as an arbitrary central authority nor as usurper of private initiative, but rather as a partner in the process of economic development, coordinating public and private initiative, and enlisting foreign and local support.

It would be a mistake to take too much away from this initial exchange of ideas. No single doctrine emerged, nor did we elicit one. However, the stories and perspectives of the panel members suggested a more general point. They suggested an openness and willingness to experiment under diverse, sometimes awkward, conditions. In this still unsettled mix of attitudes and ideas could be found materials for a new hypothesis about the nature of economic development and about the range of institutional practices that might contribute to investment and growth.

D. *Local Partners May Be Equally Important for the Success or Failure of Investment Projects*

Local partners, like the state, have emerged as a crucial determinant of the success or failure of foreign investment. The panelists repeatedly emphasized the importance of this theme. Local partners were not merely agents of an imperfect foreign consortium. In many situations, they served to complement and extend the reach of the foreign investors, connecting them to their social context and the web of government, community, and commercial ties that comprised it.

Again, no single impression defined the nature of this partnership. In some cases, local partners provided access and local presence, allowing companies to operate in distant markets and in ways they could never manage on their own. But other cases were less clear. For example, in the case of a media investment project undertaken in one of Europe's emerging markets, a panelist affirmed the project's utter dependence on the marshalling of local resources and business partners. In countries lacking fundamental legal institutions, local partners could compensate for the deficiencies in the law. They could do so, not through bribes or legislation, but rather through informal sources of influence and control, thereby opening channels of public access and information.

For the media project referred to above, the local partner was important because of the political character of the investment project and the inadequacy of existing legal and institutional arrangements in securing and promoting the project. Local partners were key contributors to the success of the media venture because only they could secure the conditions for a high-profile, politically-sensitive investment project in a country with poorly defined and inadequately enforced political and economic entitlements.

Two general insights are implied by this brief discussion. First, there neither is nor should be a rigid divide between foreign and local investment. Second, there is a need for a different kind of support in law and institutional arrangements. If foreign investment is to be enhanced and strengthened through a connection with local partners, the conception of a legal framework that supports development must also change. The appropriate legal and institutional setting must include something more than the classical property norms. It must also include legal rules and arrangements capable of informing a broad range of investment forms, including mixed public-private ventures in areas of strategic importance to the local economy and development project.

E. *The Recent Experience of Developing Countries with the Conventional Program of Legal and Institutional Reform Suggests the Need To Identify and Conceptualize Alternative Programs of Foreign Investment and Alternative Approaches to Globalization*

Considered separately, the themes outlined above need not imply a general criticism of the prevailing model of reform. However, viewing these themes together leads to the emergence of a different perspective and a different program of legal reform.

According to the orthodox approach described at the outset, a series of legal and institutional reforms are required to support the transition to market-oriented economies. These markets, in turn, are necessary to support growth and economic development. Since foreign direct investment forms a crucial part of this development agenda, foreign investor protections of the kind associated with "global best practice" become synonymous with legal reform and the market economy.

Few of the panelists questioned the continuing validity of this conception. The panelists affirmed the need to enforce law and order, to guard against rampant corruption, and to secure basic property rights and contractual obligations. The regime that governed foreign investment on the basis of these norms was more or less taken for granted. Few practitioners (or members of the audience) questioned the power or utility of the standard approach to foreign investment or its legal and institutional foundations.

However, a different perspective appeared when the panelists discussed their practical experiences. From the many stories drawn from practice, an understanding emerged that was critical of and suggested alternatives to the conventional wisdom. Before further describing elements of this understanding, it may be helpful to return to two examples mentioned above.

In the earlier discussion of the failed reforms in Argentina, the panelists emphasized that the "one-size-fits-all" model of legal reform was tried and found wanting. The defects with this model included excessive deference to foreign investors, unfair distribution of rights and privileges, and inadequate attention to local context and public interest. More importantly, critics voiced concern about the model of development based on the orthodox program of privatization. Although characterized in the literature as economically and financially sound, the model was rigid and prone to crisis, with uncertain value for foreign investors and uncertain benefit for Argentina. Even if the panelists were generally skeptical of the value of institutional orthodoxy, they did not rule out the prospect of institutional reform. On the contrary, the panelists seemed genuinely comfortable that alternatives provided in practice could occasionally solve problems left unsolved by theory.

One approach that seems to have worked in practice is to build upon local initiatives. Here again, the examples often varied on a regional basis. In Argentina, the panelists noted the example of the provincial energy cooperative, emerging in the shadows of the orthodox program of privatization and foreign investment. In Russia, Mexico, and even Chad, unorthodox partnerships between government and the private sector, and between foreign and local capital seemed critical to understanding the success of foreign investment projects in those countries. The panelists also discussed new varieties of legal and institutional form, which despite their unorthodoxy seemed able to attract foreign capital and contribute to local investment.

V. AGENDA FOR FUTURE RESEARCH

While the panel discussion produced many new insights, they cannot be generalized without further research. The information and inspiration gained from these discussions can, however, shape future research agendas on the role of law and legal institutions for foreign investment.

First, the panelists have repeatedly stressed that when analyzing foreign investment, it is crucial to differentiate among the different forms foreign investment may take. The topic of the conference and the panel was foreign direct investment, which is only a small subset of foreign investment activities. Foreign direct investment is typically defined as direct investment in *productive assets* by a company incorporated in a different jurisdiction. However, foreign investment activities may also include portfolio investment, which is typically contrasted with foreign direct investment. In addition, other forms of financial investment, such as insurance banking or project finance, are distinct from foreign direct investment.

The reason for these distinctions is that each of these forms makes different demands on local institutions and on different aspects of host country institutions. For better or worse, some forms of foreign investment can be better insulated from local institutions by using substitutes, such as contracts based on foreign law, and international arbitration as opposed to local courts, while others require a much more supportive domestic environment.

It is also important to differentiate between investments in different sectors of the economy. For example, producing or disseminating pharmaceuticals in different countries creates different challenges for protecting intellectual property rights than does oil exploration. While these points may seem trivial, it is important to recognize that many of the empirical studies that explore the role of legal institutions in foreign investment rely on international capital flows, which conflate different forms of investments in different sectors.[21] Recent research on international trade flows suggests that the relevance of domestic legal institutions for trade flows differs for different classes of goods. Differentiating between simple goods (mostly commodities) and complex goods, a distinction common among trade economists, Daniel Berkowitz, Johannes Moenius, and Katharina Pistor present evidence which suggests that domestic

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21. See the studies referred to in *supra* note 3.

institutions matter primarily for complex goods and especially for exporter countries.[22] The reason is that complex goods are more vulnerable to legal disputes. Furthermore, importers who discover problems with goods may have to use domestic legal institutions in the exporter's country to execute a court verdict or arbitration award if the exporter refuses to comply with the ruling. This reliance on the legal institutions in the exporter's country may arise even if the verdict or award were obtained elsewhere. Similarly, one may expect more nuanced results on the relevance of domestic legal institutions when differentiating among different forms of foreign investment within different sectors.

Second, the analysis of the institutional environment surrounding foreign investment should become both more specific and broader, and should capture formal and informal institutions. As discussed above, the institutional indicators currently used in empirical studies only capture whether a system is or is not dysfunctional. They do not identify specific institutions that are dysfunctional, such as the courts, the state administration, or central versus local institutions, much less what problems these specific institutions might have. Such problems may include political interference, lack of resources, capacity problems, corruption, regulatory capture, organizational problems (e.g., a lack of filing systems), or a general mistrust in the court system, which may be a function of any of the variables just mentioned or a lasting historical legacy.[23] Anyone attempting to analyze the proper causes of malfunctioning institutions, to give policy advice, or to analyze the feasibility of substituting or complementing ill-functioning institutions with alternative arrangements will first need to determine the actual cause of the observed problem.

In addition, the analysis should be broadened to include semi- or informal institutional arrangements, including contractual arrangements, private-public partnerships, and unilateral, bilateral, and multilateral monitoring and enforcement mechanisms.[24] Closer

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22. *See* Daniel Berkowitz et al., Trade, Law and Product Complexity (Feb. 2003) (unpublished manuscript, on file with The Columbia Journal of Transnational Law, *also available at* http://ssrn.com/abstract=315969).

23. On the difficulties the new Russian commercial courts faced to overcome this legacy, see Katharina Pistor, *Supply and Demand for Contract Enforcement in Russia: Courts, Arbitration, and Private Enforcement*, 22 REV. CENT. E. EUR. L. 55 (1996).

24. For the distinction between unilateral, bilateral and multilateral enforcement mechanisms, see Anthony T. Kronman, *Contract Law and The State of Nature,* 1 J.L. ECON. & ORG. 5 (1985); Paul H. Rubin, *Growing a Legal System in the Post-Communist Economies*, 27 CORNELL INT'L L.J. 1 (1994).

inspection of the functioning of developed legal systems, such as that of the United States, has revealed that law is but one governance mechanism among many, for traders and businessmen alike. In a study published in the early 1960s, Stewart Macaulay showed that local businesspeople in Wisconsin used the legal system only as a last resort and first tried to resolve disputes by informal means.[25] More recent studies lend support to these findings. Lisa Bernstein, for example, has provided evidence that entire sectors, such as diamond traders, may deliberately opt out of the existing formal legal system and develop their own set of institutions to govern transactions and resolve disputes.[26] And Robert Ellickson has shown that disputes are often resolved in ways that differ substantially from the solutions provided by formal law.[27] While it may be the case that some of these arrangements operate only in the shadow of effective law enforcement by the state,[28] it may also be true that absent informal support, formal institutions cannot function properly. In fact, the panel discussions suggest that over-reliance on the appearance of functioning formal institutions and a lack of appreciation for informal institutions and a broader set of investment relations with different constituencies in the host country may undermine the success of an investment project.

Third, greater emphasis should be placed on the role and identity of local partners in an investment project. At the most basic level, it may be important to distinguish between private parties, such as contractual parties or third-party guarantors, and state parties as partners in a joint venture. In addition, others who are not a party to the investment agreement may serve important functions as local partners. These parties may be the local government, local investment community, local lawyers, or community organizations. Their support or rejection of projects, especially large-scale projects in infrastructure (e.g., tollways, energy projects) or exploration, is likely to have important implications for the success of a project in the medium- and long-term.

Fourth, one should differentiate between the private and social benefits of the investment project as well as between the legal and

25. Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOCIOLOGICAL REV. 55 (1963).

26. Lisa Bernstein, *Opting out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992).

27. *See* ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991) (discussing dispute resolution among cattle farmers in California).

28. David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 Harv. L. Rev. 373 (1990).

non-legal arrangements that may form part of the foreign investment deal. While investors clearly want to reap private benefits from investment projects, investments in socially relevant sectors, including infrastructure, power, and natural resource exploration, will need to take into account community interests to be sustainable. Regarding the choice of legal or non-legal arrangements, project-specific support, such as a guarantee by the government in the host country or by an international financial institution like the International Finance Corporation ("IFC"), may make a particular project viable and ensure that the parties can reap private benefits from it. However, these benefits may come at the expense of the legitimacy of the investment projects, which may require a broader consensus. Conversely, general laws that may have been adopted in a democratic fashion to benefit the social good may be used by a few powerful interest groups and create disproportionate private benefits at the expense of the general public. Without some analysis of the political economy of the host country and of its interaction with the investment community, it will be difficult to determine who benefits most from different institutional arrangements.

Fifth, context matters. Not every legal institution that works well in the United States will work in Chad, India, or Colombia, nor would institutional arrangements that work in these countries necessarily survive in the United States. What may appear to be an inefficient solution to a well-known contractual problem may be an efficient adaptation in light of other existing constraints, which the parties cannot alter. Thus, it may be futile to try to develop "best practice norms" or "codes of conduct" aimed at covering a variety of investment projects in many different countries. Investors and their local partners face different constraints in different countries. Not all of these differences are unique. Nevertheless, the variations, both in the constraints presented and opportunities offered by different countries, suggest that generalizations may be of limited use.