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## An Ideal Legal System for Attracting Foreign Direct Investment? Some Theory and Reality

Amanda Perry

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# AN IDEAL LEGAL SYSTEM FOR ATTRACTING FOREIGN DIRECT INVESTMENT? SOME THEORY AND REALITY

AMANDA PERRY\*

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## INTRODUCTION

In the context of the movement towards privatization and globalization, increasing reliance has been placed upon foreign direct investment ("FDI") as a source of capital and stimulant of economic

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\* Lecturer in Law, Queen Mary and Westfield College, University of London. I am grateful to the Academic Council of United Nations System ("ACUNS") for its financial support, and to the participants at the 1999 ACUNS Summer Workshop on Rebuilding Torn Societies at Yale University for comments relating to earlier drafts of this paper.

growth in developing countries. At the same time, the international development assistance community has become preoccupied with the impact of legal systems upon economic development in general, and the promotion of inward FDI flows in particular.

During the 1990s, commentators and development practitioners slipped fairly effortlessly towards consensus regarding the relationship between legal systems and FDI. It is now generally theorized first, that foreign investors are attracted to legal systems which are predictable and efficient; and second, that it is possible to identify a uniform set of characteristics which render any legal system predictable and efficient (referred to here as the "Ideal Paradigm").

The purpose of this paper is to question the validity of this theory. The first section describes the core components of what commentators consider to be an "attractive" legal system (the Ideal Paradigm). In the second and third sections, the real attractiveness of the Ideal Paradigm is tested. A case study is used to demonstrate that, unlike the theorists, foreign investors in Sri Lanka do not necessarily share a common definition of what constitutes an attractive legal system. The possible reasons for the disparity between theory and reality, and the implications of the findings are discussed in the concluding section.

## I. THE 'IDEAL PARADIGM' FOR ATTRACTING FDI

Since the 1980s, the World Bank has been "at the forefront" of a "renaissance" in law and development. Regional development banks, and bilateral and multilateral aid organizations are now "major participants" in the provision of funding and technical assistance for law reform programs. These projects have been influential in setting the academic agenda for discussion of the role of law in economic development, as well as dictating the law reform agendas of developing and transition states. However, the size and strength of the World Bank means that it remains the most important source of law and development funding and policy.<sup>1</sup>

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1. Lawrence Tshuma, *The Political Economy of the World Bank's Legal Framework for Economic Development*, 8 SOC. & LEGAL STUD. 75, 76 (1999). See Amanda Perry, *International Economy Organizations and the Modern Law and Development*, in MAKING DEVELOPMENT WORK: LEGISLATIVE REFORM FOR

It is commonly agreed that “governance”—the manner in which economic policies are implemented—has a significant impact on the effectiveness of economic policies.<sup>2</sup> From the perspective of the state, it is argued 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.”<sup>1</sup> However, the dominant tone of commentary on the relationship between legal systems and development reflects an increased emphasis on the importance of the private sector.

Following the decline of communism, a consensus has emerged that the structure and behavior of the public sector should be guided by the needs of the private sector.<sup>4</sup> In the context of FDI, it is therefore argued that the foreign investor should generally get what the foreign investor wants, since their resulting investment will eventually benefit the economy as a whole. But what does the foreign investor want? According to the dominant theory, the foreign investor’s wish list can be boiled down to two essential items: efficiency and certainty.

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INSTITUTIONAL TRANSFORMATION AND GOOD GOVERNANCE 1, 19 (Ann Seidman et al. eds., 1999).

2. Tshuma, *supra* note 1, at 78. See WORLD BANK, GOVERNANCE AND DEVELOPMENT 1, 4 (1992); DEP’T FOR INT’L DEVELOPMENT, *Eliminating World Poverty: A Challenge for the 21st Century* 15 (1997); M. J. Trebilcock, *What Makes Poor Countries So Poor? The Role of Institutional Capital in Economic Development*, in THE LAW AND ECONOMICS OF DEVELOPMENT 1, 19 (Eduardo Buscaglia et al. eds., 1997).

3. EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT, 1996 TRANSITION REPORT, 101 (1996).

4. Tshuma, *supra* note 1, at 76. See Jeswald Salacuse, *From Developing Countries to Emerging Markets*, in FESTCHRIFT FÜR BERNHARD GROSSFELD ZUM 65, 925-33 (Ulrich Ubner et al. eds., 1999); SILVIO BORNER ET AL., POLITICAL CREDIBILITY AND ECONOMIC DEVELOPMENT 20-26, 150-53, 162 (1995); WORLD BANK, 1996 WORLD DEVELOPMENT REPORT: FROM PLAN TO MARKET 85-89 (1996) [hereinafter 1996 WORLD BANK REPORT]; Foreign Investment Advisory Service, *Administrative Barriers to Investment: The Red Tape Analysis* (visited Sept. 11, 2000) <<http://www.fias.net/services/barriers.htm>> [hereinafter FIAS]; World Bank Legal Department, *The World Bank and Technical Legal Assistance: Initial Lessons (Policy Research Working Paper, No. 1414: Washington, DC)* 15; Thomas W. Wälde & James Gunderson, *Legislative Reform in Transition Economies: Western Transplants—A Short-Cut to Social Market Economy Status?*, 43 INT’L & COMP. L.Q. 347, 361 (1994); Douglass Webb, *Legal Reform and Private Sector Development*, in ECONOMIC DEVELOPMENT, FOREIGN INVESTMENT AND THE LAW 45-46 (Robert Pritchard ed., 1996).

It is argued that the ideal legal system for attracting FDI is efficient. An inefficient legal system increases transaction costs by failing to provide cheap mechanisms for enforcing legal rights and obligations.<sup>5</sup> Low transaction costs are ensured where a host state's laws are of good quality—that is, modern<sup>6</sup>—and its courts and bureaucracies are provided with adequate infrastructure, and trained and properly compensated staff.<sup>7</sup> Although their implementation is likely to be constrained by financial considerations, these recommendations are not particularly contentious.

There also exists a broad international consensus that deficiencies in “the lawmaking process, the public administration and enforcement of laws, and the judicial interpretation of laws”<sup>8</sup> in

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5. R.H. COASE, *THE FIRM, THE MARKET AND THE LAW* 114-19 (1988). See WORLD BANK, *supra* note 2, at 4.

6. Robert Sherwood et al., *Judicial Systems and Economic Performance*, 34 Q. REV. ECON. & FIN. 101-05 (1994) (quoting DOUGLAS NORTH, *INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE* (1990) and Douglas North, *Transaction Costs, Institutions and Economic Performance*, in INTERNATIONAL CENTRE FOR ECONOMIC DEVELOPMENT OCCASIONAL PAPERS NO. 30 (1992)); ROLAND BROWN & PHILIP DANIEL, *OVERSEAS DEVELOPMENT ADMINISTRATION, The Legislative Environment For Foreign Investment in St. Helena: A Report to the Overseas Development Administration* London 11 (1996) (on file with the author); Commission of the European Communities, Directorate-General for Economic and Financial Affairs, *EUROPEAN ECONOMY: REPORTS & STUDIES* 25-32 (1993) [hereinafter EC Commission]; Wälde & Gunderson, *supra* note 4, at 353; Webb, *supra* note 4, at 47-48; Ibrahim F. Shihata, *Preface: Good Governance and the Role of Law in Economic Development*, in MAKING DEVELOPMENT WORK: LEGISLATIVE REFORM FOR INSTITUTIONAL TRANSFORMATION AND GOOD GOVERNANCE I, XIX (Ann Seidman et al. eds., 1999) [hereinafter Shihata, *Good Governance*]; Ibrahim F. Shihata, *THE WORLD BANK IN A CHANGING WORLD* 228, 234, 590 (Fransiska Tschofen & Antonio R. Parra eds., 1991); Pierre Guislain, *THE PRIVATIZATION CHALLENGE: A STRATEGIC, LEGAL AND INSTITUTIONAL ANALYSIS ON INTERNATIONAL EXPERIENCE* 47-84 (1997).

7. 1996 WORLD BANK REPORT, *supra* note 4, at 94-95 (1996); WORLD DEVELOPMENT REPORT 1997: THE ROLE OF THE STATE IN A CHANGING WORLD 7-8, 99-100 (1997) [hereinafter 1997 WORLD BANK REPORT]; Trebilcock, *supra* note 2, at 42; Sherwood, *supra* note 6, at 104-05, 113; JOHN M. STOPFORD ET AL., *RIVAL STATES, RIVAL FIRMS* 126 (Steve Smith et al. eds., 1991); FIAS, *supra* note 4; UNCTAD, *WORLD INVESTMENT REPORT 1995: TRENDS AND DETERMINANTS* 277 (1995).

8. Trebilcock, *supra* note 2, at 40.

developing and transition countries can result in uncertainty.’ Legal systems that fail to provide credible information regarding the status of legal rights and obligations must be reformed in order to create greater certainty for foreign investors. The World Bank’s 1997 World Development Report relies on a survey of domestic and foreign investors that demonstrates correlations between political credibility, as perceived by the private sector, and investment levels; countries with high perceived political credibility had high investment rates, and *vice versa*. The report concludes that a “government’s credibility, the predictability of its rules and policies and the consistency with which they are applied, can be as important for attracting private investment as the content of the rules.”<sup>10</sup>

But how is certainty best achieved? According to the dominant theory, a legal system is most likely to be predictable where the laws are stable,<sup>11</sup> accessible,<sup>12</sup> and clear;<sup>13</sup> the discretionary powers of the state (including its bureaucrats) are limited;<sup>14</sup> corruption is low;<sup>14</sup> and

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9. 1997 WORLD BANK REPORT, *supra* note 7, at 43.

10. *Id.* at 4. The concept of credibility was developed by BORNER ET AL., *supra* note 4, at 26-46, and 77-78, who conducted a survey of twenty-eight developing countries. A further survey by Borner et al. of sixty-nine countries was commissioned for the World Development Report 1997, and came up with similar results. 1997 WORLD BANK REPORT, *supra* note 7, at 32, 43. On the importance of predictability in courts, see also Webb, *supra* note 4, at 52-53; Sherwood et al., *supra* note 6, at 104-105, 109, and 112; Shihata, *Good Governance*, *supra* note 6, at xxiii; 1996 WORLD BANK REPORT, *supra* note 4, at 85-89; and 1997 WORLD BANK REPORT, *supra* note 7, at 43.

11. David Flint et al., *Constitutional and Legislative Safeguards for FDI: A Comparative Review Utilizing Australia and China*, in ECONOMIC DEVELOPMENT, FOREIGN INVESTMENT AND THE LAW 104 (Robert Pritchard, ed. 1996); STOPFORD ET AL., *supra* note 7, at 222; Shihata, *Good Governance*, *supra* note 6, at xxiii-xxiv.

12. STOPFORD ET AL., *supra* note 7, at 222. See Trebilcock, *supra* note 2, at 40; Sherwood, *supra* note 6, at 104-05; EC Commission, *supra* note 6, at 25-329 (citing the recommendations of the EU/NIS Task Force); BROWN & DANIEL, *supra* note 6, at 10.

13. Trebilcock, *supra* note 2, at 41; Sherwood, *supra* note 6, at 104-05; STOPFORD ET AL., *supra* note 7, at 126; Webb, *supra* note 4, at 48.

14. Tshuma, *supra* note 1, at 78; FIAS, *supra* note 4; 1996 WORLD BANK REPORT, *supra* note 4, at 93-97; 1997 WORLD BANK REPORT, *supra* note 7, at 8, 103-106; Trebilcock, *supra* note 2, at 30-31, 41; WORLD BANK, THE EAST ASIAN MIRACLE: ECONOMIC GROWTH AND PUBLIC POLICY (1993) [hereinafter 1993 WORLD BANK]; Robert Wade, GOVERNING THE MARKET: ECONOMIC THEORY AND

powers are separated among branches of government,<sup>16</sup> particularly through the creation of an independent judiciary.<sup>17</sup> This type of legal system can be described as the Ideal Paradigm.

## II. REACTIONS TO A THEORETICALLY 'UNATTRACTIVE' LEGAL SYSTEM

The dominant theory outlined above was tested in a case study of foreign investors in Sri Lanka. A questionnaire was sent to foreign investors in commercial operation in Sri Lanka, and further information was collected from secondary sources, and from interviews with members of the wider business community.<sup>18</sup> The

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THE ROLE OF GOVERNMENT IN EAST ASIAN INDUSTRIALIZATION 154 (1990); HILTON L. ROOT, SMALL COUNTRIES, BIG LESSONS: GOVERNANCE AND THE RISE OF EAST ASIA 139-49 (1996); Shihata, *Good Governance*, *supra* note 6, at xxii; STOPFORD ET AL., *supra* note 7, at 126, 138; Andrew Stone et al., *Public Institutions and Private Transactions: A Comparative Analysis of the Legal and Regulatory Environment for Business Transactions in Brazil and Chile*, in EMPIRICAL STUDIES IN INSTITUTIONAL CHANGE 95-98 (Lee J. Alston et al. eds., 1996); David Clark, *The Many Meanings of the Rule of Law*, in LAW, CAPITALISM AND POWER IN ASIA 32 (Kanishka Jayasuriya ed., 1999); KATHARINA PISTOR & PHILIP WELLONS, THE ROLE OF LAW AND LEGAL INSTITUTIONS IN ASIAN ECONOMIC DEVELOPMENT 53 (1999); BROWN & DANIEL, *supra* note 6, at 5.

15. 1996 WORLD BANK REPORT, *supra* note 4, at 93-97; *see also* 1997 WORLD BANK REPORT, *supra* note 7, at 8, 36, 103-06. 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 lowest corruption.

16. Shihata, *Good Governance*, *supra* note 6, at xvii; FUNDAMENTALS OF AMERICAN LAW 27-28 (Alan B. Morisson ed., 1996); Trebilcock, *supra* note 2, at 30-31; 1993 WORLD BANK, *supra* note 14; Wade, *supra* note 14.

17. 1996 WORLD BANK REPORT, *supra* note 4, at 94-95; 1997 WORLD BANK REPORT, *supra* note 7, at 7-8; CHERYL GRAY, FALSE DAWN: THE DELUSIONS OF GLOBAL CAPITALISM 151-153 (1998); Cheryl Gray, *Reforming Legal Systems in Developing and Transition Countries*, in MAKING DEVELOPMENT WORK: LEGISLATIVE REFORM FOR INSTITUTIONAL TRANSFORMATION AND GOOD GOVERNANCE 63 (Ann Seidman et al. eds., 1999); WILLIAM RATLIFF & EDGARDO BUSCAGLIA, THE LAW OF ECONOMICS AND DEVELOPMENT 323 (1997); Clark, *supra* note 14, at 32; ROOT, *supra* note 14, at 154-55; Sherwood, *supra* note 6, at 104-05.

18. Questionnaires were sent to the Chief Executive Officer ("CEO") of each of the 402 companies in Sri Lanka, which are offered extra incentives by the government because they are either export-oriented or operating in a priority sector. Sixty-seven usable questionnaires were returned. In addition, thirty-three

objective of the case study was to test how investors react to a legal system which is not of the Ideal Paradigm.

The questionnaire used two approaches in order to establish how investors react to a legal system that is not of the Ideal Paradigm, and is therefore theoretically unattractive for FDI. First, it was determined to what extent investors perceived the Sri Lankan legal system to deviate from the Ideal Paradigm. These results were then analysed in light of whether foreign investors would invest in hindsight of the legal system. Second, the questionnaire tested investor's opinions as to the attractiveness of a hypothetical legal system which does not conform with the Ideal Paradigm.

#### A. THE ATTRACTIVENESS OF SRI LANKA'S LEGAL SYSTEM

In 1977, Sri Lanka began the transition from an "inward looking, socialist system" to a liberalized market economy, when the new government tamed the opposition parties and the labor unions, and introduced an open foreign investment. In the resulting political stability, Sri Lanka was hailed as the "new investment centre of Asia."<sup>19</sup> However, "the investment climate . . . did not remain highly favorable for long." In 1982, a power struggle between various factions within the ruling party led to unstable and uncertain policies, and in 1983, ethnic strife re-emerged between the Tamils and Sinhalese.<sup>20</sup> Matters improved again when, after the civil conflict was contained in 1989, a "second wave" of liberalization began in 1990. The government reformed and relaxed its policies relating to

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semi-structured interviews were conducted with representatives of the legal profession, academia, non-governmental organizations, and businesses in Sri Lanka. This research was conducted in 1997-1998, and the findings discussed herein are on file with the author.

19. Premachandra Athukorala, *Foreign Direct Investment and Manufacturing for Export in a New Exporting Country: The Case of Sri Lanka*, 18 THE WORLD ECONOMY 547-548 (1995) (quoting the *Far Eastern Economic Review*); World Bank, *Country Guide: Sri Lanka* (visited Sept. 1, 2000) <<http://www.worldbank.org/html/extdr/offrep/sas/lk2.htm>>; DOUGLASS BULLIS, SUCCEED IN BUSINESS: SRI LANKA 40 (1997).

20. Athukorala, *supra* note 19, at 547. The United States Central Intelligence Agency reports that the ethnic conflict has created several hundreds of thousands of refugees who have left the island since the 1980s. See Government of the United States: Central Intelligence Agency, *The World Factbook: Sri Lanka* (visited Aug. 31, 2000) <<http://www.odci.gov/cia/publications/factbook/ce.html>>.



privatization, taxation, and customs duties, foreign exchange controls and foreign ownership, and created the Board of Investment (BOI).<sup>21</sup> Today most of the inward FDI in Sri Lanka comes from Asia and, since the local market is small, is often export-oriented. Investors from developing countries are generally small-scale.<sup>22</sup>

The Sri Lankan government has clearly been persuaded of the need for legal reform for the purposes of attracting FDI, and consulted the World Bank Legal Department and Foreign Investment Advisory Service throughout the 1990s.<sup>23</sup> A representative of the World Bank Legal Department visiting Colombo noted in a 1997 interview that the encouragement of FDI “is in the forefront of the government’s thinking” behind current legal reform. However, he also remarked that “one can never be sure” whether improvements in levels of FDI “can be attributed to legal reform or not. . . . but to some extent, that thought is intuitive.”<sup>24</sup>

### 1. *Foreign Investors’ Perceptions of the Legal System*

Respondents were asked to describe their perceptions the legal system, by completing a series of ten statements about the laws, courts, bureaucrats and government of Sri Lanka. In the following subsections, investors’ perceptions of Sri Lankan laws, bureaucracy, courts and government are examined in turn. Descriptors in the final column of each table show whether the response option broadly indicates conformity with (+), or deviation from (-), the Ideal Paradigm.<sup>25</sup>

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21. Athukorala, *supra* note 19, at 547-548.

22. *See generally* Athukorala, *supra* note 19. Although slightly more than half of the foreign firms established in the period 1978-1995 were from developed country host states, it was developing country host states that contributed more than half of the total foreign investment, and of total investment in firms with foreign capital participation. Premachandra Athukorala & Ric Shand, *Cultivating the Pearl: Australia’s Economic Relations with Sri Lanka*, 31-32 (Institute of Policy Studies Research Studies International Economic Series No. 5, 1997).

23. W.M. TILAKARATNA, *ISSUE OF TRANSPARENCY IN SRI LANKA: A WORLD BANK STUDY* (1995) (on file with the author); FIAS, *supra* note 4.

24. Interview 10 (on file with the author).

25. Percentages are calculated ignoring blank responses, but including “don’t know” or “don’t understand” responses. The frequency of responses is shown in brackets next to the percentages. Although respondents were given the opportunity

Perceptions of Sri Lankan Laws

The descriptor column in Table 1 indicates that most respondents perceived the laws of Sri Lanka to broadly conform with the Ideal Paradigm with regard to accessibility, verification and clarity. However, most perceived a deviation from the Ideal Paradigm with regard to the predictability of legal change. Indeed, sixty-four percent of respondents indicated that changes in laws and policies are completely, mostly, or frequently unpredictable. Unpredictable changes to Sri Lanka's laws reportedly arise from the promulgation by the President of regulations under Emergency Powers,<sup>26</sup> Parliamentary legislation,<sup>27</sup> ministerial decisions,<sup>28</sup> and delegated legislation.<sup>29</sup>

It can be concluded that although most respondents perceive that it is difficult to predict what changes in law will occur, they also perceive that once a change has been implemented, it is not difficult to discover what the written law is. Whether respondents perceive that it is easy to predict how the law will be implemented depends upon their perceptions of the courts and bureaucrats, which are discussed below.

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to select from six response options for each question, in the interests of clarity, response options are grouped, for example as "never/rarely/sometimes."

26. A 1971 declaration of a State of Emergency has never been revoked. See CENTRE FOR INDEPENDENCE OF JUDGES AND LAWYERS, JUDICIAL INTERDEPENDENCE IN SRI LANKA: REPORT OF A MISSION 13-18 (1997) [hereinafter CIJL]. Regulations passed by the President under the resulting Emergency Powers include, bizarrely, the Emergency (Games of Chance) (Jack-Pot) Regulation 1995 and more seriously, the Emergency (Generation of Electrical Power and Energy) Regulation 1997. *Id.* at 36-37.

27. Interviews 5, 7, 13, 22, 26, and 27 (on file with the author).

28. Interviews 1, 3, 5, 7, 8, 13, 22, 23, 25, 26, and 27 (on file with the author).

29. Interview 1 (on file with the author).

**Table 1**

## PERCEPTIONS OF SRI LANKAN LAWS

Statement and Response options	Responses	Descriptor
<i>Laws are ( . . ) accessible</i>		<i>Accessibility</i>
never / rarely / sometimes	8 % (5)	-
always / mostly / frequently	92% (57)	+
<i>Laws are ( . . ) ambiguous or unclear</i>		<i>Clarity</i>
always / mostly / frequently	18% (12)	-
never / rarely / sometimes	82% (54)	+
<i>Laws are ( . . ) new and untested</i>		<i>Verification</i>
always / mostly / frequently	11% (7)	-
never / rarely / sometimes	89% (56)	+
<i>Changes in the law and policies are ( . . ):</i>		<i>Predictability</i>
completely / highly predictable	8% (5)	+
fairly predictable	22% (15)	+
frequently / mostly/ completely unpredictable	64% (42)	-

*Perceptions of Sri Lankan Courts*

The descriptor column in Table 2 indicates that most respondents perceived the decisions of Sri Lankan courts to be objective and consistent enough to broadly conform with the Ideal Paradigm. Sixty-seven percent of respondents reported that courts could mostly, always, or frequently be trusted to enforce laws objectively according to transparent rules. However, most respondents perceived deviation from the Ideal Paradigm in the area of court delays. Eighty-five percent of respondents said that court procedures were always, mostly or frequently subject to unreasonable delays.<sup>30</sup> As one

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30. A report by a committee appointed by the Minister of Justice estimated, on the basis of judicial reports from a sample of courts, that the average case in Sri Lanka was delayed by a period of five years. The report included examples of

interviewee put it, "Litigation in Sri Lanka is a 100 percent successful operation, but the patient is dead."<sup>31</sup> Secondary sources and interviewees blamed delays on a lack of infrastructure, as well as the behavior of judges and legal practitioners.<sup>32</sup>

It can be concluded that most respondents perceive court procedures to be time-consuming, but that they perceive the decision making of the court to be consistent, and therefore predictable.

**Table 2**

PERCEPTIONS OF SRI LANKAN COURTS

Statement and Response options	Responses	Descriptor
<i>Courts can (. . .) be trusted to enforce the law objectively according to transparent rules</i>		<i>Objectivity &amp; Consistency</i>
never / rarely / sometimes	30% (19)	-
always / mostly / frequently	70% (45)	+
<i>Court procedures are (. . .) subject to unreasonable delays</i>		<i>Delays</i>
always / mostly / frequently	85% (57)	-
never / rarely / sometimes	15% (10)	+

individual cases in District Courts, some of which showed delays of twenty years, but which seemed to suggest that commercial cases might be subject to less delays than other matters such as family and land. See SRI LANKA LAW'S DELAYS AND LEGAL CULTURE COMMITTEE, REPORT OF THE SRI LANKA LAW'S DELAYS AND LEGAL CULTURE COMMITTEE 7, 45-61 (1985). Other sources indicate delays of one year to eighteen months in the Supreme Court, four to eight years in the Court of Appeal, and two to three years in the Colombo High Court. See Interviews 1, 14, 16, 21, and 23 (on file with the author); CIJL, *supra* note 26, at 54-56.

31. Interview 21 (on file with the author).

32. Interviews 8, 10, 21, 26, and 32 (on file with the author); CIJL, *supra* note 26, at 41; SRI LANKA LAW'S DELAYS AND LEGAL CULTURE COMMITTEE, *supra* note 30, at 3.

*Perceptions of Sri Lankan Bureaucrats*

The descriptor column in Table 3 indicates that perceptions of Sri Lankan bureaucrats were mixed. On balance, consistency in bureaucratic decision-making was slightly more often reported to be in conformity with the Ideal Paradigm. Questionnaires indicate that fifty-eight percent of respondents reported that bureaucrats always, mostly, or frequently enforce laws consistently, as against forty-two percent who indicate that this is never, rarely, or only sometimes the case.

In addition, respondents perceived that courts deviate from the Ideal Paradigm in terms of independence and corruption. Sixty-two percent of respondents felt that politicians could always, mostly or frequently influence the decisions of government officials, and a further thirty-one percent reported that this could sometimes happen. With regard to corruption, only twenty-nine percent of respondents reported that it was rarely or never necessary to use bribery when dealing with government officials. Interestingly, respondents most frequently indicated (forty-nine percent) that it is sometimes necessary to use corruption. This is probably the worst possible response, since it indicates that it may not be clear to investors whether bribery is necessary, or whether it will have the desired effect. Only eleven percent of respondents indicated that there is certainty in corruption, that is, it is always or never necessary.

It can be concluded that while respondents may, by a small margin, perceive bureaucrats to be consistent, they generally perceive those decisions to be vulnerable to corruption and political interference. It is possible that consistency in the incidence and effect of corruption and political interference may account for some of the perceived consistency in bureaucratic decision making.

Table 3

## PERCEPTIONS OF SRI LANKAN BUREAUCRATS

Statement and Response options	Responses	Descriptor
<i>Laws are( . . ) consistently enforced by government officials</i>		<i>Consistency</i>
never / rarely / sometimes	42% (28)	-
always / mostly / frequently	58% (38)	+
<i>It is ( . . ) necessary to use bribery when dealing with government officials</i>		<i>Corruption</i>
always / mostly	16% (10)	-
sometimes/ frequently	55% (35)	-
rarely / never	29% (18)	+
<i>Politicians can ( . . ) influence the decisions of government officials</i>		<i>Independence</i>
always / mostly / frequently	62% (41)	-
never / rarely / sometimes	36% (24)	+

*Perceptions of the Credibility of the Sri Lankan Government*

The descriptor column in Table 4 indicates that most respondents perceived the government to be credible enough to be in broad conformity with the Ideal Paradigm. Sixty-nine percent of respondents reported that the government announcements of major policies are always, mostly or frequently credible. This is in contrast to investor perceptions of the stability of individual laws (see above). It may be that while the Sri Lankan government generally provides macro-level credibility, it does not generally provide micro-level credibility.

**Table 4**

PERCEPTIONS OF THE CREDIBILITY OF THE SRI LANKAN GOVERNMENT

Statement and Response Options	Responses	Descriptor
<i>The government's announcements of major policies are (. . .) credible</i>		
never / rarely / sometimes	31% (20)	-
always / mostly / frequently	69% (38)	+

## 2. *Measuring the Sri Lankan Legal System Against the Ideal Paradigm*

In order to allow a more specific comparison of the Sri Lankan legal system with the Ideal Paradigm, responses to each aspect of the legal system were converted into a score based on a scale of zero to five, with five indicating maximum conformity with the Ideal Paradigm. Scores were then converted into the following verbal descriptors: "attractive," "borderline," "unattractive," and "extremely unattractive."<sup>33</sup> An overall average of the scores indicates that (if the respondent's description of the legal system is accurate) the legal system as a whole is "unattractive," according to the Ideal Paradigm.<sup>34</sup>

Table 5 shows the "attractiveness" of each aspect of the legal system, as measured against the Ideal Paradigm. No institution in the Sri Lankan legal system would be rated as attractive overall, according to the criteria of the Ideal Paradigm. The bureaucracy received the lowest score of all institutions, making it the least "attractive" component of the legal system, according to the Ideal Paradigm.<sup>35</sup> With the exception of accessibility laws, all specific features of each institution would be considered to be of "borderline"

33. Where 4 or above is "attractive;" 3 to under 4 is "borderline;" 2 to under 3 is "unattractive;" and under 2 is "extremely unattractive." Results were calculated excluding "don't know," "don't understand," and blank responses.

34. The overall average score was 2.76, and 55% of respondents returned an average score of 3 or below for the legal system as a whole.

35. The highest institutional average scores were achieved by laws (3.29), and the lowest institutional average score was achieved by the bureaucracy (2.24).

attractive at best. Court efficiency and bureaucratic independence were described as “extremely unattractive.”

**Table 5**

SRI LANKAN LEGAL SYSTEM MEASURED AGAINST THE IDEAL PARADIGM<sup>36</sup>

Institution (Overall)	Feature	Ideal Paradigm Descriptor
Bureaucracy (Unattractive)	Consistency	Unattractive
	Corruption <sup>37</sup>	Unattractive
	Independence	Extremely unattractive
Courts (Unattractive)	Consistency	Borderline
	Efficiency	Extremely unattractive
Government (Borderline)	Credibility	Borderline
Laws (Borderline)	Accessibility	Attractive
	Verification	Borderline
	Stability	Unattractive
	Clarity	Borderline

### 3. *Reactions to the Sri Lankan Legal System*

According to the dominant theory, foreign investors seek low transaction costs and high certainty, and these characteristics are best secured in the context of the Ideal Paradigm. The latter provides efficiency through high quality laws, courts, and bureaucracy; and predictability through stable, accessible, and clear laws; limited discretion; low corruption; and the separation of powers. It is clear that investors perceive the Sri Lankan legal system to deviate significantly from the Ideal Paradigm. Whether this constitutes a cue

36. Where 4 or above is “attractive,” 3 to under 4 is “borderline,” 2 to under 3 is “unattractive,” and under 2 is “extremely unattractive.”

37. The assignment of scores to responses relating to corruption was designed to take into account the fact that businesses are expected to prefer predictable corruption to unpredictable corruption. Since unpredictable corruption was worse than predictable corruption, a low level certainty score (1) was given where respondents suggested that bribery is “sometimes” and “frequently” necessary, the highest level certainty score (5) was given to response options “always” or “never,” and a mid-level certainty score (3) was awarded to response options “mostly” and “rarely.”



for reform depends upon what foreign investors want. If the dominant theory is correct, then investors should perceive the Sri Lankan legal system to be unattractive, and therefore in need of reform. But it appears that this is not always the case.

The very fact that respondents to the questionnaire had invested in Sri Lanka is evidence that their opinions of the Sri Lanka's legal system are not overwhelmingly negative. However, given that only forty-three percent (twenty-nine) of foreign investors in respondent companies were reported to have made a pre-investment investigation of the legal system,<sup>38</sup> it is possible that the original investment was made in ignorance of the legal system. Therefore, respondents were asked whether they would still invest in hindsight of the legal system. Remarkably, seventy-six percent (fifty-one) of respondents said the foreign investors in their company would still have invested in Sri Lanka in hindsight of the legal system.<sup>39</sup>

There are two possible reasons for investors' willingness to invest in hindsight of Sri Lanka's theoretically "unattractive" legal system, neither of which bode well for the dominant theory. First, it is possible that some investors are neither aware of, or do not care about, the potential damage that an inefficient and unpredictable legal system can cause to their investment. The low incidence of pre-investment investigations of the legal system among the Sri Lankan sample of foreign investors adds some weight to this argument. Support of a theoretical nature is provided by the concept of bounded rationality. This concept explains that although economic actors may be guided to some by rational economic motives, this does not necessarily mean that the decisions of economic actors are always the most efficient.<sup>40</sup> The "normative" approach to decision making offered by classic economics would suggest that a potential investor should, taking into account all the relevant information, make the decision which maximizes profit. In reality, such information may be

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38. Forty-six percent (thirty-one respondents) said they had not made a pre-investment investigation. Ten percent (seven respondents) replied "don't know" or left the question unanswered).

39. Six percent (four respondents) said they would not, 9% (six respondents) said they might not, and an additional 9% (ten respondents) did not know or did not answer.

40. David Campbell & Sol Picciotto, *Exploring the Interaction Between Law and Economics: The Limits of Formalism*, 18 LEGAL STUD. 249, 275 (1998).

non-existent, not readily available, disregarded, or misinterpreted.<sup>41</sup> In the context of a positive analysis of the relationship between legal systems and FDI, it is the investor's decision to invest in a country, rather than the merits of that decision, which is ultimately significant. The measurement of risk is "a subjective business . . . [i]t is managers' *perceptions* that count."<sup>42</sup>

The second explanation is no less problematic for the dominant theory. It may be that legal systems that deviate from the Ideal Paradigm nonetheless offer efficiency and predictability. Since respondents perceived that the Sri Lankan legal system deviates substantially from the Ideal Paradigm, but most would still invest in hindsight of that legal system, it would seem that a legal system which does not conform with the Ideal Paradigm is not necessarily unattractive to all investors. However, as the following section explains, a further test is necessary to establish why, and to what extent, this may be the case.

#### B. THE ATTRACTIVENESS OF THE HYPOTHETICAL LEGAL SYSTEM

The Institutional school of thought, upon which much of the dominant theory of legal reform relies, demonstrates that "there is no unique efficient result" of the interaction between legal systems and the economy.<sup>43</sup> It also argues that institutions "matter economically in the actual costs (and benefits) they create for businesses, not in their compliance with ideal forms," and that therefore institutions must be assessed according to their effect on the "efficiency of economic transactions," rather than on the extent of "their resemblance to rational Western norms of law and jurisprudence."<sup>44</sup> The World Bank appears to be open to the possibility that a variety of institutional mechanisms can be used to support a predictable, low cost legal environment. However, World Bank policy has nonetheless resorted to the pursuit of a normative Ideal Paradigm, although it does

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41. YAIR AHARONI, *THE FOREIGN INVESTMENT DECISION PROCESS* 35-36 (1966).

42. STOPFORD ET AL., *supra* note 7, at 142 (using emphasis in original). See F. KNIGHT, *RISK, UNCERTAINTY AND PROFIT* (1921).

43. NICHOLAS MERCURO & STEVEN G. MEDEMA, *ECONOMICS AND THE LAW: FROM POSNER TO POST MODERNISM* 118 (1997).

44. Stone et al., *supra* note 14, at 95, 99.

studiously avoid reflecting upon the remarkable similarities between that paradigm and Western legal systems.

Putting aside quarrels over possible tendencies towards neo-imperialism, the most important question is whether the Ideal Paradigm is the only attractive option. There is a lack of research objectively addressing this question. For example, the study by Borner, *et al.*, which the World Bank has heavily supported, asked domestic and foreign investors in twenty-eight countries to what extent they were able to use bribes or personal contacts to influence the speed and/or outcome of the bureaucratic or judicial process. These responses were then compared with economic growth rates in each country, and it was concluded that those countries in which the private sector was better able to influence the decisions of bureaucrats showed slower economic growth rates. This was taken as proof positive that credibility results in high economic growth.<sup>45</sup>

Two points are important here. First, a correlation between the nature of the legal system and economic growth does not prove the direction of causation. It may equally be the case that economic growth provides the resources necessary for changes to the legal system.<sup>46</sup> Second, respondents to the Borner, *et al.*, survey were not given an opportunity to indicate whether they thought such ready access to bureaucrats was attractive.<sup>47</sup> If the purpose of research in this field is to make a positive assessment of what type of legal systems investors are attracted to, rather than a normative assessment of what they ought to be attracted to, then it is surely essential to give investors a free opportunity to indicate their preferences. This is the purpose of the second set of questions in the Sri Lanka survey.

The questionnaire asked respondents to imagine that the Sri Lankan legal system had a number of hypothetical characteristics, and to comment upon what impact (good, bad, variable, or none)

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45. BORNER ET AL., *supra* note 4, at 176.

46. Richard E. Messick, *Judicial Reform and Economic Development: A Survey of the Issues*, WORLD BANK RES. OBSERVER 117-31 (1999).

47. BORNER ET AL., *supra* note 4, at 176. Similarly, a survey conducted on behalf of the Commonwealth Secretariat gave investors the opportunity to note whether certain aspects of the legal system were an "obstacle," but not whether those aspects were of assistance. See Harnik Deol, *Promoting Investment in the Commonwealth: Survey of UK Private Sector*, WORLD AWARE 18 (1998).

they expected each characteristic to have upon their investment. These characteristics were: that *laws* are inaccessible, ambiguous, untested, and change unexpectedly; that *courts* do not enforce laws consistently, and are subject to delays; and that *bureaucrats* are subject to political interference, open to bribery, and do not enforce laws consistently. In addition to controlling for respondents' varying perceptions of the nature of the Sri Lankan legal system, this series of questions provided a more detailed view of how investors react to individual aspects of a legal system that deviate from the Ideal Paradigm.

If the dominant theory is correct, then respondents should overwhelmingly indicate that each aspect of the hypothetical legal system would have a bad impact upon the value of their investments. When responses to all aspects of the hypothetical legal system are considered collectively, it is clear that nearly three-quarters (seventy-four percent or 429 respondents) of the ratings were bad. However, approximately a quarter (twenty-six percent or 147 respondents) were other than bad—that is, “good,” “variable,” or “none.”<sup>48</sup>

When the ratings returned by individual respondents are examined, it appears that just under one-third of respondents indicated that they expected *every* characteristic of the hypothetical legal system to have a “bad” impact on their investment.<sup>49</sup> Those respondents confirmed the dominant theory that all aspects of legal systems that deviated from the Ideal Paradigm would be unattractive. However, contrary to theory, the remaining two-thirds of respondents expected that at least one aspect of the hypothetical legal system would not necessarily be “unattractive.” Indeed, one-third of respondents expected that *at least three* of the nine hypothetical characteristics would not necessarily have a bad impact on their investment; and ten percent expected that *more than five* hypothetical characteristics would not necessarily have a bad impact. It is clear that the majority of respondents do not fully support the theoretical position that legal systems that deviate from the Ideal Paradigm are necessarily unattractive.

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48. Excluding “don’t know,” “don’t understand,” and blank responses.

49. Thirty-one percent (21 respondents). This includes three respondents who indicated that eight characteristics would have a bad impact, and “don’t know” to one characteristic.

Chart 1 shows that, in relation to any individual hypothetical characteristics of the legal system (e.g., that laws are inaccessible or that courts are subject to unreasonable delays), between sixty and eighty-three percent of respondents expected a "bad" impact. However, between seventeen and forty percent of respondents expected each characteristic to have an impact that was other than bad.<sup>50</sup>

**Chart 1**

EXPECTED IMPACT OF THE HYPOTHETICAL LEGAL SYSTEM  
ON THE VALUE OF INVESTMENTS

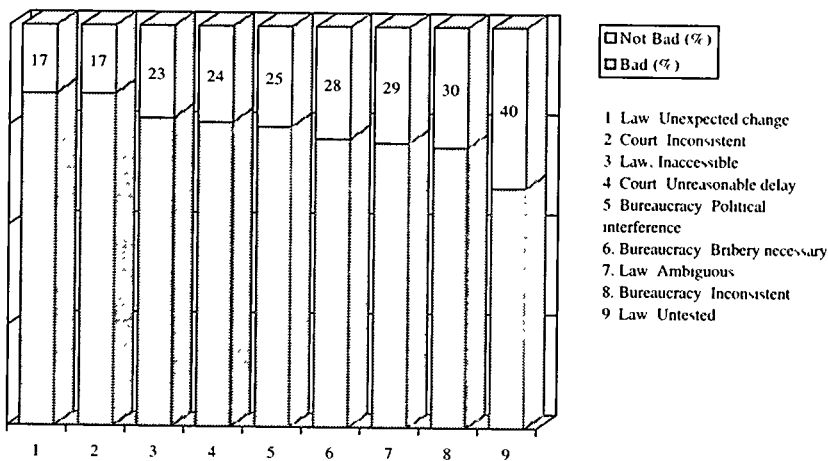


Chart 1 can be taken to indicate a descending incidence of concern (from left to right) among the sample group about aspects of legal systems that deviate from the Ideal Paradigm. Unexpected changes in laws, and the inconsistent enforcement of laws by courts, were jointly most likely to be expected to have a bad impact on investments (eighty-three, fifty-five, and fifty-three percent, respectively). The existence of untested laws was the characteristic

50. Excluding "don't know," "don't understand," and blank responses. Between 11% and 38% of respondents expected individual characteristics to have a "variable" impact, and a maximum of 9% expected the impact to be "none" or "good."

least likely to be expected to have a bad impact upon investments (sixty percent).

### C. EXPLAINING THE DISPARITY BETWEEN THEORY AND REALITY

It was noted above that there are two possible explanations for the fact that, contrary to the expectations of theorists, some investors are not repelled by host states whose legal systems deviate from the Ideal Paradigm. First, it is possible that those investors are not aware of, or are not sufficiently worried about, the potential damage that an inefficient and unpredictable legal system can cause to their investment. Second, it may be that legal systems that deviate from the Ideal Paradigm nonetheless appear to some investors to offer efficiency and predictability. It was also noted that neither of these possibilities has been fully explored by empirical research. However, respondents in the Sri Lankan case study give some support both to the first explanation, to the extent they reported a low incidence of pre-investment investigations of the legal system; and the second explanation, to the extent that they reported a high incidence of willingness to invest in hindsight of the legal system, and that two-thirds of them expected that the impact of some aspects of a theoretically “unattractive” legal system would not necessarily be bad. Why might that be?

#### 1. *Predictability and Efficiency in Non-Ideal Legal Systems*

A hint of the answer to this question is provided by the observation of Stopford and Strange that although a foreign investor may “call loudly for clear, unambiguous rules,” “continuity of policy,” and decisions which are “not capricious,” that investors may also recognize the benefits of a government which has the ability “to be flexible, to discriminate in its favor.”<sup>51</sup> In the terminology of the dominant theory, legal systems that deviate from the Ideal Paradigm by allowing broad bureaucratic discretion, instability and vagueness in laws, corruption, and interference by one branch of government in the activities of another, might provide efficiency and predictability—at least in the (all-important) eyes of investors.

To perceive opportunities for efficiency and predictability in such

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51. STOPFORD ET AL., *supra* note 7, at 13, 135.

legal systems requires a radically different conception of the relationship between the private sector and the state than that proposed by the Ideal Paradigm. In Asia, many aspects of legal systems can be described as permeable—the private sector is allowed to have a greater degree of access to the state than in the West. Large businesses have “extensive pre-emptive involvement” in the lawmaking process “that go beyond the well-known phenomenon of lobbying in the West,”<sup>52</sup> and businesses regularly make use of close connections with government officials.<sup>53</sup> The relationship between the state and individuals in Asia has been described as an “informal,” “voluntary and non-authoritarian” process of negotiation and guidance in which officials typically avoid “legal conflicts caused by the promulgation of rules.”<sup>54</sup> 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.<sup>55</sup> In this environment, it is neither productive nor realistic to view the state and the private sector as adversaries, and it is not difficult to understand how an investor might perceive valuable opportunities to influence their destiny.<sup>56</sup> Indeed Jayasuriya goes so far as to suggest

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52. PISTOR & WELLONS, *supra* note 14, at 281.

53. GRAY, FALSE DAWN, *supra* note 17, at 169, 183-85. See Carol Jones *Capitalism, Globalization, and Rule of Law: An Alternative Trajectory of Legal Change in China*, 3 SOC. & LEGAL STUD. 195-221 (1994); Anuja Rajbhandary, *Protecting Trade Secrets Through Family Businesses: A Case Study on Nepal*, 16 INT'L REV. OF L. & ECON. 483-90 (1996); Jane Kaufman Winn, *Relational Practices and the Marginalization of Law: Informal Financial Practices of Small Businesses in Taiwan*, 28 L. & SOC'Y REV. 193-231.

54. For example, see a study of six Asian countries, based on 115 interviews, in which it was found that bureaucrats could more easily resolve problems relating debt management under insolvency by stepping outside of the formal legal framework, in Bahrin Kamarul & Roman Tomasic, *The Rule of Law and Corporate Insolvency in Six Asian Legal Systems*, in LAW, CAPITALISM AND POWER IN ASIA, 151-73 (Kanisha Jayasuriya ed., 1999). For an example of the successful use in Azerbaijan of case-by-case approval by high level officials of foreign investments in the energy sector, see Thomas Wälde & Christian von Hirschhausen, *Regulatory Reform in the Energy Industry of Post-Soviet Countries: Western Transplants—The Third Way?*, in MAKING DEVELOPMENT WORK: LEGISLATIVE REFORM FOR INSTITUTIONAL TRANSFORMATION AND GOOD GOVERNANCE 97, 110 (Ann Seidman et al. eds., 1999).

55. Kamarul & Tomasic, *supra* note 54, at 151-73.

56. Kanishka Jayasuriya, *Introduction: A Framework for the Analysis of Legal*

that investors in some parts of Asia are so intertwined with the state that they are essentially part of it.<sup>57</sup> However, the relative merits of permeability have rarely been tested.

With regard to the efficiency of permeable legal systems, most studies focus primarily on an assessment of the costs of operating in full compliance with formal laws. They do not take account of the fact that in permeable states, discretion can be exercised to allow certain dispensations from formal conditions, which may reduce overall costs.<sup>58</sup> The dominant theory is particularly skeptical of the potential of bribery as an efficiency tool.<sup>59</sup> However, as Stone, *et al.*, discovered, systems that routinely rely on the use of “speed money,” such as Brazil, can be nearly as efficient as those that do not, such as Chile.<sup>60</sup>

Even fewer studies have attempted to quantify the degree of predictability provided by a permeable legal system. The dominant theory assumes that states that allow officials to have a large amount of discretion are characterized by high uncertainty. It may be true that “arbitrary decisions prove to be one of the biggest disincentives to investors,”<sup>61</sup> but decisions that appear arbitrary to some may be perfectly predictable to others. In permeable states, economic actors may be able to determine the outcome of their case by influencing

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*Institutions in Asia*, in LAW, CAPITALISM AND POWER IN ASIA, 10 (Kanisha Jayasuriya ed., 1999). See ROOT, *supra* note 14, at 170-71.

57. Jayasuriya, *supra* note 56, at 10.

58. For example, the FAIS analysis of legal systems, “[i]s undertaken from the perspective of what is required for *full* compliance with *all* existing laws and regulations,” and De Soto’s study which documented the number of steps and the costs required to enter and remain in the formal business world in Peru. FIAS, *supra* note 4 (emphasis added). It was found that, on average, it took 289 days and \$1231 (thirty-two times the monthly minimum living wage) to fulfill the eleven steps necessary to set up a small business in Peru, without using bribes. See HERNANDO DE SOTO, THE OTHER PARTY: THE INVISIBLE REVOLUTION IN THE THIRD WORLD 134 (June Abbot trans., 1989). What that study did not assess was whether alternative mechanisms had been developed to speed up or smooth out the process of “going formal” and, if so, how much those alternative routes cost. See Stone *et al.*, *supra* note 14, at 105.

59. Jayasuriya, *supra* note 56, at 8-9; ROBERT KLITGAARD, CONTROLLING CORRUPTION 26, 139 (1988); GRAY, FALSE DAWN, *supra* note 17, at 153-54.

60. Stone *et al.*, *supra* note 14, at 105-06.

61. STOPFORD ET AL., *supra* note 7, at 126; see also BORNER ET AL., *supra* note 4, at 16.



the decisions of bureaucrats or by influencing the opinions of politicians, who in turn put pressure on bureaucrats. Clearly, the ability to influence your own destiny provides a micro-level of certainty, but no macro-level of certainty. However, investors may be satisfied with the certainty of knowing that they can affect the outcome of their own case, and be less concerned about the consistent application of rules to other cases.<sup>62</sup>

This proposition is supported by the fact that in the Sri Lankan case study (Chart 1), thirty percent of respondents indicated that the inconsistent enforcement of laws by bureaucrats would not necessarily have a bad impact on their investments. Therefore, the heavy emphasis placed on bureaucratic consistency by the Ideal Paradigm appears to be somewhat misplaced. Furthermore, twenty-nine percent of respondents indicated that ambiguity in laws would not necessarily have a bad impact on their investment. In interviews it was suggested that ambiguity can leave room for bureaucrats to maneuver on behalf of the investor and therefore “a smart guy may see vagueness as a competitive advantage, while others would see it as a reason to panic.”<sup>63</sup> Private individuals can “bend or manipulate” regulations,<sup>64</sup> and many issues under the BOI’s control “are vague and can be sorted out in your favor.”<sup>65</sup> On the other hand, two interviewees suggested that vagueness might not be attractive to investors who wish to “comply with all the laws and customary practices,” and who “don’t want to be tempted to infringe the laws.”<sup>66</sup>

Where the law is not roomy enough to accommodate an investors needs, bribery offers an alternative method of ensuring a favorable result. In the Sri Lankan case study, twenty-eight percent of respondents indicated that the need to use bribery when dealing with bureaucrats would not necessarily have a bad impact on the value of an investment. Interviews and secondary materials gave ample evidence that the private sector regularly and successfully seeks to use bribery in order to avoid paying taxes, as well as to gain licenses

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62. See Jayasuriya, *supra* note 56, at 10 (providing an example).

63. Interview 20 (on file with the author).

64. Interviews 23 and 27 (on file with the author).

65. Interviews 20, 23, and 26 (on file with the author).

66. Interviews 18 and 24 (on file with the author).

and incentives.<sup>67</sup>

Alternatively, investors might find it preferable to influence the opinion of politicians, who in turn put pressure on bureaucrats to ensure that they make the desired decision. It is perfectly plausible that this method could provide the requisite level of predictability. Indeed, a 1995 survey conducted on behalf of the World Bank indicated that during the 1970s, when Sri Lanka was run in a relatively autocratic fashion, interactions with government were quicker and more transparent, since the President was the main decision maker and it was easy to determine what his decision would be.<sup>68</sup> Interviewees provided two contemporary examples of the benefits of political interference. Both involved decisions by bureaucrats to issue and later revoke authorizations for the building of new projects—one a private hospital and the other large hotel. In each case, the President stepped in and negotiated or legislated for the initial approval to be reinstated.<sup>69</sup>

With regard to litigation, the dominant theory argues that courts must make decisions that are both speedy and consistent. However, twenty-four percent of respondents to the Sri Lankan survey indicated that even “unreasonable” delays would not necessarily have a bad impact on the value of their investments. In the words of a committee appointed by the Minister of Justice to investigate delays in Sri Lanka, “undoubtedly there could always be a minority of litigants who may benefit from the slow resolution of cases.”<sup>70</sup> It is well known, not least by well-heeled lawyers and their weary clients, that litigation is a waiting game, the outcome of which depends to a significant degree on the ability of the parties to withstand the pressure on their patience and financial resources. As one interviewee suggested, a degree of certainty can be achieved by “important” litigants who sometimes have the power to increase or shorten court delays.<sup>71</sup>

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67. TILAKARATNA, *supra* note 23, at i, 7; Interviews 3, 13, and 15.

68. TILAKARATNA, *supra* note 23, at 2.

69. Interviews 20 and 26 (on file with the author).

70. SRI LANKA LAWS DELAYS AND LEGAL CULTURE COMMITTEE, *supra* note 30, at 2.

71. Interview 1 (on file with the author).

Interestingly, inconsistency in court decision making was more often expected to have a bad impact on investments than was inconsistency in bureaucratic decisions. Two factors might cause foreign investors in Sri Lanka to be more concerned about judicial inconsistency. First, the Sri Lankan courts are generally considered to be above political influence and corruption.<sup>72</sup> Second, they are considered by some to be biased against foreign investors.<sup>73</sup> If foreign investors feel that they cannot influence the court, and that the court is biased against them, then they are likely to be ill-disposed towards inconsistency in judicial decision making.

## 2. *A Class of Non-Conforming Investors?*

Are some investors more likely to perceive opportunities for efficiency and predictability in legal systems that deviate from the Ideal Paradigm? The case study of Sri Lanka indicates the possible existence of a class of non-conforming investors, in that there is a possible link between the failure to conduct a pre-investment investigation, and the perception that legal systems which deviate from the Ideal Paradigm might be attractive. Respondents who had *not* made a pre-investment investigation of the legal system were ten percent less likely (sixty-nine percent) than respondents who *had* made an investigation (seventy-nine percent) to expect that characteristics of the hypothetical legal system would have a bad impact upon their investment.<sup>74</sup> It may be that some investors do not investigate the legal system, and expect more positive outcomes from from a legal system that does not conform with the Ideal Paradigm because they consider themselves to be particularly well-equipped to deal with a developing country's legal system.

There is every reason to expect that different investors will have different perspectives as to what constitutes an attractive legal system. For example, a foreign investor coming from a home state

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72. Interviews 23 and 27 (on file with the author); CIJL, *supra* note 30, at 32-35. However, two interviewees disagreed, suggesting that the courts were open to corruption. *See* Interviews 4 and 25 (on file with the author).

73. Interviews 4, 13, and 27 (on file with the author).

74. Based on a calculation of overall percentages of "bad" responses for those who did investigate versus those who did not, excluding "don't know," "don't understand," and blank responses.

whose legal system deviates from the Ideal Paradigm may well be better able to deal with a similar legal system in a host state. However, the characteristics of the investors which legal reform is intended to support are rarely addressed by commentators.”

When differences between foreign investors are noted, it seems that those who are not deterred by a legal system that deviates from the Ideal Paradigm are considered to be of less value to the host country. For example, the FIAS program recognizes that the discretionary behavior of bureaucrats “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 countries with such legal systems “may lose the ‘good’ foreign investors they all attempt to attract.”<sup>76</sup> The implication is that those investors who are not dissuaded by such legal systems are not “good.”<sup>77</sup>

This position may become less tenable if and when foreign investment flows between Asian states increases. Athukorala noted in 1995 that the high-tech sector in Sri Lanka had thus far been dominated by investors from industrialized countries, who “usually place a greater emphasis on political stability” in choosing host states. However, he goes on to remark that Asian investors, particularly those from Korea and Taiwan, are beginning to gain ground internationally in the high-tech manufacturing sector, and that these investors “seem to place relatively less weight on political and policy instability.” He concludes that this development is “bound to have immense implications in the years to come for Sri Lanka” and other countries in the region.<sup>78</sup> The possible impact of nationality and other investor characteristics—size, export-orientation, the

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75. This issue is explored further in a book by the author (forthcoming 2000).

76. FIAS, *supra* note 4.

77. The theory of bounded rationality supports the Ideal Paradigm’s emphasis on impermeable legal systems, to the extent that the foreign investor who is unfamiliar with the host country may find it difficult to benefit from permeability. However, since the foreign investors’ perceptions of permeable systems are rarely tested, it is not yet possible to determine whether the information costs associated with the investigating them outweigh any potential benefits which they might offer.

78. Athukorala, *supra* note 19, at 562.

existence of a local partner, and location within an export processing zone—on the relationship between legal systems and FDI deserves further exploration.<sup>79</sup>

#### D. SUMMARY OF FINDINGS

The case study confirms that the Sri Lankan legal system deviates substantially from the Ideal Paradigm. However, it is also clear that some investors are not deterred by the Sri Lankan legal system. All respondents invested in Sri Lanka, despite its deviation from the Ideal Paradigm; and by far the majority indicated that they would invest in hindsight of the legal system. In addition, in relation to most characteristics of the hypothetical legal system, a significant minority of respondents indicated that they did not necessarily expect such characteristics to have a “bad” impact upon the value of their investment.

It can be concluded that a legal system that deviates from the Ideal Paradigm may not necessarily be unattractive to all investors. This may be because some investors do not expect legal systems *per se* to have a significant impact upon their investments. Alternatively, the case study suggests that some investors may perceive satisfactory levels of certainty and efficiency to exist in legal systems that deviate from the Ideal Paradigm. The ability to perceive such benefits appears to arise from a more flexible conception of the relationship between the state and the private sector than that proposed by the Ideal Paradigm. Whether accurate or inaccurate, such perceptions will allow those investors for whom legal systems are important to be attracted to legal systems such as that of Sri Lanka.

### III. IMPLICATIONS FOR HOST STATES

The foregoing discussion notes that Sri Lanka has entered into a program of legal reform with a view to attracting FDI, supported by the World Bank. The case study may have significant implications for such a reform program. In particular, it illustrates that if the objective of legal reform is to cater to the foreign investor, then the first step must be to determine what the foreign investor wants.

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79. Other relevant characteristics might include size, export-orientation, the existence of a local partner, and locations within an export processing zone.

In order to get a complete picture of how legal reform in Sri Lanka might be recommended to proceed, Table 6 connects investors' perceptions of the Sri Lankan legal system (Column 2) with the incidence of investor concern relating to each hypothetical characteristic of the legal system (Column 3), in order to suggest what priority should be given to reforming each aspect of the Sri Lankan legal system (Column 4). It may be concluded that the highest priority should be given to improving the predictability of legal change, court delays, and bureaucratic independence (all ranked number one); and the lowest priority should be given to resolving defects in the accessibility, clarity, and the verification of laws (ranked number seven).

Table 6

## PRIORITIZING LAW REFORM FOR ATTRACTING FDI TO SRI LANKA

Problem	Level of the problem <sup>80</sup>	Incidence of concern <sup>81</sup>	Rank <sup>82</sup>
<i>Sri Lankan Laws</i>			
Accessibility	Low	High	(7)
Clarity	Medium	Medium	(7)
Verification	Medium	Medium	(7)
Predictability of change	High	Very High	(1)
<i>Sri Lankan Courts</i>			
Consistency	Medium	Very High	(4)
Delays	Very High	High	(1)
<i>Sri Lankan Bureaucracy</i>			
Independence	Very High	High	(1)
Consistency	High	Medium	(6)
Corruption	High	High	(4)

Like the Ideal Paradigm, the prioritization outlined in Table 6 is based on the assumption that legal reform should be guided by the private sector, and foreign investors in particular. As a result, it does not take into account the impact of such legal reform on the broader objectives of the state and the local population. Some interviewees opined that even if some investors were attracted to, or not deterred by, those aspects of the Sri Lankan legal system that do not conform

80. The "Level of 'problem'" is derived from legal system scores where: "Attractive" is "Low," "Borderline" is "Medium," "Unattractive" is "High," and "Extremely Unattractive" is "Very High."

81. The relative scale for "Incidence of Concern" is derived from the expected impact of a hypothetical legal system where "Medium" concern is when the percentage of respondents expecting bad impact is 70% or below, "High" concern is when the percentage of respondents expecting bad impact is 71-80%, and "Very High" is when the percentage of respondents expecting bad impact is above 80%.

82. "Rank" is based on an average of verbal descriptors in Columns 2 and 3.

with the Ideal Paradigm, this is not a valid reason for failing to reform the Sri Lankan legal system since there is no “advantage for a country in having legal uncertainty.”<sup>83</sup> So, whether or not foreign investors are most attracted to the Ideal Paradigm, it is important to consider the—potentially conflicting—needs of the wider community.

The case of Sri Lanka is not entirely unique, but nor is it susceptible to broad generalizations. Governments could be advised to give priority to dealing with those issues towards the left hand side of Chart One—that is, those characteristics of the hypothetical legal system which were more often expected to have a bad impact upon the value of investments. Issues towards the right side of the Chart might be dealt with at a later date, or not at all, without serious implications for FDI flows. Generalizations are difficult since many states aspiring to host FDI may not be able to offer the non-legal advantages held by Sri Lanka. In addition, unlike Sri Lanka, most states do not have the disadvantage of being host to a civil war. These factors will affect the kind of investors who would even consider investing in a host state, and consequently, the role of legal systems as a determinant of FDI in each host state. For this reason, the more specific findings of the case study are not necessarily of use to other host states.

Two general lessons can be drawn from this study. First, the role of legal systems as a determinant of FDI is neither straightforward, nor proven, nor uniform. Second, it is important to know your investor. Before undertaking legal reform, states must identify: which kinds of investors they hope to attract; the extent to which those investors actually take account of the legal system; what kinds of legal systems, if any, those investors are attracted to, or deterred by; and finally, what are the financial and social implications of reforming the legal system to attract those investors. Sadly, such calls for research may well be considered quaint in a development climate which often equates progress with newness (if not of the idea, then at least of the terminology), and rarely with evaluation.

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83. Interview 25 (on file with the author); *see also* Interviews 3, 10, 18, 23, 26, 27, and 31 (supporting the same idea contained in Interview 25) (on file with the author).