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FOREIGN DIRECT INVESTMENT

Does the Rule of Law Matter?

John Hewko

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1779 Massachusetts Avenue, N.W.
Washington, D.C. 20036
Phone: (202) 483-7600
Fax: (202) 483-1840
www.ceip.org

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About the Author

John Hewko is a visiting scholar at the Carnegie Endowment for International Peace. He is a partner in the law firm of Baker & McKenzie and has spent the past 12 years practicing law in Moscow, Kiev, and, most recently, Prague.

FOREWORD

During the past decade, promoting the rule of law in developing and post-communist countries emerged as a crucial new priority of the international aid community. A plethora of organizations—including bilateral aid agencies, multilateral development banks, and nongovernmental aid organizations—embraced the challenge of constructing programs to facilitate legal and judicial reform around the world. They did so in the hope and belief that progress on the rule of law would help struggling countries achieve economic growth, consolidate democracy, and reduce social problems like crime and corruption. With the heightened attention to foreign aid in both North America and Western Europe that has come about in the wake of the terrorist attacks of last September in New York and Washington, rule-of-law development is today even more in the spotlight.

Despite the many aid programs and initiatives in this domain, the body of knowledge about how external actors can actually help effect positive change in the rule of law in other countries remains surprisingly thin. Aid providers tend to proceed from common sense assumptions about both goals and methods, yet these assumptions are rarely grounded in empirical research or subjected to careful scrutiny. To help fill this gap, the Democracy and Rule of Law Project of the Carnegie Endowment for International Peace has commissioned a series of papers by persons with experience in rule-of-law development to examine specific lessons of experience. The aim is to provide thoughtful, practical, and challenging analyses of some of the key questions in this field.

In this paper, the first in the series, John Hewko analyzes the relationship of foreign direct investment and the rule of law. He takes a hard look at what has become a familiar article of common wisdom in international aid circles: the proposition that developing and transitional countries must establish a well-functioning rule of law to attract foreign direct investment. He also explores the other, less-accepted side of the causal chain: the ways in which foreign investment can stimulate positive change in the rule of law. And he draws some conclusions about how international aid providers can improve law reform initiatives by better incorporating the perspectives of foreign investors.

The paper focuses on the post-communist countries, reflecting the author's background. John Hewko lived and worked as a lawyer for more than ten years in Moscow, Kiev, and Prague with the firm of Baker & McKenzie before coming to the Carnegie Endowment for a year as a visiting scholar. Yet the lessons he extracts from the post-communist world are widely applicable and deserve the attention of rule-of-law aid practitioners everywhere.

THOMAS CAROTHERS
Co-Director, Democracy and Rule of Law Project
Carnegie Endowment for International Peace

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THE CONVENTIONAL WISDOM within the international development community is that foreign direct investment (FDI) is an important component of economic growth and prosperity in transitional and developing countries and that a crucial, if not decisive, factor in enticing such investment is a stable, consistent, fair, and transparent legal and judicial system. As a recent World Bank publication concluded:

> The massive move by developing and transition countries toward market economies necessitated the adoption of strategies for the encouragement of private investment, domestic and foreign. Naturally, there was a general realization that such an objective could not be achieved without modifying and, sometimes, completely overhauling the legal and institutional framework and firmly establishing the rule of law, thereby creating the necessary climate of stability and predictability.[1]

Implicit in this general realization is the premise that the foreign investor is a passive spectator of the reform process, hesitant to enter the fray until a modification or overhaul of the legal system has occurred.

This conclusion is based on the theory that a transparent, modern "Western" legal system is a prerequisite for foreign investors to venture into host states. The logic of this argument derives from neo-institutional theory of the behavior of economic actors, which maintains that efficient and transparent legal systems reduce transaction costs for economic actors, including foreign investors. Since transaction costs increase the costs of direct investment, foreign investors should be adverse to investing in countries with such higher costs and, thus, will gravitate toward states with more "effective" or "efficient" legal regimes.[2]

Based on this assumption, governments, multilateral institutions, development agencies, and various non-governmental organizations (NGOs) have expended considerable resources in initiating, encouraging, and funding a myriad of legal and judicial reform programs throughout the transitional and developing world. These actions appear to have been taken in the belief that legal reform and the

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1 See *Initiatives in Legal and Judicial Reform* (Washington, D.C.: International Bank for Reconstruction and Development, December 1999), pp. 1–2.

2 For the general importance of institutional transparency for investors, see *World Development Report 2002: Building Institutions for Markets* (New York: Oxford University Press, 2002). For a discussion of the role transaction costs play in deterring foreign investors in developing countries, see Ibrahim F.I. Shihata, "Legal Framework for Development: Role of the World Bank in Legal Technical Assistance," *International Business Lawyer*, September 1995, pp. 360–68; Jeswald Salacuse, "Direct Foreign Investment and the Law in Developing Countries," *ICSID Review*, vol. 15, no. 2 (Fall 2000), pp. 382–400; Ann Seidman, Robert B. Seidman, and Thomas Walde, "Building Sound National Frameworks for Development and Social Change," in Seidman et al., eds., *Making Development Work: Legislative Reform for Institutional Transformation and Good Governance* (Boston: Kluwer Law International, 1999). For a critical discussion of the institutional theory as applied in developing countries and by international institutions, see Lawrence Tshuma, "The Political Economy of the World Bank's Legal Framework for Economic Development," *Social and Legal Studies*, vol. 8, no. 2 (1999), pp. 75–96.

establishment of the rule of law could be accomplished in relatively short order and in the hope that, once the reform process was completed, FDI would finally begin to flow.[3]

This paper argues that the philosophical framework the international development community has traditionally used to carry out its legislative and institutional reform efforts in the post-communist countries of Eastern Europe and the former Soviet Union is incomplete and has failed to take into account several critical concepts and factors.[4] The principal conclusions may be summarized as follows.

First, the experience of most post-communist societies demonstrates that legislative and institutional reform is an organic process not conducive to easy or quick solutions. Regardless of whether one holds the view that such reforms can be accomplished from the "top down" through aid to state institutions, from the "bottom up" through assistance to NGOs and other elements of civil society, or through a combination of both, and regardless of the amount of resources allocated to the problem, the fact remains that the process of legislative and institutional reform is long and tortuous. Genuine reform requires that a new legal culture be developed and ingrained in a society; this takes considerable time, effort, and several generations. As a result, the framework within which legal reform efforts are structured and implemented must consider that, in the absence of an external factor (such as harmonization of legislation as a precondition to EU membership or reunification), most transitional and developing countries will require several decades to develop the requisite legal culture and foundation required to implement effective judicial reform and the rule of law.

Unfortunately, many of the early and ambitious international development programs to, for example, "reform country X's judiciary in three years" often failed to appreciate the long-term nature of legal reform. Consequently, they were doomed to fail. They produced an avalanche of reviews, studies, reports, recommendations, and other beautifully bound "deliverables" that were often not implemented by host states. The programs created false expectations and gave rise to an entire cottage industry of NGOs, consultants, and government advisors with noble aims but often few results to show for their efforts.

Second, an extensive overhaul of a country's legislative and institutional framework is generally not a necessary precondition to attract direct investment from large multinational investors (although certain changes are generally required to retain such investment) or from smaller, entrepreneurial investors. Significantly more important factors for investors are the existence of real business opportunities and the overall visceral perception that foreign investors have of a host country.[5]

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[3] Many publications from the European Bank for Reconstruction and Development (EBRD) emphasize and discuss the importance of legal and institutional reform as a prerequisite for foreign investment. See EBRD *Transition Report 1996*; EBRD *Transition Report 1998*; and EBRD *Transition Report 1999*. Numerous other scholars also make this assumption; see Jeswald Salacuse (2000) and Ann Seidman et al. (1999). This conventional wisdom is also presented in studies of specific regions; for Central and Eastern Europe, see Cheryl W. Gray and William W. Jarosz, "Law and the Regulation of Foreign Direct Investment: The Experience from Central and Eastern Europe," *Columbia Journal of Transnational Law*, vol. 33, no. 1 (1995), pp. 1–40, and Mohammed Ishaq, "Foreign Direct Investment in Ukraine Since Transition," *Communist and Post-Communist Studies*, March 1999, pp. 91–109; for the Mediterranean and North Africa, see George Joffe, "Foreign Investment and the Rule of Law in the Middle East and North Africa," *Mediterranean Politics*, Spring 2000, pp. 33–49.

[4] References in this paper to "post-communist" or "transitional" countries or economies are references to post-communist societies or economies of Eastern Europe and the former Soviet Union. References to "foreign investors" refer to foreign investors making direct investments and do not include portfolio investors.

[5] The state of the legislation and legal system is generally much more important to mid-sized foreign investors or foreign investors with little international experience (see discussion below).

Third, foreign investors, at least in the context of most post-communist economies, are not passive spectators in the legislative and institutional reform process as is widely assumed. Rather, foreign investment is a dynamic force in the forefront of the push for change and an agent for such reform. This phenomenon has been largely misunderstood by the international development community and ignored in the prevailing literature.

Fourth, the international development community has traditionally analyzed and discussed legislative and institutional reform in grand, sweeping terms and focused on large general concepts, with calls to modernize bankruptcy legislation, eliminate corruption, and establish an efficient and rule-based judiciary. It has encouraged countries to carry out large-scale and radical legislative reform and to adopt legislation that emulates that of highly developed countries. This approach, although easy to articulate at conferences and television interviews and in eye-catching headlines, is misplaced.

Most foreign investors, when faced with an attractive business opportunity, are prepared to accept the fact that, in general terms, the legislation and legal system in post-communist countries are inadequate and that a given piece of legislation does not fully conform to an ideal standard. However, once their investment is made, a short laundry list of specific complaints usually arises which, if rectified, would greatly facilitate the success and continued viability of their investment. As a result, the emphasis of legislative reform efforts should be on the details (not the general concepts) and on determining *specific* (very often mundane) changes that need to occur for *existing* legislation to function within the cultural, political, and economic realities of the host countries.

Fifth, if a goal of legislative and institutional reform is to attract FDI, considerably more attention needs to be paid by the international development community to the *specific* concerns of foreign investors and their advisors. Foreign investors place their own resources at risk and spend considerable funds on lawyers and accountants to identify the specific risks and problems relating to their investments. As a result, foreign investors and their advisors, much more so than a guru flying in for a weekend of diagnostic analysis, are best suited to identify the *exact* changes needed in the legislative framework in order to facilitate FDI and address foreign investor concerns.

Finally, in those sectors where FDI is a factor, it facilitates certain legislative and institutional change in a manner that is often more efficient, relevant, and cost-effective than that of the international development community and its plethora of reform projects. This is particularly true in areas such as training of personnel and in reforming the legal and accounting professions.

Nevertheless, a healthy dose of caution is required when addressing any issue as complex as the process of legislative and institutional reform in transitional countries. Although the role of foreign investment in the process has been neglected and misunderstood, FDI is by no means a panacea. Foreign investors are generally not altruistic organizations, and their interests may not always coincide with those of society as a whole or with those of domestic investors. As a result, the legislative and institutional reform process should not (and cannot) be left exclusively to foreign investors; domestic institutions, bilateral donors, international development agencies, and local and international NGOs must continue to wield the laboring oar, although within a revised philosophical approach.

In addition, any analysis of FDI and the legislative and institutional reform process must recognize that not all foreign investors are created equal. Investors from different countries have varying degrees of tolerance for imperfections in the host state legal system, and they bring to the table a variety of values, perspectives, and practices. A foreign investor from a country with a tradition of corruption and weak enforcement institutions may have a different view of, and contribution to make to, legislative and institutional reform than an investor from a country at the opposite end of the enforcement and corruption spectrum.[6] To the extent that foreign investors encourage or support the prevailing legislative or institutional situation or engage in bribery and other forms of corruption, they become, of course, part of the problem and not the solution.[7]

Similarly, not all post-communist countries are created equal: for example, the historical, political, and economic context within which Hungary or the Czech Republic has attempted to institute legislative and institutional reform is different from that of many of the former Soviet Republics. As a result, although this paper attempts to provide conclusions that may be applied generally to post-communist countries, the development community and foreign investors must consider those differences when designing specific programs or prescriptions for a given country.

FOREIGN INVESTMENT: THE INITIAL PHASE

The conventional wisdom correctly argues that FDI is a vital aspect of economic development. Rather than a pernicious force (as maintained by the anti-globalization protestors at multilateral institution meetings in Seattle, Prague, and Genoa), foreign investment is generally beneficial to a host country.[8] The conventional view is also correct in recommending that developing and transitional countries undertake measures to encourage and promote FDI.

However, the view that attraction of FDI can occur only by "modifying and, sometimes, completely overhauling the legal and institutional framework and firmly establishing the rule of law,"[9] at least as it relates to post-communist countries, is not correct. A legal and judicial system that includes consistent, modern legislation and effective and efficient courts and regulatory institutions that interpret and enforce the laws in a fair and transparent manner is a desirable and laudable goal and, all things being equal, a country that has such an ideal system will attract more FDI than one that does not. Additionally, a foreign investor will generally prefer a country whose legal system is

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6 For more on this point, and a critique of the neo-institutional view of foreign investors and legal institutions, see Amanda Perry, "Effective Legal Systems and Foreign Direct Investment: In Search of the Evidence," *The International and Comparative Law Quarterly*, vol. 49 (2000a), pp. 779–99.

7 Bribery and other forms of corruption represent an area in which foreign investors play a negative role in the process of institutional reform. However, corruption requires not only the outstretched hand of an official or judge, but the willingness of a foreign investor to slip the envelope under the table. Most U.S. investors feel constrained by the threat of criminal prosecution under the U.S. Foreign Corrupt Practices Act; however, this has not been the case in the past with many investors from Western Europe and Asia, where similar laws do not apply to their citizens. Although the topic is beyond the scope of this paper, the battle against foreign investor participation in corruption will only be won if *all* of the major industrialized countries adopt and enforce effective legislation against bribery by their companies and citizens in foreign countries. It is unrealistic to rely on the internal efforts of the post-communist countries since most do not have the resources or the political will to increase civil servant salaries or to crack down on corruption. However, tough legislation and enforcement by the major industrialized countries and a consistent and unified refusal by investors from such countries to pay bribes would be relatively easier to achieve and would act as a major deterrent to corruption.

8 See *World Investment Report* 1999.

9 See *Initiatives in Legal and Judicial Reform* (1999), p. 2. For more on this point see John L. Taylor and François April, "Fostering Investment Law in Transitional Economies: A Case for Refocusing Institutional Reform," *Parker School Journal of East European Law*, vol. 4, no. 1 (1997), pp. 1–52.

developed, fair, open, and transparent to one in which the rule of law is absent.[10] Nevertheless, the existence of such a pristine system is often not the decisive factor in attracting foreign investment.[11]

What Attracts Foreign Investment?

The most important factor in attracting FDI remains the existence of real business opportunities. Even if a country, under the careful guidance of the development community, were to implement a modern, fair, efficient, and transparent legal system, it would not attract foreign investment in the absence of genuine economic opportunities.[12]

However, the opposite of the above statement is also true: if such economic opportunities exist and are made available, the simple fact that the country's legal system is imperfect will not dissuade FDI. This can be seen in the post-communist countries when the advent of perestroika resulted in an explosion of interest by foreign investors. Clearly, the enticing factor for foreign investors could not have been the legal systems in these countries: in the early 1990s, their laws and legal institutions were generally primitive, undeveloped, and incapable of addressing the many issues that arise in a market-based economic system. Rather, early investors were drawn to these countries by the large untapped markets, a highly educated yet inexpensive labor pool, and tremendous natural resources.[13] In many cases, the deficiencies in a country's legal and institutional structures were simply factored into the risk-reward analysis: the higher the perceived potential rate of return on a given investment, the more investors were willing to look past deficiencies in a given country's legal system. In others, the foreign investors were attempting to implement a long-term strategy to penetrate a given market (or were mimicking or anticipating moves on the part of their competitors) and were not influenced by the state of the legal system.

As a result, if a country offers significant business opportunities (through privatization or otherwise) and does not present any formal barriers to investment (e.g., war, significant social unrest, severe economic crisis, or legislation that prohibits foreign investment), it will attract a certain level of foreign investment despite the lack of an "ideal" legal system. In the case of the post-communist countries, even if the countries in the region had immediately reformed their laws and legal institutions following the fall of the Berlin Wall and the advent of perestroika, it is doubtful that during the initial period of euphoria they would have obtained significant additional foreign investment beyond the amount actually received.[14] Although the potential global investment pool

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10 However, the lack of legislative and institutional reform is often a barrier to retaining foreign investment.

11 For an example of qualitative survey data on this issue, see, "Attracting Private Investment: Capitalists' Perceptions of the Investment Climate in Europe, the Middle East, and North Africa," Regional Study by the EMENA Technical Department, Industry and Energy Division, December 8, 1992. See also Perry (2000a).

12 See Klaus E. Meyer, *Direct Investment in Economies in Transition* (Aldershot: Elgar, 1998); Klaus E. Meyer, "Foreign Direct Investment in the Early Years of Economic Transition: A Survey," *Economics of Transition*, vol. 3, no. 3 (1995), pp. 301–20. Meyer discusses the premium investors place on basic economic incentives to invest.

13 See Meyer (1998).

14 Even though the amount of foreign investment in transition economies at the beginning of the 1990s was small relative to later amounts, it was still much larger than the amounts invested in previous years. The annual flow of foreign investment to these economies reached US$5 billion in 1993 and increased to US$11 billion in 1995 and US$19 billion in 1997, well before the EBRD granted many of these countries higher scores on its "legal reform" scale. These investment figures indicate that many investors entered these markets regardless of the high legal risk and lack of institutional foundations. For more details on these statistics, see Meyer (1998) and *World Investment Report* 1998. In 1993, only a few years into the transition period, there were roughly 77,000 registered foreign firms in those transition countries that had entered into association agreements with the European Union. See Jamuna Prasad Agarwal, "Impact of 'Europe Agreements' on FDI in Developing Countries," *International Journal of Social Economics*, vol. 23, no. 10–11 (1996), pp. 150–63.

was considerably larger than the amount initially ventured into the region, foreign investors who chose not to invest during the early period were generally investors with a corporate culture adverse to risk, with little foreign investment experience, or with a competitive cost structure that could not absorb the costs of higher risk in an uncertain environment. For these less courageous foreign investors, the fact that laws and institutions had been reformed on paper would not have been terribly relevant to their decision-making process; they were more concerned with onerous tax regimes and inadequate accounting standards and practices, the risk of expropriation, the ability to repatriate profits, the manner in which the host countries operate in practice, and the fate of their more adventurous colleagues.[15]

A second factor in attracting foreign direct investment in post-communist countries was the overall investor perception of the stability and investment climate in the host country. This perception was rarely based on a thorough understanding of the political, social, legal, and cultural situation in the country, but rather on information obtained from newspaper headlines and television news reports back home, anecdotes from previous trailblazers, perceptions as to what their competitors were thinking and doing, or an article read in the *International Herald Tribune* during the flight over. Although the issue of "the legal system" formed a part of the overall perception of the foreign investment community, very rarely was the legal system and its failings (e.g., the difficulty in enforcing contract rights, an unclear foreign investment law, or a poorly drafted or nonexisting bankruptcy act) the pivotal factor in determining whether an investment was made.

In short, most foreign investors were willing to accept or ignore actual problems in the legislation and legal system if they had a visceral "feel good" perception of the target country. Conversely, if the general perception of a country were to decline, foreign investors would be more hesitant even if, on paper, the state of the legal system were actually improving.[16]

Finally, foreign investors tended to place a high premium on clear lines of authority and decision making. A common complaint of investors in those countries that were least successful in attracting FDI was that there was no one in a position of authority to take a decision. Nothing exasperates an investor more than the need to shuffle from ministry to ministry or to negotiate a seemingly endless bureaucratic maze where everyone and no one is in a position to resolve issues or grant approvals. As a result, an ideal legal system is not nearly as important as the existence of a clear, consistent, and unambiguous decision-making process.

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[15] In countries such as Russia, the onerous tax regime and inadequate accounting standards and practices served as a much greater source of investment disincentive than did the lack of an ideal legal system. The anecdotal evidence from practitioners in Russia indicates that most foreign investors would identify the recent tax reforms instituted under the Putin administration (e.g., lowering of personal and corporate tax rates, decreasing social insurance contributions, and phasing out of turnover taxes) as the single most important action taken to encourage foreign investment in that country.

[16] See "Attracting Private Investment" survey results (1992). Perry (2000a) also argues that foreign investors have imperfect information and can be influenced by flawed indicators; foreign investors rarely carry out pre-investment investigation into the actual problems of a host state's legal system. See also Amanda Perry, "An Ideal Legal System for Attracting Foreign Direct Investment? Some Theory and Reality," *American University International Law Review*, vol. 15, no. 6 (2000b), pp. 1627–57. This viewpoint challenges the conventional view that host state policy decisions with respect to institutional reform are crucial to attracting foreign investment. For support of this conventional view, see K. Wilhems, "Foreign Direct Investment and its Determinants in Emerging Economies," July 1998, <www.eagerproject.com/discussion9.shtml>.

With respect to the post-communist countries, while certain FDI (largely represented by mid-sized companies) was lost due to legal uncertainties and the absence of the rule of law, a significant portion of potential FDI was not affected by such imperfect conditions. Although objective factors often adversely affected investment decisions, factors such as corruption, a weak court system, and uncertain laws were generally not basic deterrents (if so, one would not have had any foreign investment at all since these conditions existed in all of the transitional countries).[17]

Thus, to the extent that the international development community is structuring its legal reform activities under a framework that assumes foreign investment is largely passive and will only enter a transitional country when the legal system has been modified or overhauled, such assumptions are not, at least in the context of the post-communist countries, correct. Foreign investors, in making their investment decisions, were influenced first and foremost by the nature of the business opportunity, the potential for high returns, the risk of expropriation, the ability to repatriate profits, the existing tax regimes, and an often superficial "feel" about a country. Although the state of the laws and legal system was a component of foreign investors' perception, it was generally not the decisive factor in making an investment decision.[18]

The Early Players

The early players who took the investment plunge in the post-communist countries in the face of a less than adequate legal system were generally large multinationals and individual entrepreneurs.

For the multinationals, legal considerations, although certainly important, generally took a back seat to market potential: these companies were investing for the long term and had the resources necessary to withstand the bureaucracy, the inefficiency, and the many other difficulties. If a serious investment opportunity was abandoned, it was usually for narrow, specific reasons: war or significant social unrest was present; the existing legislation created a formal barrier to the investment (e.g., foreign investors being prohibited from owning a majority interest in the target entity); the business case, after further examination, was less attractive than initially anticipated; the local partner was not reliable; the process for obtaining a key government approval was taking too long; or the investor was caught in the crosshairs of a local political struggle. Very rarely did a large multinational fail to make an investment on the basis that a country's legislation was unclear or in a state of flux or that the issue of enforcement of contract rights was uncertain. If the initial investment made business sense, if the anticipated rate of return justified the perceived risks, and if the host state's law and bureaucratic process permitted the investment to occur, the multinational investor would generally go forward.

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17 Predictable corruption can be factored into the cost/benefit analysis as one of the costs of doing business. However, where the level of corruption is either unpredictable or too high, it can drive away investment, although even in such cases this is not a given.

18 See Meyer (1995) and Meyer (1998); Saul Estrin and Klaus Meyer, "Opportunities and Tripwires for Foreign Investors in Eastern Europe," *Thunderbird International Business Review*, vol. 40, no. 3 (May/June 1998), pp. 209–34. See also Perry (2000a) and Perry (2000b).

With respect to the individual foreign entrepreneurs (very often returning émigrés who knew how to work the system and had old school friends in high places), unclear legislation and a weak, opaque, unpredictable and corrupt system were at times highly desirable. Many of these individuals were able to exploit the lack of structure and to use their connections and knowledge of the system to carry out profitable investments. As a result, for these investors legal considerations were not necessarily a barrier or relevant to their investment activities.[19]

Mid-sized companies faced the greatest difficulties in investing. They were generally too large to use the informal methods of individual entrepreneurs, yet too small to muster the resources needed to deal with the bureaucratic and other hurdles of the system. In contrast to most large multinationals, where an investment in a post-communist country represented a relatively small or insignificant portion of overall foreign investment activities, for most mid-sized companies a failed investment experiment would significantly and adversely affect overall financial performance. For these companies the state of the host country's legislation and legal system and the certainty of legal protection played a much larger role in their investment decisions. However, even in these cases, a sufficiently attractive potential rate of return would generally placate any concerns regarding a country's laws and legal institutions.[20]

FOREIGN INVESTMENT AND LEGISLATIVE REFORM

The Cycle of Foreign Investment and Legislative Reform

The interplay between foreign investment and legislative reform can be seen most clearly in the process of revising laws and regulations affecting commercial activities. This still-present dynamic in post-communist countries was largely cyclical, with many starts and stops, and can be summarized as follows:

- As part of the process of perestroika, the post-communist countries adopted the political decision to open their borders to foreign investment.
- Legislatures or governmental organizations with little or no experience in market concepts or principles adopted legislation, issued decrees, or announced regulations permitting varying degrees of foreign investment. These legislative measures were generally very primitive and failed to address the myriad of issues that arise in a normal market-based economy.[21]
- Many multinationals and small entrepreneurs invested in the country despite an inadequate legal system.[22]

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[19] Agarwal (1996) argues that FDI into these economies tends to come from small business units because of personal connections or low transportation costs from the neighboring states.

[20] See Perry (2000a) for an expansion of the argument; investor size plays a role in how the investor will function in a foreign legal environment. Small investors may be more likely to use informal ties and thus not be concerned with the existence of a modern, efficient legal system.

[21] The situation was less dramatic in Poland, Hungary, and the former Czechoslovakia since these countries were able to resuscitate pre-communist era legislation, implementing a more solid initial legislative base than in the former Soviet Union. Nevertheless, even in these countries, the initial legislation was less than ideal, as evidenced by the numerous changes made to the commercial codes and other commercial legislation in those countries over the past decade.

[22] See Agarwal (1996).

- In carrying out their investments, foreign investors attempted to undertake actions that were a necessary part of their business activities (and which were standard procedure in the West) but which were either prohibited by, or not addressed in, the legislation. In addition, investments began to falter as problems arose with joint venture partners and the bureaucratic burdens of operating in the country became difficult to accept.
- As a result of the growing number of legal problems, foreign investors and local elites with a vested interest in the foreign investment began to complain and demand changes in legislation and procedures; embassies began to lobby the host country; and negative press stories in both the domestic and foreign media put indirect pressure on the host government to address the failure of the initial wave of laws and regulations.
- The host states adopted amendments to the commercial legislation. These amendments tended to be poorly drafted and only partially resolved the problems. It was at this point that investors, frustrated with the process, began to falter and withdraw their investments. The negative publicity of these withdrawals, in turn, deterred potential new foreign investors.
- This entire cycle was repeated several times until gradually the domestic legislation began to conform to the standards required for a sophisticated market economy, the overall perception of the country improved, foreign investors able to stay the course began to spread the word that the investment climate had improved, and foreign investors who had been sitting on the sidelines began to stir.
- With respect to the Czech Republic, Hungary and Poland, a further external factor—the need to harmonize domestic legislation with that of the EU as a precondition to EU membership—significantly influenced the pace and scope of the legislative reform process.[23]

Lessons Learned

What are the lessons that can be learned from this process?

Legislative Reform through Cyclical and Incremental Change. Reform of commercial legislation is a tedious process characterized by a continuous and seemingly unending series of small, incremental changes resulting from the cycle described above. Even in those cases where a country adopts the "big bang" approach and significantly rewrites its commercial legislation, the effort almost always is incomplete and gives rise to such a cycle, in which the significantly amended legislation becomes subject to a further series of smaller changes and corrections. A significant driving force in identifying these needed changes is members of the foreign investment community (and their advisors), who almost immediately identify the problems and inadequacies in new legislation as they

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[23] Ramasastry et al. (1999) describe a variant of this cycle in general terms. They note that, after the initial passage of laws, private actors struggled with the lack of enforcement of those laws. Countries may receive higher scores from the EBRD and other agencies if those laws have not been tested sufficiently. Thus, a country's legal standing in the investor community can fluctuate over time as investor perceptions are actually tested. For example, the EBRD gave Moldova a higher legal rating in 1998 than in 1999 due to problems with the execution and implementation of various laws. See Anita Ramasastry, Stefka Slavova, and David Bernstein, "Market Perceptions of Corporate Governance—EBRD Survey Results," *Law and Transition*, Autumn 1999, pp. 32–39.

attempt to apply the fresh, untested provisions to existing and contemplated transactions and commercial activities.

The Role of Inexperienced Legislators. Very few legislators and drafters of commercial legislation have had the necessary understanding of how business transactions were carried out in well-established market economies. Often parliamentary drafting committees or governmental agencies were staffed with civil servants or academics with a limited theoretical understanding of how a market economy functions, but with little practical business experience or understanding as to how private actors would respond to poorly drafted or enforced legislation.

One could see this quite clearly during the first few years of Ukrainian independence. In 1991–1992, as a legal advisor to the Ukrainian Parliament and member of the drafting committees of the original Ukrainian foreign investment law, anti-competition act, and corporations law, I observed the initial stages of this process firsthand. Given that Ukraine was a newly independent state, there was tremendous political pressure to adopt legislation, regardless of the quality, to put into place symbols of the country's new status. Generally, these laws were drafted on the basis of existing USSR legislation adopted during the two years preceding the breakup of the Soviet Union. What was painfully obvious was how little the Ukrainian parliamentarians and committee experts drafting the legislation understood about even the most rudimentary aspects of how foreign investors, corporations, and a market system operated in reality.

Laws Lag Behind Actual Transactions. The legal system is generally several steps behind what is occurring in real world business transactions. This is not surprising: it is a rare legislator or government that is capable of foreseeing future trends in the marketplace. As a result, legislation dealing with cutting-edge legal issues in the commercial context almost always follows actual transactions taking place in the market.

An example of this lag is the derivatives market in the Czech Republic. The Czech government did not, in an act of foresight and wisdom, pass legislation regulating derivative transactions to enable Czech corporations and financial institutions to utilize legitimate (and needed) risk-hedging mechanisms available in more developed market economies. Rather, Czech corporations and domestic and foreign financial institutions, out of economic necessity, entered into derivatives transactions despite the legal uncertainty regarding such fundamental issues as the definition of a "derivatives transaction" for purposes of the existing legislation, set-off, termination netting, and the rights of a bankruptcy administrator. Only after the local derivatives market and the number of derivatives transactions grew to a critical mass were foreign and local banks and corporate counterparties able to pressure the Czech National Bank and Parliament to implement regulatory and legislative measures to enable such transactions to occur within an appropriate legal framework. (Even so, the initial measures proved inadequate and had to be amended and improved over time.)

Inadequate Consultation with Foreign Investors and Other Affected Parties. Although many changes in legislation were either induced by pressure from the investment community or were intended to reflect new innovations occurring in the host country's marketplace, very rarely did the drafters of the legislation consult with foreign investors or the lawyers and accountants representing such investors. A common complaint among the law and accounting firms in the region concerns the considerable disconnect between politicians and policy advisors, on the one hand, and those in the business world, on the other, attempting to carry out the very transactions the proposed reforms were intended to foster. As a result of this disconnect, changes in legislation adopted to address a given problem were often not "quite right," but could have been had someone experienced in carrying out transactions under the existing inadequate legislation been consulted in advance.

As a general matter, the legislative reform process in post-communist countries fails to canvas the views of those elements of society that will be most affected by proposed reforms. Often legislative reform is hijacked by an elite group that determines the contents of the new law, obtains limited comments from a narrow circle of cronies, and then pushes the new legislation through a parliament that tends to rubber-stamp executive initiatives. A preferable process would obtain the views of those who need the reforms to pursue their activities more effectively (e.g., the business community) and include broader public debate among the interest groups affected by the proposed changes.

The failure to include a broad range of stakeholders in the reform process *prior to adoption of legislation* creates at least three negative consequences. First, it can perpetuate the anti-competitive interests of cartels, monopolies, and elites who represent only one set of the many interests involved. Second, it creates "enemies" of the specific reform who can hamper its implementation out of self-interest or even revenge for not having been included in the process. Third, it encourages a lack of respect for the legislative process and the rule of law generally.[24]

As a result, the quality and appropriateness of legislation adopted would increase substantially if legislatures were to institute a process in which proposed draft commercial legislation were made available for public scrutiny and comment prior to being brought before the legislature for formal adoption. Such a procedure should be the centerpiece of any development agency proposal to reform a given country's legislative procedures.

Foreign Investors—The Ideal Source for Identifying Legislative Deficiencies. The foreign business community and its legal and accounting advisors represent the most efficient and accurate mechanism for identifying inadequacies and problems in existing commercial legislation and regulations. Foreign investors are putting their own funds at risk in transactions and spend considerable sums on legal and accounting advice in order to understand the *exact* deficiencies in the existing legislation as it relates to their investment. If one purpose of legal reform efforts is to create conditions that attract foreign investment, then no actor is better placed to understand and explain the precise necessary changes in a given country than those entities (and their legal and accounting advisors) investing in that country.

A popular goal of the international development community has been to determine the changes in legislation needed to improve the efficiency, transparency, and functioning of a given country's capital markets—and, in particular, to specify the legislative changes needed to facilitate access by

[24] For elaboration of the argument that self-interested groups have an interest in maintaining partial reforms and blocking further economic reform, see Joel Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions," *World Politics*, January 1998, pp. 203–35.

local companies to foreign capital markets through the issuance of global depositary receipts (GDRs) or other financial instruments. The traditional approach of the development community has been to issue a detailed request for proposal to several consortia of consulting, law, and accounting firms. (Very often the effort would be repeated with several development agencies funding a study of the same problem and little or no coordination between them.) Often foreign firms with very little or no experience in the country would bid as a means of establishing a foothold for future business in that country. The winning consortia would at times be chosen not so much for its skill or experience, but on the basis of political considerations (e.g., not enough Portuguese consulting firms have had a chance to dip their hand into the EBRD technical assistance trough). Each winning consortia would then carry out a detailed diagnostic review of the host country's capital markets. Since the fees to the consortia were in most cases subject to a cap, generally junior staff would carry out the review so the consortia would make a profit on the work (or very often to minimize the loss). Occasionally a Western senior securities guru would fly in to explain how such legislation is structured and implemented in the West. The result of this effort would be a thick and extensive report presented to the relevant host country governmental agency recommending radical and sweeping changes to the country's securities legislation based on the system in the United States or Western Europe, but often with little regard for whether there was a demand in the local market for such legislative changes or for how such legislation would operate within the existing legal culture and system.

Unfortunately, this approach is astonishingly costly, inefficient, and ineffective and often results in advice being provided by experts who have considerable knowledge in the field, but very little understanding of the country and its legislation, or by junior staff with perhaps an understanding of the country and its legislation, but limited knowledge in the field. A more useful and cost-effective approach should be worth considering. In it, rather than conducting a tender among a plethora of consortia, the development institution funding the diagnostic analysis and the relevant governmental agency would only need to approach those major law and accounting firms in the country that have represented an underwriter or an issuer in a previous GDR transaction. Since these firms have been paid considerable sums to analyze all the legal and accounting issues related to these types of transactions and are subject to significant liability risk if they get it wrong, one can be very confident that they have an extensive understanding of the legal problems and can immediately identify the *exact* provisions in the *existing* legislation that need to be modified or clarified. This approach would obviate the need for extensive and expensive diagnostic studies funded by external agencies since they already exist in the form of memoranda that these firms have supplied to their clients and which summarize in excruciating detail the issues faced by actual clients attempting to carry out a real international offering under the host country's existing legislation. These memoranda could be sanitized to remove client-sensitive information, be repackaged, and, for a fraction of the cost of the traditional approach, provide legislators with a detailed explanation of the needed legislative changes.

As a result, the guiding principle in addressing inadequate commercial legislation should not be to suggest wholesale amendments so as to ensure that the resulting system complies with an abstract and uniform utopian standard; rather, it should be to determine the specific provisions (or lack thereof) in existing legislation that prevent honest foreign investors from executing business activities in that country and to recommend changes that make sense in light of the country's social, economic, and cultural conditions. No one is better positioned to provide that information than existing foreign investors and their legal and accounting advisors.

The Big-Bang Approach to Legislative Reform. There is a tendency in the international development community to view reform in large sweeping terms. Emphasis is often placed on macro issues articulated in an almost detached and general fashion: the need to eliminate corruption, to implement legal and judicial reform, and to develop transparent capital markets is repeated at legal-reform and development conferences in mantra-like fashion. However, serious implementation of reforms that have a practical impact on a country's investment climate requires a focus on the details and not on the general concepts, since it is usually the details that give rise to real day-to-day problems. Unfortunately, the international development community often fails to give sufficient attention to micro-level problems and issues that affect the private sector.

This is especially true with respect to legislative reform and foreign investment. Once a foreign investor takes the leap of faith and makes an investment, he is generally not concerned with corruption in general or the need for legal reform in the abstract. Rather, he is focused on how specific aspects of the law and system affect his particular business: the fact that the ambiguity of one word in an existing piece of legislation puts at risk the legality of his proposed transaction or that official X at window Y at Ministry Z is requiring a bribe to issue a routine permit.

As a result, most foreign investors who have committed resources to a given country are prepared to accept the fact that, in general terms, the legislation and legal system are inadequate. They are also prepared to accept that a given piece of legislation does not fully conform to an ideal standard. Their real focus tends to center around a short laundry list of specific complaints about the one piece of legislation or regulation that, if rectified, would greatly facilitate the success and continued viability of their investment.

Unfortunately, many investor surveys carried out by the development community tend to focus on very broad areas of concern: Is the current bankruptcy law effective? Are contract rights enforced effectively by the courts? Is the pledge law incomplete? Is it a concern that laws are not being enforced consistently, expeditiously, and impartially? When faced with these sorts of general questions, most foreign investors will tend to respond that the situation needs improvement. Of course, a foreign investor will prefer to see a better bankruptcy law or commercial code or be in favor of improved enforcement mechanisms—who would not? However, understanding in general terms what concerns a foreign investor is not terribly relevant. What is important is to isolate *specific* provisions in legislation that need amendment. And this can only be carried out by providing to the legal and accounting advisors of foreign investors active in the country extremely detailed survey questionnaires that delve to the level of specific problematic clauses of specific laws.[25]

In the mid-1990s I spoke at a conference in London on a panel which included the Ukrainian Prime Minister, Minister of Finance, and several other prominent Ukrainian politicians. The topic for discussion was economic reform and development in Ukraine.

One of the problems facing Ukraine was the lack of any meaningful international private sector financing. Since the pool of funds available from multilateral and intergovernmental lending

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[25] The EBRD surveys of legal reform are admirable in that they cover a large number of indicators in the commercial and financial sectors and also ask investors to evaluate the extensiveness and effectiveness of legal rules. But the EBRD's simple five-point scale, while a useful general metric, cannot capture the detailed flaws in each country's investment laws. The results only provide a general overview of the situation, not the necessary changes that must take place in each transition economy.

institutions pales in comparison to the amount of capital required to develop the Ukrainian economy, the only long-term solution for the country was, and is, to attract considerable private sector financing. However, at the time, even if a given financing transaction made economic sense, it was very difficult (if not impossible) to execute due to six or seven seemingly insignificant provisions of Ukrainian law.[26] If these provisions could have been amended (in some cases all that was needed was to add one additional word or sentence), the legal barriers to project financing in Ukraine would have been largely eliminated (of course, political and credit risk would still remain as an obstacle to be addressed).

When I spoke, I summarized the key *specific* changes to existing Ukrainian law that were needed to facilitate private sector financing. The response: eyes glazing over. I finished, received polite applause, and the Western experts and Ukrainian panelists continued their discussion in the most general of terms about macroeconomic stabilization, current account deficits, and the need to "implement market reforms and stamp out corruption." Although these are all admirable goals, those of us who were practitioners shook our heads and went back to lamenting that once again the failure to focus on the admittedly boring details was hurting significantly the cause of meaningful legislative reform.

Thus, efforts to reform commercial legislation should concentrate on understanding the shortcomings of existing laws in detail and suggesting changes to such existing legislation, rather than proposing widespread changes to conform the country's legislation to an ideal model. Often problems can be resolved by adding a word or a sentence, rather than by wholesale revision, or by drafting a clarification to a vague provision or term. However, urging a country to adopt a series of often highly technical and arcane changes is less exciting than proposing a wide-ranging reform package, and certainly not as conducive to developing a career as a policy guru.

Critical Mass for Reform and the Need to Retain Foreign Investment. There is little doubt that in the post-communist countries certain FDI was (and will continue to be) lost in the absence of an ideal legal system. However, with respect to the goal of developing appropriate commercial legislation to attract foreign investment, the important point is not that potential investment has been lost as a result of an imperfect system, but that enough investment has been initially attracted to create a critical mass of large multinational investors that is capable of unleashing and participating in the process of legislative reform as described above. It is this critical mass that, if successful, will set an example for new foreign investors and will attract considerably more FDI than the long-awaited, and difficult to achieve, ideal legal system.[27]

Nevertheless, it is not sufficient to attract foreign investment; it must also be retained. This is necessary for two reasons. First, foreign investors play an important role in the legislative reform

[26] These included the requirement that a Ukrainian exporter receive and repatriate revenues from an export transaction within 90 days of a product's export or face significant fines, the requirement that a Ukrainian borrower obtain a license from the National Bank of Ukraine (NBU) to enter into a foreign currency loan transaction (this licensing procedure was at the time in the hands of one NBU official who had previously been a criminal prosecutor) or to establish an offshore escrow or project control account, the requirement for a state fee in the amount of 5 percent of the value of a pledged asset in order to notarize a pledge agreement, and several others.

[27] Some foreign investors piggyback on other firms' efforts in the host state and build on the improved regulatory framework. See Estrin and Meyer (1998).

process (as discussed above) and in the process of institutional reform (as discussed below). Significant losses of FDI necessarily weaken the overall process of such reforms. Second, and perhaps most important, a failure to retain the initial pioneering foreign investors severely affects a country's attempt to encourage new FDI. There is nothing more frightening to a foreign investor contemplating an investment than to hear or to read in the papers about existing investors losing their shirts or liquidating their investments as a result of corruption, inadequate legislation, and the lack of the rule of law.

Whereas an inadequate legal system is often not a decisive factor in attracting FDI, the lack of legislative and institutional reform is a significant barrier to retaining such investment. Even the most entrepreneurial foreign investors have a limit as to the type and level of systemic difficulties that they are willing to endure. In Russia, for example, a significant number of foreign investors lost considerable sums in the 1998 financial crisis. These events had a significant impact on foreign investor perception—not only were the losses significant, but they occurred in a manner that made painfully evident the inadequacies of Russian laws and the lack of the rule of law and a legal culture. When Russian banks start rescinding currency swaps and forward contracts on the grounds that they constitute "illegal gambling," when foreign creditors see assets being blatantly stripped from their debtors, and when the courts begin to rule that force majeure events have occurred (the force majeure event being that one party to the transaction has no money)—all of these actions raise again among foreign investors the "Wild East" concerns that were pushed aside when things were going well.

As a result, reform efforts must recognize that it is extremely important for the host state to retain a critical mass of foreign investment and that legislative and institutional reform be a key component of such efforts.[28] However, in carrying out such reforms, it is important to bear in mind, and to work within, the lessons and principles outlined above—in particular, to consult adequately with foreign investors and to identify the specific deficiencies in the legislation of concern to such investors.

The Need for a New Paradigm

In light of the lessons learned, a fundamental shift is required in the manner in which the international development community views certain aspects of legal reform in post-communist countries, particularly in the area of commercial legislation and regulations. The community should shift away from a process almost exclusively driven and created by multilateral organizations and NGOs to a process that recognizes and expands the role of the private sector. The new paradigm also calls for a change in focus from working feverishly to develop a perfect set of legislation that will attract all possible investment and funding grandiose diagnostic studies to an emphasis on working with host countries in order to attract and *retain* a threshold level of investment. This new effort would establish (together with the host country) a more direct and meaningful dialogue with existing

[28] Efforts taken to either attract or retain foreign investment should not include incentive schemes that favor foreign investors over their domestic counterparts. Not only are such schemes anti-competitive, damaging to the growth of local investors, and sources of resentment toward foreign investors in the local business community, they are generally not decisive considerations in a potential foreign investor's decision to invest. In addition, the needs of domestic investors cannot be ignored since foreign investors (except perhaps in the mineral-based extractive industries) are generally reluctant to invest in a country where the locals are not willing to invest.

foreign investors (perhaps through the various Chambers of Commerce located in each country), focus on *specific* investor concerns within the framework of *existing* legislation, and recognize that the process of legislative reform is long, tedious, and subject to an almost continuous cycle of incremental change and trial and error.

THE SEQUENCE OF LEGISLATIVE AND INSTITUTIONAL REFORM

Attracting a threshold level of investment and adopting changes in the commercial legislation are but one half of the reform equation. Equally important is the development of institutions to implement and enforce such legislation. It does little good to enact legislative changes that respond on paper to investor needs, but which in practice are not enforced or administered in a fair and consistent manner.

The efforts over the past decade in the transition economies with respect to legislative reform have largely focused on assisting the countries in revising legislation and adopting new laws and regulations. However, it has been argued that the sequence of these efforts has been flawed:

> A distinction should be drawn between the process of the formulation of new rules and policies (e.g., the enactment of laws) and the coming into force of the new law. New laws should not merely be promoted with, or followed by, a corresponding strengthening of the institutions responsible for their enforcement [(e.g., civil service, regulatory and administrative agencies, the legal profession and the judiciary)]; such strengthening ought to precede (or at least be initiated prior to) the date on which new laws actually come into force. . . . Although it could be argued that the enactment of laws gives the necessary moral and legal leverage to the executive body for the implementation of new norms and rules, experience shows that such measures do not always achieve this goal.[29]

This position is correct in the abstract: in a perfect world one would strengthen the legal profession, civil service, law enforcement agencies, and courts prior to adopting new legislation to ensure that such laws are properly, consistently, and fairly enforced. However, such an approach, regardless of how laudable on paper, would have been impossible to execute in the post-communist countries. Given the long-term nature of institution-building, the initial focus on enactment of laws was the only approach that could have been undertaken given the political, economic, and cultural realities of the region.

The disintegration of the Soviet bloc opened the floodgates of investment and economic activities in the region. Economic forces pent up under decades of communist rule exploded. In the face of the new economic reality, Soviet-era laws that were wholly inadequate had to be amended quickly in order to permit the most elementary forms of economic activity. As a result, it would have been impossible (and undesirable) to have attempted to hold back the process of enacting legislation until institutional reforms had been completed. The enactment of commercial laws, however poorly drafted or enforced, was necessary for five reasons.

First, even if considerable resources and effort had been made immediately available, the process of reforming the enforcement institutions would have taken decades and several generations to carry out. Entrenched bureaucracies and sclerotic institutions are not commando units and assimilate

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[29] Taylor and April (1997), pp. 41–42.

change at less than lightning speed. The enactment of new laws could not have waited for this process to have occurred.

Second, most of the governments in the region had neither the experience, the political will, nor the financial resources to institute widescale and radical institutional reform. However, enactment of legislation could be carried out relatively quickly and for a fraction of the political or financial cost. In addition, the process under which legislation was adopted was often so chaotic that it is somewhat naive to believe that the legislatures in the region would have had the foresight and the bureaucratic and legislative skill to put in place effective enforcement institutions before legislation was adopted or became effective.

Third, the enactment of laws *does* give "the necessary moral and legal leverage to the executive body for the implementation of new norms and rules."[30] Although "experience shows that such measures do not always achieve this goal,"[31] this is largely the exception and not the norm. The process of legislative reform is cyclical and the product of continuous incremental changes through trial and error; it depends on the participants in the market place to identify those areas where the legislation needs to be amended and the specific enforcement and implementation issues that need to be addressed. These market pressures accelerate the pace of institutional reform. Thus, a delay in the enactment of legislation until the institutional reforms had been implemented would have simply resulted in further delays in such reforms.

Fourth, good laws not properly enforced are better than bad laws not properly enforced. The lack of respect for the rule of law in post-communist countries generally existed prior to the adoption of new legislation and not as a result of such legislation. Although the failure to enforce and implement new legislation does contribute to a climate of cynicism and skepticism about the process of legislative reform, this danger is more than outweighed by the impetus such laws give to the cause of institutional reform.

Finally, given that the process of institutional reform takes several decades and generations, it is preferable to finalize this reform once the legislative framework has become fairly well developed. Just as laws should not be adopted that "do not accord with local values and existing administrative and judicial procedures,"[32] legal institutions should not be created or modified in a manner that does not accord with the laws and regulations such institutions must enforce and implement. Since the adoption of laws and regulations is relatively simple and will inevitably occur before institutional reform is completed, there is a value in having the more expensive and complex process of institutional reform molded to the legislation than vice versa. This is especially true if the legislation is evolving in response to the needs and demands of the market.

There is no question that, with respect to the post-communist countries, it is vitally important that institutions responsible for the enforcement of laws be strengthened and reformed and that this process proceed in tandem with that of enacting new legislation. Well-written laws will serve a useful

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30 Taylor and April (1997), p. 42.

31 Ibid.

32 Taylor and April (1997), p. 39.

purpose only if they are effectively implemented and enforced.[33] However, the process of institutional reform will take considerable time and effort, and the need for it should not serve as a reason for delaying or decelerating the pace of legislative enactment.

FOREIGN INVESTMENT AND INSTITUTIONAL REFORM

The process of legal reform requires the strengthening of those institutions charged with implementing and enforcing legislation. These include the courts, the legal and accounting professions, the civil service, and regulatory and administrative agencies. It also requires the development and inculcation of a general culture that respects and supports the rule of law and the fair and impartial application of laws and regulations.

What is striking in the literature on the issue of institution-building is the almost complete lack of attention to the role that foreign investment can (and does) play in this process. The impact of foreign investment is particularly significant in two key areas—the development of a culture of respect for laws and the development of the legal and accounting professions—but has been largely ignored by scholars and commentators.[34]

Foreign Investment as an Institution Builder

Serious foreign investors (largely multinational firms) play a vital role in training and educating individuals and in developing a cadre of citizens who understand and accept those practices and concepts that are critical to creating a civil society and a respect for the rule of law. They transfer to employees not only valuable business know-how and technical expertise, but expose them to a certain work ethic, business practices, ethical standards, and codes of conduct. Committed foreign investors almost universally pay taxes, are concerned about complying with all laws and regulations, implement environmental standards that are generally higher than those mandated by local law, pay above-market wages, and expose the local market to sophisticated types of business transactions and legal documentation.[35]

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[33] Pistor et al. (2000) argue that effective legal institutions, as opposed to mere written laws, have a strong positive impact on drawing in external finance for transition economies. Their work builds upon the work done by La Porta et al. (1997) that focuses mainly on the existence of laws that protect external investors. See Rafael La Porta et al., "Legal Determinants of External Finance," *Journal of Finance*, vol. 52, no. 3 (July 1997), pp. 1131–50; Katharina Pistor, Martin Raiser, and Stanislaw Gelfer, "Law and Finance in Transition Economies," CID Working Paper no. 49 (June 2000), pp. 1–43. Well-enforced laws also reduce incentives for private actors to participate in informal networks. See Raja Kali, "Business Networks in Transition Economies: Norms, Contracts, and Legal Institutions," in Peter Murrell, ed., *Assessing the Value of Law in Transition Economies* (Ann Arbor: University of Michigan Press, 2001). See also Taylor and April (1997).

[34] Meyer and Pind briefly mention the impact Western accounting and banking services have in the region, but do not discuss the potentially significant positive effects such services can have. See Klaus Meyer and Christina Pind, "The Slow Growth of Foreign Direct Investment in the Soviet Union Successor States," *Economics of Transition*, vol. 7, no. 1 (1999), pp. 201–14.

[35] See Meyer (1998); for a general discussion of the benefits of FDI, see *World Investment Report* 1999. Lankes and Venables (1996) argue that increased FDI into states that have progressed in legal reform assists export-oriented industries. See Hans-Peter Lankes and A. Venables, "Foreign Direct Investment in Economic Transition: The Changing Patterns of Investments," *Economics of Transition*, vol. 4, no. 2 (1996), pp. 331–47. For the specific economic benefits of FDI in Eastern Europe, see Mark Broeck and Vincent Koen, "The 'Soaring Eagle': Anatomy of the Polish Take-off in the 1990s," *Comparative Economic Studies* vol. 43, no. 2 (Summer 2001), pp. 1–33; see also Simeon Djankov and Bernard Hoekman, "Foreign Investment and Productivity Growth in Czech Enterprises," *World Bank Economic Review*, vol. 14, no. 1 (2000), pp. 49–64.

These actions create over time a critical mass of citizens who have been inculcated (if not indoctrinated) with a reform mentality and who will support and demand reforms in the country's laws and enforcement institutions. Many from these ranks will enter politics or the public sector or will be appointed to positions of authority within the civil service. A manager who spends ten years working for a serious multinational will have a radically different approach to business and the respect for law than a "red director" and his cronies who obtained wealth and power through manipulation of the system, personal contacts, theft, and corruption.

Foreign investors are also extremely efficient and effective in providing training and transferring know-how. The impact of investors such as McDonalds in training thousands of young people throughout the region has been much more meaningful and had a much greater impact on the process of creating the appropriate cultural framework for institutional reform than any series of lectures, training videos, or reform programs ever can. In fact, the most useful activities of many of the various NGOs on the ground may actually be the training and experience they provide to their own local staff.

The criticism is often made that these trained individuals are merely a drop in the bucket and, even if interested in advocating change, often become overwhelmed or coopted by the existing structures. These individuals (especially those from the former Soviet Union) themselves often complain that, even with the best of intentions, it is not possible to fight the system. However, this is not fatal: a good house requires a solid foundation, and the process for constructing the foundation for institutional reform is long and difficult. The values encouraged and the cadre of individuals developed by foreign investors over the past ten years will gradually over time form the core of this much-needed foundation. The key for the future is to ensure a continued and steady stream of trained employees over the next ten years.

Finally, foreign investment plays a role in the process of reforming the civil service and judiciary. Although the impact is significantly less than in other areas, the interactions that foreign investors and their advisors have with government officials and the courts often result in a transfer of know-how and a better appreciation in such organs of the needs of foreign investors, the manner in which a sophisticated legal and economic system operates, and the types of reforms needed. In addition, continuous and vocal complaints by foreign investors as to the failings of the bureaucratic and judicial system often act as a catalyst for change and reform.[36]

Foreign Investment and the Legal and Accounting Professions

An independent, sophisticated, and well-trained legal and accounting profession is an essential element of any attempt at institutional reform. It is in this area that foreign investment has made its greatest contribution to the effort.

There are now in almost all of the post-communist countries a significant number of well-trained, sophisticated accountants and auditors. This is due almost exclusively to two factors: foreign investors

[36] Although the point is not addressed in greater detail in this paper, it should be noted that the international commercial banks, often on the front lines of transactions, have played a very important role in training, transferring know-how, and identifying bureaucratic and judicial failings.

and the Big Five accounting firms[37] (and their pre-consolidation predecessors). Their influence on the profession in the region has been extraordinary.

Each of the Big Five has substantial operations in all of the countries of the region. They employ thousands of accountants, consultants, auditors, and support staff; almost all are locals. They dominate the local markets.

The accounting firms are present in the region for one reason only: their clients demand that they be there. Foreign investors need to comply with not only the tax, accounting, and auditing requirements of the host country, but with those of their home country. Since local accountants were generally incapable of providing these services on a level required by foreign investors, the task fell to the Big Five who essentially colonized the markets of the region with a fervor last seen in the days of Cortés and Pizarro. And, in the process they produced and trained legions of English-speaking, market-savvy accountants and auditors and revolutionized the practice in these countries.

Today, not only foreign investors but almost all domestic banks and large and medium-sized enterprises in the region utilize the services of the Big Five. Their influence in the local chambers of accountants and other institutions governing the profession is considerable. In addition, the Big Five, through their auditing and consulting activities, play a significant role in training the management of their domestic client companies and exposing such managers and their staffs to modern Western concepts, practices, and procedures.

The same phenomenon can be seen, although on a somewhat smaller scale, with respect to the legal profession. Foreign investors in the region demanded that transactions be carried out using Western-style documentation and that they receive advice from attorneys fluent in English (and in some cases German) and familiar with the issues arising in the types of activities they were attempting to carry out. This demand fueled an invasion of U.S., UK, and Western European law firms. As with the accounting profession, these firms (at least in the early years) had an almost exclusive monopoly on major inbound investments, privatizations, and cross-border financing work and had a significant impact on developing and training sophisticated local attorneys with a deep understanding of how law is to be practiced, the role of law in society, and the need for legal reform. Although initially most foreign firms were staffed by an equal combination of foreign and local attorneys, the vast majority are now comprised almost exclusively of well-trained local partners and associates.

A similar phenomenon occurred with the local law firms. Today, one can find a large number of local firms that operate on a level equal to that of the Western firms. To the extent that these local attorneys represented foreign investors, they were forced, in a very short time, to modernize and work at a level and in a manner acceptable to their clients. In the process, they were exposed to Western-style documentation, procedures, terminology, and concepts. It is not surprising that many of today's top local firms in Central and Eastern Europe were established by local attorneys with significant foreign clients, by attorneys who left foreign firms, or by local attorneys with strong ties to Western law firms.

This cadre of trained attorneys is making its mark as it begins to assume positions of leadership in local bar associations and chambers of advocates. Although they practice almost exclusively in the

[37] The Big Five accounting firms are Arthur Andersen, PriceWaterhouseCoopers, KPMG, Deloitte & Touche and Ernst & Young.

area of commercial law, these lawyers are having a slow but steady influence on colleagues who practice in areas such as criminal and family law, judges, lawmakers, and bureaucrats: they serve as transmitters of know-how and, most importantly, a philosophical approach to the rule of law and its implementing institutions. Many of these attorneys teach at the local law schools and universities and appear at conferences and symposia. A local attorney with extensive experience in representing foreign investors and practicing law on a sophisticated level is generally not interested in bribing officials, representing clients who act unethically, or practicing before incompetent and corrupt judges. In the game of power and prestige, money does matter and most attorneys working for foreign firms or local firms with an extensive foreign client base make considerably more than their colleagues in other firms or practice areas. Their influence on the legal profession will only continue to grow.[38]

As a result, it is not at all surprising that those post-communist countries that are viewed as having a relatively sophisticated and skilled body of lawyers and accountants are precisely those with high levels of foreign investment and a significant number of foreign accounting and law firms. However, much of the scholarly and applied literature on legal and institutional reform ignores the extraordinary contribution that foreign investment and foreign accounting and law firms have made to the development of the legal and accounting professions. The influence of the many legal-training programs funded by the international development community absolutely pales in comparison with the impact of foreign investors and foreign accounting and law firms: no amount of reform programs and resources could have even remotely been able to affect the quality and level of the accounting, auditing, and legal professions as did the private sector. If the goal is to increase the quality of the legal and accounting profession in a given country, there is no faster or more efficient mechanism than to encourage in that country a critical level of foreign investment and foreign law and accounting firms.

INCENTIVES AND DEMAND FOR REFORM

Incentive as a Key Element of Reform

Foreign investors and foreign law and accounting firms have been successful in inculcating values and modifying behavior for two simple reasons. First, many in the domestic population desire to work for such investors and firms. These entities generally pay salaries considerably higher than those offered by most local companies and by government agencies; they offer the possibility to study and work abroad and to improve one's foreign language skills; and they provide excellent training and exposure to Western business practices, techniques, and culture. The demand for change is extremely high: the employee or attorney wants to change and act in a given manner to obtain the coveted job.

However, demand is only part of the equation. Equally important is the element of incentive: either the employee performs and acts as requested or he or she will be fired. Few things motivate

[38] A related issue is the relative lack of influence of the legal departments within many private enterprises in the transition economies, particularly Russia. Much of the private sector, including entrepreneurs, still have not utilized their own lawyers; these advisors are still sidelined and prevented from playing a crucial role in interpreting, challenging, or executing new corporate governance procedures. For legal reform to be effective, the international community will have to find a way to get these domestic legal departments to play a more active role in the discussion and implementation of laws. See Kathryn Hendley, Peter Murrell, and Randi Ryterman, "Agents of Change or Unchanging Agents? The Role of Lawyers within Russian Industrial Enterprises," *Law and Social Inquiry*, Summer 2001, pp. 685–715.

individuals as much as their economic well-being, and it is this combination of a demand and desire for change on the part of the individual coupled with a healthy dose of incentives from foreign investors and foreign firms that allows the latter to play such an effective and dramatic role in certain aspects of the legal and institutional reform process.

Similarly, a threshold level of demand and subsequent meaningful incentives are necessary for any legal and institutional reform process to move forward. Just as an overweight individual who wishes to lose weight often needs the assistance of a trainer, so too institutions need at times the hand of "coercion" to implement institutional and legislative reform. This can be seen most clearly in the process of EU accession where the drive to join the European Union has accelerated dramatically the pace of legislative and institutional reform in candidate countries. The challenge for the international development community is to create mechanisms and programs that combine the appropriate mix of demand and incentives.

The Case of the Reluctant Elites—Creating Demand for Reform

In many countries, the ruling economic and political elite and civil servants view legal reform as a threat and often resist such efforts. As a result, one of the most difficult challenges in this area is the development of a mechanism or series of mechanisms for legal reform in the face of such recalcitrance.

A heavy dose of incentives is one approach. However, incentives in the absence of a certain minimum level of demand are unlikely to succeed: you can lead a horse to water, but you cannot make him drink. The same is true of a country's elites.

The simple fact is that, short of methods involving the use of force, there is little the development community can do to create in the short term demand for reform among an intransigent elite. What is required is a long-term, sustained evolution in the composition of a country's elite that will create demand for reform and the support and encouragement of those development activities that contribute to this goal.

How can this be done? Short courses and seminars for civil servants, one-week visits to foreign legislatures for politicians, increased training materials for judges, and conferences on corruption or the rule of law are better than nothing, but are not the solution. When working in Kiev, I had a rule of never hiring anyone over 30 since the task of retraining and re-orienting the older generation was too time-consuming, difficult, and often ultimately impossible. Similarly, programs focused on existing entrenched elites and civil servants often result in good money being thrown after bad. If legal and institutional reform is a process of several decades and involves the creation of an elite that believes in and understands the concept, one should, in effect, write off the current elite and civil service and recognize that the solution lies in training, educating, and converting the younger generations.[39]

[39] An argument can be made that there is some hope for the current elite—once the oligarchs have amassed power and wealth, they will realize that they will only be viewed as legitimate power brokers and players in the international arena and will only be able to protect their assets in the long run if legislative and institutional reforms are implemented in their countries. However, in most cases these elites will favor reform measures that act to consolidate their grip on power and not for the purpose of creating laws and institutions that establish a level and fair playing field for all.

The development community should address this situation by channeling (as a matter of priority) funds into long-term and sustained programs of training young locals. Thousands of a given country's best and brightest university graduates should be sent to the West for one- and two-year graduate study programs (but be required to return).[40] One shudders at the thought of how many young graduates could have been trained with the millions spent by the development community on feasibility studies, diagnostic reports, foreign consultants, and travelling delegations.

The development community should also work on creative mechanisms to harness and utilize more fully the tremendous training capability of the private sector. As discussed above, foreign investment plays a significant role in creating a demand in society for reform in the legislation and enforcement institutions; this role seems to have been largely ignored by the literature and international institutions.

This alternative approach is long range and does not produce visible, tangible results in either the short or medium term. It also strikes at the core of the enormous international aid infrastructure that has been created in the wake of the dissolution of the Soviet Union and would reduce the need for the many Western consultants and entities currently tapping into the development well. However, if the institutional pressures and inertia are such that these activities must remain in place, then at least one should be honest and accept them for what they often are—subsidies to Western consultants—and allocate additional funds to put in place long-term programs that will ultimately deliver the needed results.

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[40] Some scholars recommend a more generous U.S. program to encourage Russian students to study law in the United States to alleviate the shortfall of legal professionals in Russia (though they do so with the intention of expanding Russia's academic legal community). A similar plan could be useful for all transition economies. See Jane M. Picker and Sidney Picker, Jr., "Educating Russia's Future Lawyers—Any Role for the United States?" *Vanderbilt Journal of Transnational Law*, January 2000, pp. 19–76.

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