UNIVERSITY OF CALIFORNIA,
IRVINE

The Rule of Law and Foreign Direct Investment in the Developing World

DISSERTATION

submitted in partial satisfaction of the requirements
for the degree of

DOCTOR OF PHILOSOPHY

in Political Science

by

John Seth Alexander

Dissertation Committee:
Associate Professor Charles Anthony Smith, Chair
Professor Dorothy Solinger
Professor Nina Bandelj

2014

© 2014 John Seth Alexander

DEDICATION

To

Alison and Roy

TABLE OF CONTENTS

LIST OF FIGURES

LIST OF TABLES

ACKNOWLEDGMENTS

This dissertation would not have been possible with out the help and hard work of my committee, family, and friends. First and foremost I would like to thank the members of my dissertation committee who provided me with invaluable help throughout the process. In particular I want to thank Tony Smith, my committee chair, for his consistent support throughout my time at UCI. Early in my time at UCI Tony gave me an article that began the journey into comparative public that would eventually lead to my dissertation. He has been my consistent advocate and I would not have made it here without him. His advice was always spot-on and his words always honest and assuring. I would also like to thank Dorie Solinger. I took a class with Dorie years ago and expressed an interest in China's legal system. Since that time I have consistently received emails from Dorie with articles, books, and ideas relating to China's legal system. Her expertise was critical in helping me to understand China and her kind words were always reassuring. Finally, I would like to thank Nina Bandelj who was always there to answer my questions about the literature or stats. Nina's own work on foreign direct investment served as a jumping off point for the insights of my dissertation and opened my eyes to an entirely different way to think about foreign direct investment and social interaction. Her inclusion on the committee was one the best decisions I made and I am forever grateful for her help.

During my time at UCI I received financial support from the Center for the Study of Democracy, the School of Social Science, and Political Science Department and I am greatful to each for allowing me to complete my research. In particular I would like to thank John Sommerhauser for always answering my endless questions, make sure all the forms were signed, and being a source of support during trying times.

I would also like to thank the friends I made at UCI. Talking over problems and brainstorming ideas with these people helped me immensely in the process of formulating, researching, and writing my dissertation. In particular, I would like to thank Josh Gellers, Bron Tamulis, Robert Nyenhuis, Jenny Garcia, Chris Stout, Peter Miller (another win for team democracy!), and Albert Wolf. I would like to extend a special thank you to Kris Coulter for always being there for me during some very challenging circumstances. I truly would not be here without your support.

I must also thank my family: Mom, Dad, and Mary. I want to thank my Mom for always supporting me, encouraging me, and 'holding good thoughts' for me. I want to thank my Dad for instilling in me a love of politics and I must thank my sister for making me laugh and understanding me better than anyone else.

Finally, my deepest thanks goes to my wife Alison and son Roy. Alison's love, support, and kicks in the butt made this dissertation possible. You believed in me when I did not believe in myself and I could not have done this without you. Roy, you are the world's greatest and cutest motivator. Thank you for showing me what is important in life.

CURRICULUM VITAE

John Seth Alexander

2005 B.A. in Government University of Redlands

2010 M.A. Political Science University of California, Irvine

2014 PhD Political Science University of California, Irvine

FIELD OF STUDY

Comparative Politics, Public Law, International Political Economy

PUBLICATIONS

Review of Randall Peerenboom and Tom Ginsburg (eds). *Law and Development of Middle-Income Countries: Avoiding the Middle Income Trap*. New York: The Cambridge University Press, 2014. *Law and Politics Book Review* Vol. 24 No. 7.

ABSTRACT OF THE DISSERTATION

The Rule of Law and Foreign Direct Investment in the Developing World

By

John Seth Alexander

Doctor of Philosophy in Political Science

University of California, Irvine, 2014

Associate Professor Charles Anthony Smith, Chair

Foreign direct investment (FDI) is an increasingly important part of the world economy. Foreign investment is especially important in developing countries where it can make up for a lack of domestic capital, increase tax receipts, improve employment, and hopefully lead to economic development. Given the potential importance of foreign direct investment it is important to understand why some countries receive more foreign investment than others. This dissertation examines the role a country's respect for the rule of law plays in its ability to attract FDI. Using regression analysis I find investors prefer countries that protect contract, property, and physical integrity rights. At the same time, countries with a weak rule of law are still able to attract FDI. Using the results of an original survey of U.S.-based CEOs, phone interviews, statistical analysis, and a case study of China, I argue investors use personal relationships with business partners and government connections to reduce the uncertainty created by a weak rule of law. Furthermore, investors prefer personal relationships more than formal rule-of-law substitutes like bilateral investment treaties and special economic zones.

Chapter 1: Introduction

In 1978 the 30,000 people living in Shenzhen, China worked primarily as fishermen. The city exported virtually nothing and contributed little to the Chinese economy, but by 2010 nearly 11 million people would call Shenzhen their permanent home. Countless more Chinese would migrate in and out of the city to work in one of Shenzhen's new factories, producing products sold all over the world including Apple's iPhone, Dell laptops, and Nike shoes. These workers would become part of the $4 billion in foreign direct investment (FDI) based in Shenzhen. Beginning in 1979 and continuing to the present, FDI would transform Shenzhen from an underdeveloped fishing village into a center for international trade and manufacturing. In 2010, Shenzhen's exports totaled $250 billion and the city stood as China's fourth largest economy with $400 billion in international trade passing through the city. Shenzhen's spectacular growth and transformation are indicative of broader changes experienced throughout the developing world. Indeed, Shenzhen's transformation embodies the story of modern economic globalization. Beginning in the 1980s countries throughout the world lowered barriers to trade, lowered taxes, and increased incentives to foreign investors all in an effort to jump-start economic growth.

Developing countries seek out FDI for a number of reasons including increased employment, technology and skill spillovers, and increased exports, all of which contribute to economic growth. FDI increases employment in host countries by creating new facilities and new jobs. In 2009 FDI contributed to 7.9% of employment in the developing world as a whole and nearly 10% of employment in South East Asia (UNCTAD 2012, 33). The presence of these firms in developing countries can also lead to technological innovation through reverse engineering (Cheung and Lin 2004; Hale and Long 2006), as well as through the direct transfer

of technologies to domestic firms through vertical and horizontal connections during the production and distribution process (Javorcik 2004). Host countries can also benefit from the expertise workers gain as employees of multinational corporations (MNCs) when domestic firms hire these skilled workers and take advantage of their experience (Gorg and Strobl 2005; Markusen and Troflimenko 2009; Poole 2007). Taken together, increased employment and the resulting spillover effects can increase economic development and ultimately help reduce poverty.

FDI also benefits host countries by increasing exports, as many firms choose FDI to produce goods for sale or use in markets outside the . FDI can increase a host-country's exports when firms export resources, final products, or product components (Zhang and Song 2000, 389-390). Multinational firms, like oil companies, can boost a host-country's exports by extracting and processing oil for sale to other countries. Many firms use FDI to produce goods like shoes or clothes at lower costs, which are then shipped overseas to markets like the United States. Finally, firms use FDI to produce one component of a product, such as a microchip, which is then shipped to another country for final assembly. The effect of FDI on exports varies by type of investment as some FDI is designed specifically to produce goods for sale in the . However, on the whole, FDI can increase a host-country's exports and boost its economy by improving its trade balance and generating foreign exchange (Jensen 2006, 30-31).

Between 1980 and 2010 foreign direct investment (FDI) flows to the developing world increased by over 8000 percent, from $9 billion to $749 billion (World Development Indicators Online (WDI)). As a result, FDI has become an even bigger part of the world economy as private capital becomes the central feature of international investment (Jensen 2003, 589). However,

great disparity exists in the allocation of FDI among developing countries, with just ten countries receiving 56% of all FDI to the developing world.

Table 1.1 demonstrates the remarkable growth in FDI to the developing world over the past 30 years. In 1984 a total of $15.5 billion flowed into developing countries, by 1990 this number was up to $30.5 billion, by 2000 FDI inflows were up to $181 billion, and by 2010 $513 billion. Over this period, FDI to the developing world increased twice as fast as FDI to developed countries. At the same time, the growth and location of FDI within the developing world is varied. Table 1.2 highlights regional differences in FDI. Throughout the past thirty years Asia and Latin America have received the most FDI, while other regions have lagged behind. Table 3 helps to demonstrate the great disparity in FDI inflows across the developing world. The top five recipients of FDI in each decade accounted for approximately half of all FDI inflows to the developing world. Amazingly, during this time period the seventy-one countries outside the top twenty only accounted for about 10% of all FDI inflows. Understanding the sources of this inequality is important given the critical role FDI plays in the developing world, where countries rely heavily on outside investment to make up for a lack of domestic capital (Asiedu 2002, 107).

The importance of FDI to host-country economies, FDI's growing role in the world economy, and the unequal distribution of FDI around the developing world make understanding the determinants of FDI critical. Existing theories focus primarily on economic factors, like wages, market size, and trade policies, as well as political factors like democratic institutions and political stability. More recently, scholars have begun focusing on the role of the rule of law and legal institutions in helping to attract FDI (e.g., Staats and Biglaiser 2011). There are strong theoretical reasons to expect a stronger rule of law encourages FDI, by suggesting host

governments can credibly commit to enforcing contracts and protecting property (Haggard et al 2008, 207; Staats and Biglaiser 2011, 2-3). Yet a number of countries with comparatively weak respect for the rule of law continue to attract FDI. This suggests the relationship between the rule of law and FDI may be more complex and varied than scholars originally suggested.

Table 1.1: FDI Inflows to Developing Countries

Year	Average Net Inflows
1970-1974	$1.8 Billion
1975-1979	$5.4 Billion
1980-1984	$10.1 Billion
1985-1989	$14.2 Billion
1990-1994	$48.6 Billion
1995-1999	$138 Billion
2000-2004	$165.1 Billion
2005-2010	$465.1 Billion

Source: Net Inflow data from WDI 2014

Table 1.2: Total FDI Inflows by Region in Millions of U.S. Dollars

Region	1980s	1990s	2000s
Asia	47,485.9	540,338.8	1,119,062.8
Latin America	36,594.4	378,068	798,733
MENA	14,750.5	39,184.7	520,193
Sub-Saharan Africa	7,799.8	44,229.8	244,018
Post-Soviet	00.0	39,359.3	400,167

Source: UNCTAD 2014

I argue that the rule of law plays a critical role in helping countries attract FDI by reducing uncertainty, protecting investments, and making it easier for investors to engage in long-term planning. Additionally, I contend countries with a weak rule of law are able to attract investment because investors rely upon personal relationships with business partners and government officials to provide them with the same kinds of benefits the rule of law provides. In particular, personal relationships provide investors with information about how to operate in the host-country's market and provide assurances that investments will be protected. This reduces

the investors' uncertainty and improves their ability to plan for the future, which makes it easier for them to invest.

To test this argument I combine quantitative and qualitative analysis. I use regression analysis to test the importance of the rule of law for FDI to developing countries between 1984 and 2010. These analyses focus on FDI from both the entire world and from the United States. The first data set contains over 2000 country-year observations and over 100 countries, while the United States dataset contains nearly 800 observations and covers sixty-five countries. The conclusions of the quantitative analysis are supported by the results of a survey of seventy-three U.S CEOs who engage in FDI, and phone interviews with fifteen CEOs, lawyers, and business association workers familiar with the FDI process. Finally, I use a case study of China to examine more closely the mechanisms that underly the associations established by the statistical analysis.

Outline of the Project

I divide the dissertation into five chapters. This opening chapter introduces the topic and reviews the relevant literature. In Chapter 2, I identify the importance of different rule-of-law elements for FDI using both statistical analysis and the results of an original survey of U.S. investors. The statistical analysis tests the importance of five elements of the rule of law: contract and property rights protection; judicial independence; control of corruption; workers' rights; and the protection of physical integrity rights. These elements are central to most definitions of the rule of law and testing their impact on FDI helps to clarify our understanding of the relationship between the rule of law and FDI. This analysis is the first step in the process of developing an understanding of why some countries with a weak rule of law are able to attract FDI. A survey of U.S. investors supports the conclusions of the statistical analysis. In

particular, investors consider the rule of law to be an important factor when deciding to engage in FDI and investors are specifically concerned about contract, property, and physical integrity rights.

Chapter 3 again uses statistical analysis and survey results, this time to begin explaining why countries with a weak rule of law are able to attract FDI. This chapter examines whether or not certain formal institutions substitute for a weak rule of law. The statistical analysis uses interaction effects to test whether the presence of bilateral investment treaties (BITs) or special economic zones (SEZs) increase FDI in countries with a weak rule of law. The chapter also tests whether or not a country's level of economic opportunity (defined as market size, level of economic development, and level of economic growth) can increase investment in countries with a weak rule of law. Finally, the chapter examines whether or not personal relationships can help increase FDI where the rule of law is weak. Overall, Chapter 3 demonstrates that formal substitutes do not help countries with a weak rule of law attract FDI. Instead the statistical analysis points to the importance of economic opportunity for mitigating a weak rule of law. Additionally, both the statistical analysis and survey results support the theory that investors use personal relationships to overcome a weak rule of law.

Chapter 4 is a case study of China. This chapter identifies and explains the mechanisms underlying the associations found in the statistical analysis. I examine how investors build personal relationships, the benefits of personal relationships for investors, and how conditions in a country drive investors to form personal relationships. At the same time the chapter highlights the important role economic opportunity plays in the investment process. The chapter compares FDI in China in the 1990s and 2000s. Splitting up these two time periods allows me to examine how changes in China's rule of law alter the importance of personal relations for FDI. The

analysis reveals that personal relationships provide investors with similar protections to the rule of law, but the importance of personal relationships declines as the domestic rule of law improves.

Chapter 5 concludes the dissertation. This chapter highlights the importance of personal relationships around the developing world and suggests the role of personal relationships in FDI is not unique to China. The chapter also highlights the implications of my findings before concluding with some thoughts on the relationships between formal and informal institutions.

Defining FDI

FDI comes in a variety of different forms all of which involve the transfer of private capital from a firm to a location outside the firm's home nation. Examples of FDI include the purchase of existing firms in a host-country or the building of new factories. Any transfer that gives a MNC at least 10% control over the firm in the host-nation qualifies as FDI. Anything short of 10% is referred to as portfolio investment (PI). Examples of portfolio investment include smaller stock purchases and loans from sources other than the parent firm. Unlike FDI, portfolio investment is very mobile and can enter and leave a country quickly. Though the distinction between FDI and PI, established by the International Monetary Fund (IMF), is somewhat arbitrary it stands as an internationally recognized standard.

FDI can be further divided into resource-seeking, efficiency-seeking, and market-seeking (Cohen 2007, 66-71; Dunning 1988, 13). These divisions are useful because investors may respond to different factors when making investment decisions based on the type of investment they are planning to make.

Resource-seeking FDI focuses primarily on the extraction of natural resources for use in production elsewhere (Brouthers et al. 1996, 360). This type of investment generally occurs

outside of population centers and relies on a host-nation's infrastructure to help export the resources. Efficiency-seeking FDI looks to use advantages of the to lower the cost of production. For example, a company investing in efficiency-seeking FDI may choose to locate a production facility in a with low labor costs to help decrease the overall cost of production (Brouthers et al. 1996, 360). Finally, market-seeking FDI endeavors to sell products and services within a (Brouthers et al. 1996, 360). While efficency-seeking and resource-seeking FDI are part of a vertical production structure, market-seeking FDI is horizontal in nature (See Blonigen 2005, 393 for more on horizontal vs. vertical production). This means, for the most part, that the entire production process takes place within the .

Traditional Determinants of Foreign Direct Investment

In order to explain why some countries attract more FDI than others political scientists and economists have focused primarily on economic, policy, and institutional variables. Research points to the importance of certain factors such as level of economic development, market size, and rate of economic growth as important economic determinants. Scholars also identify a country's openness to trade and level of capital account openness as two policy factors that help determine FDI levels. Finally, more recently scholars have noted the importance of political institutions, like democratic governments, in attracting FDI. Underlying these variables is a belief that investors are rational cost-benefit maximizers who use the values of these variables to determine whether a country is worth investing in. However, some criticize this theory by pointing out it assumes that investors have access to the information necessary to accurately measure these variables (Bandelj 2008). These theories were built, in large part, upon analyses of stable, developed countries where it is possible to obtain accurate information. However, this assumption of accurate information does not hold for all the countries in the

world. Many countries exist under conditions (such as a weak rule of law) that make it difficult for investors to engage accurate in cost-benefit analysis.

Economic Conditions

Economic variables have consistently proven to have significant influence on FDI, so much so that they are now routinely included as controls in models seeking to explain FDI. One study (Edwards 1990) found economic variables explained nearly 60% of the variation in FDI to developing countries. Among the economic variables GDP and GDP per capita are included in virtually every study of the determinants of FDI because of their consistently strong positive association with FDI (e.g. Oneal 1988; Schneider and Frey 1985; Tsai 1994). Scholars use these variables to measure the size of a ’s market. Higher levels of both measures signal a robust market. The impact of economic conditions depends on the type of FDI. Firms seeking out new markets for goods are likely to be attracted to countries with a high GDP, while those seeking to produce goods for exports are likely to look for less-developed countries. Countries with lower GDP and GDP per capita represent a market with lower costs now and greater potential for growth in the future, making them attractive to efficiency-seeking FDI (Edwards 1990 and Jaspersen et al. 2000).

The previous level of FDI in a country is another consistent predictor of current FDI (e.g. Biglaiser and DeRouen 2006; Jensen 2003 and 2006; Tuman and Emmert 2004). FDI entails large sunk-costs which make it hard to remove FDI from a country once an initial investment is made (Staats and Biglaiser 2011, 610). As a result, it is likely that investors will continue to invest in areas of previous investment. Furthermore, previous investment in a country suggests existing knowledge of that country’s business and legal system (Jensen 2006, 45). Since these systems can vary from country to country it is often easier to reinvest in areas where this

knowledge has already been gained than have to re-learn it in a new country. Finally, in order to maximize the benefits of FDI, companies may choose to locate new investment in countries where they already have invested elsewhere on their supply chain (Jensen 2006, 45). For instance, a computer manufacturer may choose to locate a computer assembly plant in the same country it produces microchips in order to save on transportation costs by reducing how far the chips must travel before they are added to the computers.

Among the macroeconomic indicators, the least consensus exists around the role Real GDP per capita growth plays in attracting FDI. Some studies have identified a positive relationship between growth and FDI (Tsai 1994; Gastanga et al 1998; Li and Resnick 2003; Tuman and Emmert 2004). This variable captures a country's level of economic growth and this may help explain the conflicting results. A growing economy results in higher wages, which are actually harmful to FDI seeking to use a host-country to produce goods more cheaply. At the same time, firms who look to sell products overseas would be more attracted to a growing market with more consumers able to buy their products.

Labor costs are another factor capable of affecting the level of FDI. Higher labor costs are negatively associated with FDI because they increase the cost of doing business (Cole et al 2009; Kumar 1994; Tsai 1994). These studies take the average wage rate to measure the cost of labor. Once again the type of investment plays a role in the importance of an economic determinant of FDI. Wages have the greatest impact on FDI that seeks out low-cost labor. Tsai, for instance, focused on investment in least developed countries during the 1970s and 1980s and finds wages had a negative effect on FDI. Investment in these countries during this time period generally sought to exploit low labor costs and made use of low skilled labor. Likewise, Cole et al. (2009) look at the difference in FDI between various Chinese provinces. They find higher

wages negatively effect FDI and attribute this effect to a desire by investors to take advantage of low skilled labor (Cole et al. 2009, 1508). Studies that fail to find any effect of wages on FDI use a combined measure of FDI that does not separate out firms that seek low-cost labor from those that seek out higher skilled (meaning higher paid) labor. For example, Li and Resnick (2003) look at the change in the cost of labor, hypothesizing that sharp increases in labor costs would deter investment. However, their measure is not statistically significant. Loree and Guisinger (1995) also use a wage variable to proxy for labor cost, but it is not statistically significant. They argue this is a result of the diversity of their sample and that because wage rate may mirror the skill-level of the workforce with higher skilled workers getting paid more. This suggests the influence of wages may vary based on the type of investment. Since Loree and Guisinger's (1995) dependent variable captures a wide range of FDI, including basic manufacturing and high-tech assembly, the effect of labor costs may be distorted (295). Conversely, both Tsai (1994) and Cole et al. (2009) use samples that more naturally control for the type of investment.

Economic Policies

A country's economic policies can also alter its level of FDI. Trade and trade policies are both used to capture a government's openness to international trade. In general the literature finds that investors prefer countries that are more open to trade, have lower tariffs, and fewer capital controls. Positive trade balances (Tsai 1994) and higher total levels of trade (Biglaiser and DeRouen 2006) are both positively associated with FDI, as they signal an overall environment conducive to international trade. On the other hand, specific policies like restrictions on capital mobility make it harder for investors to enter a market, exit a market, or both, all of which have a negative effect on FDI (Gastanga et al 1998 and Li and Resnick 2003).

The relationship between tariffs and FDI is more complicated because tariffs have the potential to affect different types of FDI in different ways. For instance, market-seeking FDI may be positively associated with high tariffs because these MNCs decide to produce in the host-country in order to avoid paying an import tariff (Brainard 1993; Carr et al 2001; Gastanga et al 1998). Once established in the host-country, these companies can also enjoy the protection of the tariff from outside competition. Other types of FDI that require imports for production and/or produce goods for export may be negatively associated with high tariffs raise their cost of doing business. Chantasasawat et al (2010) find support for this argument by comparing FDI in Latin America with that in East Asia. In Latin America, where markets are more developed and tariffs are generally higher, FDI is positively associated with high tariffs. In East Asia, where markets are less developed and production costs lower, FDI is negatively associated with high tariffs. While Chantasasawat et al (2010) do not disaggregate by type of FDI the structural differences between the two regions and the differing effects of tariffs on FDI level suggest that different types of FDI respond differently to tariffs.

Institutions

Institutional checks provide investors with a credible commitment that the government will not renege on its original promises to protect investment. Limits on executive power and strong courts are two often-cited ways to generate a credible commitment. The rule of law limits the executive to only creating law through a standard practice, typically through the legislature. Research also links increasing the number of veto points in a political system to both economic growth and FDI (Henisz 2000). Veto points are points within the political process that can stop a given action, like the expropriation of property. More veto points makes it more difficult to carry out a certain action and this creates a check on the government.

However, democracy and elections do not necessarily support the logic of credible commitments and economic growth. Theoretically, democratic elections should provide the ultimate check on government behavior by threatening government officials with removal should they renege on their promises. In practice, however, evidence of the effect of democracy on economic growth and FDI is mixed. Some scholars posit a negative association between FDI and democracy (e.g. Huntington 1968; O'Donnell 1978; Tuman and Emmert 2004). These scholars argue authoritarianism improves investment because authoritarian regimes are better able to limit labor unrest and protect property. Another group of scholars contend the opposite. Their research shows democratic regimes increase investment because of a host of secondary benefits that flow from democratic governance. Early work by North (1990) and North and Weingast (1989) established the theoretical basis for this belief. These authors argue democratic institutions provide investors with a credible commitment that government leaders are constraining their own power. More empirical support for this argument comes from large-N studies of FDI flows (e.g. Jensen 2003 and 2006) which find that increases in the level of democracy (measured using Polity IV scores) increase FDI inflows (Jensen 2006, 84-88). While Jensen's work establishes a link between democracy and FDI inflows it does not tell us what aspects of democracy affect FDI. Li and Resnick (2003) parse this relationship somewhat and find increases in FDI are associated with increases in the protection of property rights. These protections are seen as a by-product of democracy, but are also possible under other regime types, meaning democracy may not be necessary for increases in FDI. Biglaiser and DeRouen (2006) come to a similar conclusion finding an inverse relationship between the risk of expropriation and FDI, controlling for the level of democracy. This means investors care more about the outcome (expropriation) than they do about the institution (level of democracy). These

works suggest the general intuition of the credible commitment argument is true, but that the commitment can be made without a general commitment to democracy.

The Rule of Law and Foreign Direct Investment

The political science and economic work focusing on the role of institutions in determining FDI levels suggests that the rule of law should be important for FDI. Existing work on the rule of law and FDI comes in two forms. The first are studies that explicitly try and determine the impact of the rule of law on FDI by using aggregate measures of the rule of law, such as the World Bank's World Governance Indicators' (WGI) Rule of Law measure. The second are more traditional studies of the determinants of FDI, which include in their analysis measures for variables that, depending on one's definition of the rule of law, capture parts of the rule of law. The former studies suggest that the rule of law, in a general sense, is important for FDI investment, but because they are aggregations they do not make it clear what elements of the rule of law matter the most. The latter studies point to the fact that certain elements of the rule of law may be more or less important than others, but do not explicitly compare different elements of the rule of law with one another.

The aggregate studies primarily use two measures of the rule of law. One is the WGI's Rule of Law measure, which purports to measure "the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence" (Kaufman et al. 2009, 6). The other is the International Country Risk Guide's (ICRG) Law and Order Index which measures the strength and impartiality of the legal system and popular observance of the law (ICRG Online). These two measures are perception-based measures that seek to capture the on-the-ground reality of the rule of law in a particular country. Asiedu (2006) uses the ICRG

measure to assess the effect of the rule of law on all incoming FDI in 22 sub-Saharan African countries between 1984 and 2000, and finds it to have a statistically significant impact on FDI. Substantively, Asiedu finds an increase in respect for the rule of law, from the lowest level in Nigeria to the highest level in South Africa, would modestly increase FDI (Asiedu 2006, 70-74). Conversely, Chantasawat et al. (2010) use the ICRG's Law and Order variable to see its effect on all FDI inflows to East and Southeast Asia and Latin America between 1985 and 2002. Here the rule of law variable is not significant in any model specifications, perhaps suggesting that the importance of the rule of law may vary by region. Fan et al. (2009) look at the determinants of all inward FDI to 120 developed and developing countries between 1982 and 2001. They find the ICRG's variable to be statistically significant and to have a positive effect on FDI (Fan et al 2009, 859-860). Additionally, they run separate models with individual measures of elements of the rule of law. These models find the elements like executive constraints (measured using the Polity IV data on barriers to entry, nature of transition, and selection of government officials), level of democracy (measured using Polity IV data), and corruption (using the ICRG's corruption index) to be insignificant. The authors attribute this difference to the slow changing nature of the Polity data and to the fact that corruption may actually facilitate FDI (Fan et al. 2009, 858). Mengistu and Adhikary (2011) use the WGI measure of the rule of law to test the effect of good governance factors, like the rule of law, on all FDI into 15 countries in Eastern, Southern, and Southeastern Asia between 1996 and 2007. They find the rule of law to have a statistically significant positive effect on FDI. Naude and Krugell (2007) also use the WGI rule of law measure to compare the effect of policy variables, geographic variables, and institutional variables on FDI into 44 African countries in four different time periods: 1971-75, 1976-80, 1981-85, and 1986-1990. They too find the rule of law variable to be statistically significant.

Overall, nearly every study finds the aggregate measures of the rule of law are positively associated with FDI.

In addition to these aggregate studies there are a number of other studies, which look at different elements of the larger rule-of-law concept. For instance, providing security or 'law and order' first became a part of our understanding of the rule of law during the enlightenment (Belton 2005, 10-11). Security can range from preventing crime to the prevention of civil conflict. At every stage lawlessness and insecurity have a negative impact on society by diverting resources and reducing the ability of individuals to plan for the future. Collier (1999) makes the point that civil conflict is particularly negative because of the adverse consequences for economic development.

In the determinants of FDI literature, insecurity is often measured as political instability. General measures of instability take into account a variety of acts that may cause instability. Edwards (1990) finds an aggregate measure of instability (including irregular transfers of power, coups, and coup attempts) negatively affects FDI (11). Likewise, Schneider and Frey (1995) measure instability as demonstrations, riots, strikes, assassinations, coups, and civil war and find it negatively impacts FDI (173). More specific measures look at the composite elements of these aggregate measures. For example, Tuman and Emmert (2004) consider the impact that deaths due to revolutionary movements and the number of riots have on FDI (17). Each variable has a negative effect on FDI. Most of these works share the same underlying theory for why instability is bad for FDI: instability reduces the security of property rights (Schneider and Frey 1985, 166; Tuman and Emmert 2004, 14).[1] However, this calls into question the utility of the political stability measure. If stability is important because it leads to secure property rights,

[1] Some of these works either provide no explanation for why they are including political stability (i.e. Edwards 1990) or simply state instability is potentially bad for investment without explaining why (i.e. Li and Resnick 2003).

then the real variable of interest is the security of property rights and not political stability. This can be problematic when the political stability variable is included in a regression equation with other variables designed to capture the security of property rights.

Some scholars also link protecting human rights, a key part of the rule of law, to FDI. Several definitions of the rule of law, particularly those used by NGOs, include the protection of human rights in their understanding of the rule of law. The most prominent example is the United Nations' defintion, also used by USAID, which begins defining the rule of law as: "a principle of governance in which all persons, institutions and entities, public and private, including the State itself, are accountable to laws that are publicly promulgated, equally enforced and independently adjudicated, and which are consistent with international human rights norms and standards" (UN 2004). Research focuses on three types of rights that affect economic development and FDI: personal integrity rights, education rights, and workers rights (Apodoca 2001; Tuman and Emmert 2004; Mosely and Uno 2007; Blanton and Blanton 2007).

A small body of literature deals directly with the effect of human rights on FDI. Blanton and Blanton (2010) investigate the how respect for personal integrity rights, labor rights, and education rights determine U.S. investment in the developing world. Unlike most studies of the determinants of FDI, Blanton and Blanton (2010) look at the differences in determinants across different types of FDI. This disaggregation is important because different types of investment may view rights protection differently. Each mode has a different theoretical expectation about how they would treat human rights. Briefly, resource-seeking investment generally seeks low-cost labor and therefore would be expected to have little concern for human rights. The relationship between efficiency-seeking FDI and rights is dependent on how the firm realizes its efficiency gains. When these gains occur through the use of low-cost labor the expectation is for

little support of human rights (Blanton and Blanton 2010, 6-8). However, when firms tap into a 's stock of highly skilled labor to make efficiency gains, human rights are more likely to be supported. Finally, market-seeking FDI is most likely to support better human rights (Blanton and Blanton 2010, 6-8). First, market-seeking FDI generally involves the use of highly skilled workers, which means a need for education. Second, since the firm's customers are located in the the firm has an incentive to generate and maintain a positive identity with the society as a whole. Lastly, unlike many types of resource-seeking FDI, market-seeking FDI is generally located near or within major population centers, making it harder for the firm to detach itself from the pressures and issues of society at-large. The authors find statistical support for their hypotheses about the effect of human rights on determining investment across different sectors of the economy.

Corruption can have a negative impact on the rule of law's ideal of equal protection and due process. It can harm FDI by increasing the cost of doing business for investors and increasing uncertainty. Weingast called the rule of law, "a set of stable political rules and rights applied impartially to all citizens" (1997, 245). Dicey's second characteristic of the rule of law also dealt with equality. He wrote, "when we speak of the 'rule of law' as a characteristic of our country, we mean not only that with us no man is above the law, but (what is a different thing) that here every man, whatever be his rank or condition, is subject to the ordinary law of the realm and amenable to the jurisdiction of the ordinary tribunals" (Dicey 1915, 189). Corruption undercuts development by removing predictability from the legal system. Without equal enforcement of laws, investors are unsure what laws apply. It also means that government institutions cannot be relied upon to consistently enforce the laws. This makes corruption costly for businesses, as they must seek other means to enforce agreements privately or pay-off corrupt

officials. All of these practices drive up the cost of doing business in a country regardless of whether a business is forced to pay a bribe or not.

Theoretically, corruption can negatively impact FDI by reducing efficiency, raising costs, decreasing productivity, and increasing instability (e.g. Wei 2000; Habib and Zurawicki 2002). However, empirical results have been mixed on corruption's impact on FDI with several studies concluding that corruption actually facilitates FDI (e.g. Wheeler and Moody 1992; Egger and Winner 2005). Corruption can help investors by expediting paperwork, providing them access to government contracts, and generally facilitate business in countries with inefficient bureaucracies (Tanzi and Davoodi 2000). Corruption may help FDI but hurt economic growth because it allows foreign investors and corrupt officials to benefit at the expense of domestic firms.

The concept of judicial power underlies most definitions of the rule of law. As a part of his larger definition of the rule of law, Carothers includes the importance of courts: "The central institutions of the legal system, including courts, prosecutors, and police are reasonably fair, competent, and efficient. Judges are impartial and independent, not subject to political influence or manipulation" (1998, 96). Fallon (1997) identifies five elements of the rule of law one of which says, "courts should be available to enforce the law and should employ fair procedures" (9). Finally, of Raz's eight principles of the rule of law four deal with the courts (1979, 7-9). Powerful courts are capable of providing a credible commitment to investors that their interests will be protected once investments are made. Courts also provide a venue where investors can turn to ensure their property rights are protected and contracts are enforced. For this to work the court must be powerful. Judicial power, like the rule of law, is a complex concept open to many interpretations. The judicial politics literature points to the important role courts play in ensuring

government officials live up to their legislative promises (Landes and Posner 1975, 879; North and Weingast 1989, 819) and larger political agreements (Finkel 2005, 2008; Ginsburg 2003). Likewise, courts also act as effective enforcement mechanisms for agreements between citizens (North 1990; Olson 1993).

One study has attempted to measure the direct effect of judicial institutions of FDI. Staats and Biglaiser (2011) use three measures to test the effect of what they call judicial strength/rule of law. These are judicial independence, impartial courts, and the protection of property rights. The variables are tested independently and as a composite using both U.S. inflows to Latin America and Global inflows to Latin America as their dependent variables. All the variables have a statistically significant effect except for judicial independence in the model using U.S. inflows to Latin America as the dependent variable. These results suggest that judicial power is important in attracting FDI.

FDI and a Weak Rule of Law

Table 1.3 demonstrated the unequal distribution of FDI among developing countries. A number of the top recipients of FDI also have or had weak respect for the rule of law. This raises the question of why investors choose to invest in countries with a weak rule of law. The literature suggests two possible explanations. First, the standard political science and economic explanation for FDI (reviewed above) focuses on the analysis of costs and benefits during the decision-making process. Under this view, a weak rule of law is added to list of costs, which are weighed against potential benefits like market size or the chance for economic growth. If the benefits outweigh the costs then the firm will invest. However, a weak rule of law increases costs in ways much different from other potential factors such as the cost of labor or tax rates. A weak rule of law presents investors with the challenge of managing uncertainty. Uncertainty

presents a unique set of problems for investors that complicates their standard cost-benefit analysis.

Table 1.3: Unequal Distribution of FDI in the Developing World

Country	1980s	1990s	2000s
Top 5	52%	59%	48%
Top 10	71%	74%	63%
Top 20	92%	88%	80%
Remaining 71 Countries	8%	12%	20%

Source: UNCTAD 2014

Formal Substitutes

Since investors need certainty in order to plan it seems likely they would search for substitutes for the rule of law in countries with a weak rule of law. Both host-countries and home-countries have worked to develop formal institutional substitutes for a weak domestic rule of law. These include signing bilateral investment treaties (BITs) between host and home countries and the creation of special economic zones (SEZs).

Bilateral investment treaties are formal agreements between two countries that provide investors with a number of different benefits. These include requirements of national treatment (not favoring domestic firms over foreign-owned firms), protection against expropriation, and requirements for openness to capital transfers. Using these agreements, host countries can overcome deficiencies in other areas and boost their attractiveness to investors. These BIT commitments are seen as more credible than the domestic commitments because the BITs typically include an enforcement mechanism to ensure compliance. Formally stronger BITs should then lead to a greater increase in FDI than formally weak BITs. Hallward-Driemeier (2003), Tobin and Rose-Ackerman (2005), and Yackee (2008) all fail to find a relationship between FDI and BITs, while other studies by Salacuse and Sullivan (2005) and Neumayer and

Spess (2005) find a positive relationship between the two. One scholar suggests this results from investors being unaware of the provisions found in BITs (Yackee 2008). A look at the data on cases brought before one of the main arbitrators of BIT disputes shows an increase in disputes arising from BITs, but that the total number of cases remains low. While low caseloads may suggest that investors simply do not have a need for dispute resolution, this may also indicate investors are underutilizing the arbitration provisions found in BITs.

In addition to signing BITs, host-countries create SEZs to help attract FDI. SEZs attract investors in a number of different ways. Primarily these zones attract investors by allowing for tariff free export and import, streamlined regulatory processes, tax reduction or exemption, and improved infrastructure. At the same time, some SEZs offer investors greater property and contract protections than typically found outside the zone (Wang 2009; 2013). These extra guarantees may provide investors with greater confidence that their investments will be protected. Unfortunately, investors must rely on the same domestic legal institutions to enforce these new guarantees. This means SEZs offer more *de jure* protections than domestic laws, but may not necessarily offer these protections in practice.

Personal Relations

While governments establish formal rule-of-law substitutes like bilateral investment treaties, investors themselves may look to establish their own substitutes for the rule of law. Personal relationships represent a possible substitute that investors can establish themselves. Previous research has established that during times of uncertainty, people prefer to do business with those with whom they have a personal relationship (Dimaggio and Louch 1998). Applying this logic to FDI, scholars have argued that personal relationships can mitigate the uncertainty created by significant political, economic, and social change such as occurred during the opening

of China to the West (Weidenbaum and Hughes 1996) and during privatization in former communist countries (Bandelj 2002, 2008). Personal relationships do this, these scholars have posited, by providing investors with knowledge about the 's political, economic, and legal systems (Bandelj 2008, 117).

I draw upon the economics and business literatures to argue this same logic can be applied to countries with a weak rule of law. First, economic historians have identified the important role personal relationships played in governing economic activity prior to the development of laws and formal institutions (North 1990). While the Law and Development school of economics argued for the importance of formal legal institutions for economic, the transaction cost economics stresses the role of informal institutions in facilitating economic processes (Williamson 1990). Business scholars and economists have long noted the importance of personal ties in business performance (Granovetter 1985; Heide 1994; Uzzi 1997). This literature notes personal ties can be especially important during times of uncertainty (Heide and Wathne 2006; Uzzi 1997).

These relationships can help investors overcome a weak rule of law in several ways. First, personal relationships with business partners can create less of a need for the formal legal system. Trusted business partners are less likely to violate agreements and trigger a need for the formal legal system (Stone et. al 1995, 101; Zhou and Poppo 2010). Additionally, some types of personal relationships formed out of ethnic networks carry with them an element of social-sanction that will punish those that fail to uphold agreements (Bowles and Gintis 2004). Those who violate a personal relationship with a business partner can face reputational costs that may make it more difficult for them to do business in the future (MacLeod 2007; Woodruff 1998; Xin and Pearce 1997). Finally, when formal legal institutions are weak people often turn to private

methods of enforcement including protection organizations (Frye and Zhuravskaia, 2000; Hay and Shleifer, 1998; McMillan and Woodruff, 1999). These organizations help businesses enforce contracts through the use of force. Unfortunately, this type of informal enforcement does not help against the government.

Second, personal relationships with government officials can help investors overcome a weak rule of law by helping to ensure compliance (Ambler and Witzel 2004). Here, investors turn to government connections to enforce contracts rather than the formal legal system. Officials can act more quickly than the legal system (particularly in countries where legal institutions are plagued by chronic delays) and are better able than other types of personal relationships to enforce agreements because they carry the weight of the state behind their actions (Li et al 2008). The use of government connections in this manner may represent a breach in the rule of law, in that investors are receiving special treatment based on their connections. However, using government connections to ensure a supplier honors the terms of a contract or someone who stole intellectual property is prosecuted is not necessarily the same as using those same connections to obtain a government contract or avoid prosecution for safety violations or gain access to government contracts.

Finally, personal relations provide investors with information about a market and make it easier for investors to learn how to behave in the market. This information is critical because it makes it easier for investors to calculate the costs and benefits of an investment. Information also facilitates long-term planning that allows investments to be successful. Connections allow investors to learn about market changes, how products preform, and help investors learn what partners are trustworthy (Heide and John 1992; Lusch and Brown 1996; Poppo and Zenger

2002). Connections with government officials can also provide investors with important information about changes in government policy (Hillman et al. 1999).

I hope to develop a more complete understanding of the relationship between the rule of law and FDI by integrating a variety of different literatures. The political science literature makes important steps in identifying the structural factors like economic conditions or political institutions that impact FDI. I contribute to this literature by identifying what specific aspects of the rule of law matter for FDI.

At the same time the political science literature does not do a good job of explaining how investors evaluate these important factors under conditions of uncertainty. The literature in business, sociology, and economics is much better at explaining how investors deal with uncertainty through the use of personal relations and informal institutions. I contribute to this literature by extending their insights about uncertainty to countries with a weak rule of law.

Chapter 2: The Rule of Law and Foreign Direct Investment

Introduction

Many scholars and policy makers cite the rule of law as a key factor in a number of different positive outcomes. In particular, policy makers point to the important role the rule of law plays in facilitating FDI and economic development. However, as the last chapter made clear, the rule of law is a complex phenomenon with many different elements and its links to FDI are understudied. In general, there is support for the idea that a strong rule of law relates positively to FDI. However, the reasons why remain unclear. In order to understand this underlying mechanism it is important to disaggregate the concept of the rule of law. Disaggregation allows us to empirically establish a link between specific elements of the rule of law and an empirical outcome: FDI. Additionally, disaggregation allows us to *begin* to look more closely at why the rule of law matters, as the mechanisms linking specific aspects of the rule of law to FDI are more easily understood than those linking the overall concept to FDI.

Through the use of quantitative analysis, this chapter focuses on how the rule of law relates to FDI, and has two goals. The first is to establish if there is a relationship between the rule of law and FDI when controlling for other potential explanatory factors. Second, I seek to establish what aspects of the rule of law are related to FDI when controlling for other potential explanatory factors. I hypothesize that the rule of law is positively associated with FDI and that specific elements of the rule of law drive the relationship between the rule of law and FDI.

Many of the rule of law's benefits come from the way it provides predictability, stability, and reduces uncertainty (Hayek 1994, Raz 1979). In the context of FDI, this means the rule of law reduces uncertainty, allows for long-term planning, and therefore increases FDI. As I

explained in the last chapter I look at three aspects of the rule of law (judicial independence, control of corruption, and rights protection) and their impact on FDI.

Governments that establish independent courts commit to protecting investment against both citizens and the government itself (Staats and Biglaiser 2011). Independent courts provide investors with a clear venue for defending their rights and help to reduce overall uncertainty. Corruption reduces efficiency, raises costs, decreases productivity, and increases instability (Wei 2000; Habib and Zurawicki 2002). As a result, investors are more attracted to countries that can control corruption because these countries make it easier for investors to plan for the future. Finally, rights protection is one of the main outcomes of the rule of law. Previous work established a strong positive connection between FDI and contract, property, physical integrity (Harms and Ursprung 2002; Blanton and Blanton 2007, 2009), workers' (Kucera 2002; Neumeyer and de Soysa 2006) and education rights (Noorbakhsh, Paloni, and Youssef 2001; Blomstrom and Kokko 2003). Investors value contract and property rights as a way to protect their investment from government expropriation and from business partners reneging on agreements (Li and Resnick 2003; Biglaiser and DeRouen 2006; Jensen 2008; Li 2009). Protection of the other rights mean a country is more stabile, a more educated work force, and that the host country government that expresses concern for their citizens' well being. These are all conditions investors find attractive.

At the same time, many scholars focus on the importance of economic factors within a host country for FDI levels. They argue a country's macro-economic conditions such as market size, level of economic development, and rate of economic growth encourage FDI because these factors provide investors with an opportunity for a strong return on their investment (e.g. Oneal 1988; Schneider and Frey 1985; Tsai 1994). Likewise, a country's resource endowments can

also influence its level of FDI. Resource-seeking firms, like oil companies, are especially attracted to countries with strong resource endowments because they offer the greatest potential profit (Asiedu 2002, 2006). A country's economic policies may also offer investors certain advantages over other potential locations. In particular, scholars note the influence of capital controls on FDI and argue that more open countries receive more FDI (Asiedu and Lein 2004). Finally, some authors debate the importance of political and institutional factors, such as regime type, for FDI. While scholars initially believed authoritarian regimes were better able to attract FDI (e.g. Huntington 1968; O'Donnell 1978; Tuman and Emmert 2004), more recent work established that democracies are actually better at committing to investor-friendly policies and protecting property and contract rights over the long term (Henisz 2000; Li and Resnick 2003, Jensen 2008).

Based upon this literature, I hypothesize that the rule of law is positively associated with FDI, even when controlling for other possible explanatory factors and that the particular rule of law elements are behind this relationship. To test these hypotheses this chapter proceeds as follows: first I explain the data and methods used in the regression analysis, then I consider the main regression results, check the robustness of my findings, and finally offer some conclusions.

Data and Methods

Dependent Variable

To measure FDI, I use net FDI inflows in millions of U.S. dollars from the United Nations Conference on Trade and Development (UNCTAD) between 1984 and 2010. Inflows measure the total amount of FDI flowing into a country minus any FDI leaving the country. The distribution of this variable is highly skewed. To help normalize the distribution I take its natural

log.[2] This conceptualization of FDI is better than FDI as a percentage of GDP because FDI/GDP more accurately captures the impact of FDI on a country's economy. Since I am interested in understanding factors that affect how much FDI a country receives and not FDI's impact on an economy it makes sense to use the net inflows variable. The data set contains over two thousand country-year observations and includes over one hundred countries.

Control Variables

Several economic variables are included to control for standard explanations of FDI. All independent variables are lagged by one year to establish causal priority. First, I include a lagged version of the dependent variable. Because of the nature of FDI, previous investment should be tied to future investment given sunk-costs and increased familiarity with a particular country. Additionally, including a lagged dependent variable helps to control auto-correlation within the dependent variable over time.

To measure market size I include a measure of GDP taken from the WDI Online (World Bank). Large markets are likely to attract market-seeking FDI in search of new consumers for their products and services. Additionally, an economy's level of economic development, measured by GDP per capita from the WDI Online, can potentially affect FDI levels. More developed economies can offer investors enticing features like more wealthy customers and improved infrastructure. Conversely, investors may be attracted to countries with underdeveloped economies because they see a chance for greater profits. By including a measure of GDP per capita growth, I help control for the effect of changes in economic development on FDI. A small but growing economy may be more attractive to investors than a

[2] Because you cannot take the log of zero or a negateve number I use the following procedure to deal with these values (Li and Vashchilko 2010, 773). First I add 1 to the FDI variable; this does not substantively alter the impact of any variable but rescales it so that zero now equals one. I then transform any negative values to 0.1. This allows me to take the log of all variables while still preserving the difference between negative FDI, zero FDI, and positive FDI.

large but stagnant economy. A country's openness to trade can also impact its level of FDI. Market-seeking firms want countries that make it easy for them to import goods to sell in the new market, while efficiency-seeking and resource-seeking firms each want countries that make it easy for them to export. One way to measure a country's openness to trade is to look at its total level of trade. I create this variable by combining the WDI Online's measures of exports and imports and dividing by GDP. Finally, I log transform both variables to help normalize their distributions.

I also include a variable to account for the amount of income a country earns through natural resource rents. Many countries attract a great deal of FDI because of their natural resources. Firms may ignore factors they would otherwise consider important when seeking out resources because they are forced to invest in countries possessing the resource. To control for this I use the total of all mineral exports divided by GDP, also taken from the WDI Online.

Investors may also be more attracted to countries that liberalize capital controls. To control for this fact I include the Chinn-Ito index measuring a country's capital account openness (Chinn and Ito 2006). The variable ranges from −1.86 to 2.43, with higher values indicating greater capital account openness. This variable has the advantage over other measures of capturing both the intensity and efficacy of capital controls. This makes the Chinn-Ito index the best available time-series measure of capital account openness.

To test how a country's level of democracy affects FDI I include Polity IV's measure of democracy, ranging from −10 to 10, with higher scores signifying higher levels of democracy. More democratic countries may be more committed to maintaining the policies used to attract investment over the long term than less democratic countries, and are therefore expected to attract more FDI.

Independent Variables of Interest

I employ one aggregate and five specific measures to test the effect of the rule of law on FDI. As an aggregate measure I use Political Risk Services' (PRS) International Country Risk Guide's (ICRG) Law and Order variable. This measure ranges from 0 to 6 with higher numbers representing higher levels of the rule of law. The PRS measure captures both the strength and impartiality of the legal system and popular observance of the law (PRS Methodology Online). I hypothesize that the rule of law has a positive effect on FDI because investors seek assurances their investment will be legally protected over the long term.

The Law and Order variable is imperfect, like all aggregate rule-of-law measures. It combines a measure of the strength and impartiality of the legal system as well as popular observance of the law. As Chapter 1 showed, scholars often define the rule of law in much broader terms than those used by the ICRG, and by using this measure I am potentially missing out on some important aspects of the rule of law. However, legal system strength and popular observance of the law are fundamental aspects of the rule of law and found in virtually all definitions of the concept. This means the ICRG variable is at least capturing some core concept of the rule of law. Additionally, the ICRG variable represents the only variable with data available for the time period under study.

The World Bank's WGI rule of law measure represents the only real alternative to the ICRG measure, but the WGI measure has its own potential problems. The WGI variable aggregates from thirty-one different sources to produce an estimate of a country's respect for the rule of law. Given the variety of definitions for the rule of law, the WGI variable may appear a better measure for a country's respect for the rule of law. However, the WGI measure's reliance upon a variety of different sources calls into question its concept validity (Thomas 2010; c.f.

Kraay et al. 2010; Langbein and Knack 2010; c.f. Kaufman et al. 2010). By using less sources the ICRG variable is better able to avoid these issues. Furthermore, the WGI measure is only available every two years beginning in 1996 and then every year beginning in 2002. As a consequence, using the WGI variable would preclude me from examining the impact of the rule of law on FDI during the initial growth in FDI in the 1980s, as well as during the 1990s when FDI inflows skyrocketed. As a result, I contend the ICRG Law and Order variable is the best available aggregate measure of a country's respect for the rule of law.

I employ five specific measures of the rule of law: Physical Integrity Rights, Workers' Rights, Judicial Independence, Contract/Property Rights Protection, and Corruption. The Physical Integrity Rights and Workers Rights' measures both come from the Cingranelli and Richards Human Rights Data Project (CIRI). The CIRI dataset, compiled by reviewing the US State Department Country Reports on Human Rights Practices and Amnesty International's Annual Report, is one of the most widely used databases on human rights. The data set is available from 1981-2010, and covers most countries in the world including those in my study. While there may be some cause for concern that the use of US State Department reports will bias results for US allies, a comparative analysis of the State Department reports with the independent Amnesty International reports from 1976 − 1995 shows a large amount of convergence between the two (Poe, Carey, and Vazquez 2001, 662). The Physical Integrity Rights Index measures a government's respect for rights against torture, extrajudicial killing, political imprisonment, and disappearance. It ranges from 0 to 8 with higher levels indicating greater respect for these rights. The Workers' Rights variable is ordinal and ranges from zero to two. A score of zero indicates severe restrictions on workers' rights, a one means rights are somewhat restricted, and a two

indicates full protection of workers' rights. To my knowledge, the CIRI dataset is the only dataset with world wide coverage on respect for workers' and physical integrity rights.

To measure judicial independence I utilize Linzer and Staton's (2012) measure of judicial independence. The authors use Bayesian techniques to estimate a country's level of judicial independence based upon eight extant measures of judicial independence. This technique helps to overcome issues of measurement error and missing data found in other measures. Furthermore, the measure only captures *de facto* independence. Other variables capture in whole or part a court's *de jure* or formal independence, which does not necessarily correlate with their actual ability to act independently. If judicial independence does matter for FDI, investors are most likely to respond to a court's actual independence and not just formal rules, making the Linzer and Staton variable the best choice. The resulting measure ranges from zero to one with higher levels indicating greater judicial independence.

The controlling corruption measure is based on an assessment made by editors at the ICRG using a set questionnaire designed to produce consistent results over time. The variable ranges from 0 to 6 with higher levels indicating less corruption. It is preferable to Transparency International's (TI) Corruption Perception Index because TI's methodology changes year-to-year, making its measure inappropriate for the type of cross-national time series analysis I conduct. The ICRG measure captures "actual or potential corruption in the form of excessive patronage, nepotism, job reservations, 'favor-for-favors', secret party funding, and suspiciously close ties between politics and business. In our view these insidious sorts of corruption are potentially of much greater risk to foreign business in that they can lead to popular discontent, unrealistic and inefficient controls on the state economy, and encourage the development of the black market" (ICRG Methodology Online).

As a measure of contract and property rights protection I use Clague et al.'s (1999) measure of Contract Intensive Money (CIM). This measure captures the legal protection of property rights by expressing "the ratio of non - currency money to the total money supply" (Clague et al 1999: 188). The resulting variable is an index ranging from zero to one with higher values indicating that people are storing more money in banks and other institutions rather than in cash. This measure captures property rights and contract protection by assuming that people are more likely to trust institutions to hold their money when they believe effective third-party enforcement exists (Clauge et al. 1999: 188). This variable is better than other measures of contract and property protection because it captures the de facto protection of these rights, is not based upon subjective judgements, and is available for virtually every country across the time period under consideration.

Methods

To test the relationship between the rule of law and FDI I use OLS regression with panel corrected standard errors (Beck and Katz 1995). A Wooldridge Test indicates autocorrelation within the data, which I control for by including a lagged dependent variable as a predictor. Also, a Wald test detected heteroskedasticity in the data, which the panel correct standard errors will correct. Finally, a Hausman test indicates the need for both country and time fixed effects. By controlling for country fixed effects the regression results are interpreted as "for a given country, as X varies … by one unit, Y increases or decreases by B units" (Bartels 2008, 6). Thus, these results explain what factors determine a specific country's level of FDI, not what factors lead an investor to choose one country over another. I will discuss the results of each model below.

Regression Results

I begin by examining the direct effect of each of the rule of law variables on FDI levels. Here I test two hypotheses. First, the rule of law, in the aggregate, is positively associated with FDI when controlling for the other potential explanations outlined in the literature. Second, particular elements of the rule of law are driving the relationship between the rule of law and FDI. Table 2.1 presents the results for the aggregate rule of law measure (Model 1), the protection of contract and property rights (Model 2), and controlling corruption (Model 3). The rule of law and contract and property rights are both positively associated with FDI, when controlling for other potential determinants, but controlling corruption has no effect.

A one-unit increase in a country's overall respect for the rule of law, on a zero to six scale, will increase FDI by twenty-seven percent. Put differently, this result means (holding other variables fixed) that if the Democratic Republic of Congo (DRC) increased its respect for the rule of law from the very low level of .99 to Singapore's very high level of 5.33, the DRC could increase FDI by 185%. Likewise, a .10 increase in a country's protection of property and contract rights on a zero to one scale increases FDI by twelve percent. More substantively this means if the Republic of Congo were to improve its relatively weak protection of contract and property rights from .29 to Singapore's relatively high level of .75, the Congo could increase its FDI by sixty-five percent.

Table 2.2 shows the results for protection of physical integrity rights, workers' rights, and judicial independence. Only the protection of physical integrity rights had a statistically significant effect on a country's level of FDI. Here a one-unit increase in the protection of these rights (on a zero to eight scale) equates to a seven percent increase in FDI. This means that China could improve its FDI by fifty-three percent if it were to increase its respect for physical integrity rights from an average of 1.81 to Costa Rica's level of 7.18.

Among the control variables only the level of economic development, market size, and capital account openness are statistically significant in all the different rule of law models. The economic development result suggests that investors prefer comparatively less-developed developing countries. Using the values from Model 1, a five percent increase in a country's level of economic development is associated with a forty-one percent decrease in FDI. For a country like China a five percent increase in economic development would mean improving its average income per capita from $934 to $980. Such an increase would mean a reduction in its average level of FDI from $40.966 million to $24.26 million, holding the level of all other variables constant.

Conversely, the variable for market size is positive and consistently significant. This means increasing GDP by five percent increases FDI by two percent. Finally, capital account openness also has a consistently positive effect on FDI. Again using the estimates from Model 1, increasing capital account openness by 1 unit increases FDI by seven percent. This means if China were to open up its capital markets to the level of Singapore, its level of FDI would increase by twenty-seven percent.

Table 2.1: Rule of Law and FDI in Developing Countries 1984 – 2010: Aggregate Rule of Law, Contract Protection, and Control of Corruption

	Model 1	Model 2	Model 3
Lagged DV	0.350	0.371	0.363
	(0.053)***	(0.051)***	(0.053)***
Log Econ. Development	-1.345	-1.522	-1.332
	(0.534)**	(0.485)***	(0.534)**
Log Market Size	0.973	1.272	1.183
	(0.586)*	(0.555)**	(0.580)**
Trade	0.001	0.002	0.001
	(0.003)	(0.003)	(0.003)
Econ. Growth	0.000	0.000	0.000
	(0.000)	(0.000)**	(0.000)
Resources	0.013	0.010	0.013
	(0.009)	(0.009)	(0.009)
Capital Acct. Lib.	0.066	0.079	0.079
	(0.040)*	(0.041)*	(0.041)*
Democracy	0.020	0.019	0.020
	(0.010)**	(0.010)*	(0.011)*
Rule of Law	0.243		
	(0.054)***		
Contract and Property		1.106	
		(0.446)**	
Corruption			0.066
			(0.055)
Constant	-13.643	-19.203	-18.005
	(9.895)	(9.417)**	(9.780)*
Country FE	Yes	Yes	Yes
Time FE	Yes	Yes	Yes
R^2	0.71	0.71	0.70
N	2,234	2,274	2,234
Country Count	103	102	103

Dependent Variable = Log of FDI Inflows. Panel corrected standard errors in parentheses.

* p<0.1; ** p<0.05; *** p<0.01

Table 2.2: Rule of Law and FDI in Developing Countries 1984 – 2010: Physical Integrity Rights, Workers' Rights, and Judicial Independence

	Model 4	Model 5	Model 6
Lagged DV	0.366	0.369	0.366
	(0.051)***	(0.051)***	(0.051)***
Log Econ. Development	-1.256	-1.217	-1.360
	(0.508)**	(0.522)**	(0.507)***
Log Market Size	1.057	1.057	1.118
	(0.585)*	(0.590)*	(0.561)**
Trade	0.001	0.001	0.001
	(0.002)	(0.002)	(0.002)
Econ. Growth	0.000	0.000	0.000
	(0.000)	(0.000)	(0.000)
Resources	0.013	0.012	0.013
	(0.009)	(0.009)	(0.009)
Capital Acct. Lib.	0.074	0.080	0.078
	(0.040)*	(0.042)*	(0.041)*
Democracy	0.016	0.020	0.008
	(0.010)	(0.010)**	(0.014)
Physical Integrity Rts	0.079		
	(0.025)***		
Workers' Rights Somewhat Protected		0.071	
		(0.091)	
Workers' Rights Protected		0.089	
		(0.133)	
Judicial Independence			0.809
			(0.650)
Constant	-15.901	-15.823	-16.344
	(9.825)	(9.886)	(9.438)*
Country FE	Yes	Yes	Yes
Time FE	Yes	Yes	Yes
R^2	0.70	0.70	0.70
N	2,307	2,283	2,329
Country Count	103	102	103

Dependent Variable = Log of FDI Inflows. Panel corrected standard errors in parentheses.

* $p<0.1$; ** $p<0.05$; *** $p<0.01$

The democracy variable is significant and positive in four of the six models. Overall, this supports the argument that democratic governments attract more FDI than authoritarian regimes (e.g., Jensen 2006). However, democracy is not significant in the models that control for respect for physical integrity rights and judicial independence. Model 4 (Table 2.2) shows the physical integrity rights measure is significant and positive while the democracy variable is not. This suggests that investors care more about the protection of these rights than democratic institutions when making investment decisions. Model 6 shows that both judicial independence and the democracy variable are not significant when included in the same model. However, each is a significant and positive predictor of FDI when they are included in the model separately. A closer look at the relationship between these two variables may explain why. The correlation coefficient between the two variables is high at 0.80. This points to multicolinearity between the variables, which can make it difficult for the variables to obtain statistical significance. To test this further I include an alternative measure of judicial independence from the CIRI Human Rights Data Set. This variable is an ordinal measure of a country's judicial independence. When this variable is used the democracy variable is statistically significant and positive, again pointing to the importance of democratic institutions for FDI.

The results for the control variables suggest that investors value large markets, but not necessarily highly developed markets. This may be the result of the higher costs associated with increased levels of economic development. For instance, as China's economy continues to develop, the cost of doing business in the country is also climbing. In fact, a 2013 survey of U.S. businesses operating in China found the rising cost of labor to be the greatest challenge faced by firms operating in the country (USCBC 2013, 8). As a result of rising costs many firms,

particularly in manufacturing, are moving all or part of their business out of China (Chandran 2011; Economist 2011; Kuchler 2011).

Conversely, large markets represent an opportunity for investors who are seeking either new customers for their products or efficiency in production. The positive results for capital control liberalization supports the Washington Consensus view that opening capital accounts can have long-term benefits for a country. International organizations like the IMF and World Bank, and countries like the United States and Great Britain during the 1980s and 1990s, regularly prescribed capital account liberalization as a condition of loans to bail out bankrupt countries in the developing world. However, following the Asian Financial Crisis of 1997, removing capital controls came under intense scrutiny. Many argued that removing these controls precipitated the crisis by encouraging speculation in currency and by making it very easy for investors to pull money out of a country. Proponents of liberalization argued that foreign investors were more likely to choose countries with fewer capital controls. My research supports these arguments by suggesting more liberal capital controls are positively associated with foreign direct investment.

What Elements of the Rule of Law Matter the Most

Tables 2.1 and 2.2 show the effect of the different rule of law variables when controlling for existing economic, institutional, and policy determinants. These results show the rule of law is related to FDI and that some rule-of-law elements are more important determinants than others. However, in practice these rule-of-law elements do not exist in isolation. Instead they all exist to some degree or another in every country. In order to assess which elements of the rule of law are most important for FDI, I run a new model with all the different rule-of-law elements included.

Table 2.3: Relative Importance of Different Rule of Law Elements

	Model 7	Model 8
Lagged DV	0.352	0.362
	(0.053)***	(0.053)***
Log Econ. Development	-1.344	-1.407
	(0.574)**	(0.574)**
Log Market Size	0.983	1.188
	(0.615)	(0.613)*
Trade	0.000	-0.000
	(0.003)	(0.003)
Econ. Growth	0.000	0.000
	(0.000)**	(0.000)**
Resources	0.010	0.011
	(0.010)	(0.010)
Capital Acct. Lib.	0.052	0.055
	(0.040)	(0.041)
Democracy	0.024	0.013
	(0.015)	(0.015)
Rule of Law	0.213	
	(0.055)***	
Contract and Property	1.021	1.128
	(0.449)**	(0.457)**
Corruption	-0.024	0.028
	(0.055)	(0.056)
Physical Integrity Rts	0.067	0.077
	(0.027)**	(0.027)***
Workers' Rights Somewhat Protected	0.041	0.062
	(0.094)	(0.095)
Workers' Rights Protected	0.066	0.094
	(0.135)	(0.136)
Judicial Independence	-0.448	0.252
	(0.730)	(0.704)
Constant	-14.474	-18.463
	(10.285)	(10.264)*
Country FE	Yes	Yes
Time FE	Yes	Yes
R^2	0.71	0.71
N	2,138	2,138
Country Count	101	101

Dependent Variable = Log of FDI Inflows. Panel corrected standard errors in parentheses.

* $p<0.1$; ** $p<0.05$; *** $p<0.01$

Table 2.4: Standardized Variables

	Model 9	Model 10	Model 11
Lagged DV	0.354	0.367	
	(0.053)***	(0.051)***	
Log Econ. Development	-1.504	-1.466	
	(0.541)***	(0.503)***	
Log Market Size	1.102	1.206	
	(0.607)*	(0.578)**	
Trade	0.000	0.001	
	(0.003)	(0.003)	
Econ. Growth	0.000	0.000	
	(0.000)**	(0.000)**	
Resources	0.011	0.010	
	(0.010)	(0.009)	
Capital Acct. Lib.	0.054	0.069	
	(0.040)	(0.040)*	
Democracy	0.016	0.015	
	(0.011)	(0.010)	
Standardized Rule of Law	0.284		0.284
	(0.080)***		(0.080)***
Standardized Contract and Property	0.215	0.239	0.215
	(0.095)**	(0.094)**	(0.095)**
Standardized Physical Integrity Rts.	0.153	0.171	0.153
	(0.061)**	(0.059)***	(0.061)**
Standardized Econ. Development			-2.432
			(0.874)***
Standardized Market Size			2.639
			(1.455)*
Standardized Lagged DV			1.162
			(0.175)***
Standardized Trade			0.014
			(0.131)
Standardized Econ. Growth			0.188
			(0.088)**
Standardized Resources			0.170
			(0.159)
Standardized Capital Acct. Lib.			0.083
			(0.061)
Standardized Democracy			0.119
			(0.077)
Constant	-14.555	-17.421	0.731
	(10.252)	(9.704)*	(0.563)
Country FE	Yes	Yes	Yes
Time FE	Yes	Yes	Yes
R^2	0.71	0.71	0.71
N	2,166	2,256	2,166
Countries	102	102	102

Dependent Variable = Log of FDI Inflows. Panel corrected standard errors in parentheses.

* $p<0.1$; ** $p<0.05$; *** $p<0.01$

Model 7 of Table 2.3includes all the rule of law elements along with the aggregate rule-of-law measure and Model 8 of Table 2.3 drops the aggregate measure. These models support the earlier analysis and show that contract protection, protection of physical integrity rights, and the overall rule of law measure are all significant and positive predictors of FDI.

To further explore the relative importance of these three factors Models 9 and 10 (Table 2.4) include rescaled versions of each of the significant rule of law variables. The rescaling procedure creates variables with a mean of zero and standard deviation of one. This accomplished by subtracting the mean from each value and then dividing the result by the standard deviation, resulting in a standard deviation of one. This process makes it possible to compare the effects of the different rule of law variables. Figure 2.1 uses the coefficients from Models 9 and 10 to compare the effect of a one unit increase in each of the rule of law variables on FDI. As the Figure makes clear improving a country's overall respect for the rule of law has the greatest impact on FDI. When we look at specific elements, improving the protection of contracts and property rights has a greater effect on FDI levels than improving protection of physical integrity rights. Using the same standardization on both the rule of law and control variable makes it possible to assess the relative importance of all the possible predictors of FDI. Model 11 (Table 2.4) shows that the most important factors are level of economic development and market size, but that the rule of law is the third most important factor.

Figure 2.1: Relative Impact of Different Rule of Law Variables

Variable	Coefficient	Effect of 1 Unit Increase on FDI
Law and Order	0.284	32%
Contract and Property Rights	0.215	23%
Physical Integrity Rights	0.153	16%

Physical Integrity Rights

The positive result for physical integrity rights undermines the 'race to the bottom' view of FDI that countries will adopt policies that negatively impact their citizens in the hopes of attracting FDI. According to this argument, countries can attract investors by violating physical integrity rights in order to repress opposition groups and maintain regime stability (Blanton and Blanton 2007, 144). However, my results show the opposite: countries can attract more investment by improving their protection of these rights.

The reason investors prefer countries with a better respect for these rights remains unclear. One possible explanation is normative. It is important to support human rights and investors do not want to be seen as supporting a regime with a bad human rights record. The other explanations are more strategic. First, the protection of physical integrity rights may be associated with other outcomes investors find attractive, such as increased human capital or a more productive workforce. Second, investors may prefer more stable countries and violations of these rights are typically associated with periods of instability (Poe, Tate, and Keith 1999, 306).

I divide my sample up by time period to test for the possibility that investors choose countries with a stronger human rights record out of a normative belief in the importance of human rights. During the Cold War there was a greater tolerance of human rights abuses in the international community as governments and international organizations were more concerned about political affiliations (Meernik, Krueger and Poe 1998). However, following the end of the Cold War, a shift occurred with government expressing greater concern for human rights globally (Cigranelli and Richards 1999). To capture this trend, and examine its effect on the importance of physical integrity rights, Models 11 and 12 (Table 2.5) compare the effect of

physical integrity rights on FDI during the Cold War and after the Cold War. During the Cold War, when overall respect for human rights was lower, physical integrity rights are not a significant predictor of FDI. However, after the Cold War a country's respect for physical integrity rights is positively associated with FDI.

To test whether investors are attracted to countries that protect physical integrity rights I include a measure for the level of educational attainment within the workforce (Barro and Lee 2013). If investors value the protection of physical integrity rights because of their association with human capital, the education variable should be positive and significant and the physical integrity variable should lose it significance or at least diminish. Model 13 (Table 2.5) shows the results of this test. Inclusion of the education variable does not alter the effect of the physical integrity rights variable and the education variable is not significant. This suggests that investors do not value physical integrity rights because of links to education and human capital.

Finally, Models 14 and 15 (Table 2.5) look more closely at the relationships between physical integrity rights and political stability. I use two variables to capture stability. The first is the political risk rating from the ICRG. This variable measures a country's overall political stability through twelve different sub-components: government stability, socioeconomic conditions, investment profile, internal conflict, external conflict, corruption, military in politics, religious tensions, law and order, ethnic tensions, democratic accountability, and bureaucratic quality (ICRG-Methodology Online). By including so many sub-components, the ICRG variable embodies a broad definition of political stability. The second measure I choose looks more closely at one aspect of stability: domestic conflict. This variable is a weighted additive index of the number of different conflict-related events in a country. The variable comes from the widely used Banks' Cross-national Times Series Database (CNTS) and combines the number of

assassinations, general strikes, guerrilla warfare, major government crises, purges, riots, revolutions, and anti-government demonstrations. Compared to the ICRG variable, the CNTS conflict variable is more closely linked to the type of instability associated with violations of physical integrity rights. If stability drives the relationship between physical integrity rights and FDI then including these variables in the regression should cause the effect size of physical integrity rights to diminish or the variable to lose statistical significance all together.

Model 14 includes the ICRG political risk variable and Model 15 the CNTS conflict variable. The physical integrity rights variable loses its significance in Model 14 supporting the idea that political stability is driving the relationship between physical integrity rights and FDI. Model 15 shows that as domestic conflict increases FDI decreases, but the inclusion of this variable does not affect the physical integrity rights variable.

This analysis indicates investors care about physical integrity rights both because of a normative belief in the importance of such rights as well as for the association between these rights and political stability. Investing in countries that support these rights shows that firms are 'good corporate citizens' who care about their employees' quality of life outside of the office or plant. At the same time, the results demonstrate investors care a great deal about political stability and, for the most part, countries that violate physical integrity rights tend to be unstable.

Contract and Property Rights

Contract and property rights protection is the rule-of-law element with the largest effect on FDI in the developing world. The protection of these rights can provide investors with assurances that their investment will be secure, particularly against government expropriation. Though government expropriation of foreign investment is becoming rare, it remains a threat to businesses and embodies the greatest danger investors face in foreign countries. Despite a

decline in the number of expropriations globally, it is still possible that investors' perceptions of the threat of expropriation in a country may dictate the importance of contract and property rights protections. To test this hypothesis I investigate the impact of a country's history of expropriation on the importance of contract and property rights for FDI.

To measure a country's history of expropriation I use data from Li (2009) and Hajzler (2012).[3] These scholars define expropriation as "the forced divestment of equity ownership of a foreign direct investment" (Li 2009, 1102). I take the cumulative count of expropriations from 1960 to 2005 to capture a country's history of expropriation. I then interact the expropriation and the contract and property rights protection variables. Model 16 (Table 2.5) shows the result of this regression. Here, the contract/property rights protection variable is still significant. However, the results in Model 16 only reveal part of the picture because the model presents the effect of contract protection if the interaction term is zero, meaning cases with no expropriations. In reality, fifty-seven percent of cases had one or more expropriations in their history. In order to see the true effect of the variables I present in Table 2.6 the marginal effect of history of expropriation on the importance of contract and property rights protection when the other independent variables are held at their means. Table 2.6 demonstrates that the positive effect of contract protection on FDI increases as the number of expropriations increases. This means having strong contract and property rights protection is more important in countries with a history of expropriation. Figure 2.2 graphs the marginal effect of contract protection on FDI inflows as the number of expropriations increases. The X-axis shows the number of expropriations in a country's history. The Y-axis on the right shows the marginal effect of contract protection (with 95% confidence intervals) as the number of expropriations change. The Y-axis on the left shows the percentage of cases with a certain history of expropriation.

[3] I would like to thank both authors for sharing their data with me.

Table 2.5: A Closer Look at Physical Integrity Rights, Contract and Property Rights, and FDI

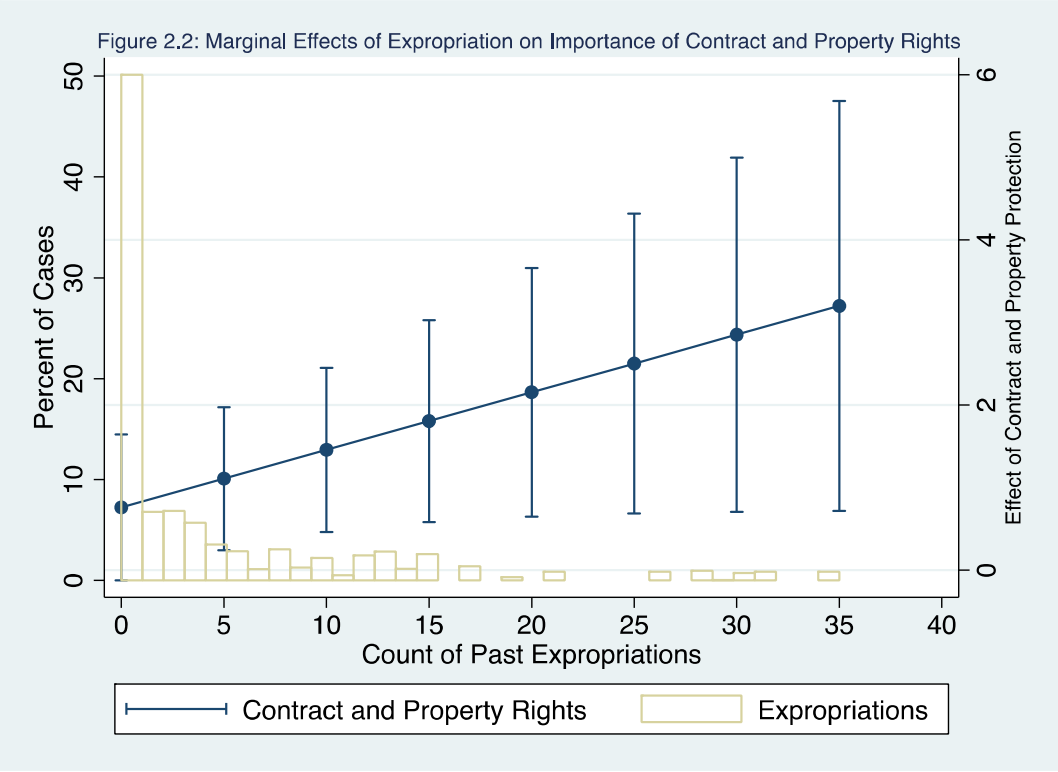
	Model 12	Model 13	Model 14	Model 15	Model 16	Model 17
Lagged DV	-0.004	0.364	0.367	0.346	0.357	0.365
	(0.146)	(0.068)***	(0.051)***	(0.054)***	(0.052)***	(0.051)***
Log Econ. Development	0.064	-1.553	-1.185	-1.347	-1.050	-1.314
	(2.253)	(0.669)**	(0.497)**	(0.544)**	(0.514)**	(0.500)***
Log Market Size	2.524	1.241	0.874	0.871	0.977	1.051
	(2.351)	(0.760)	(0.569)	(0.605)	(0.582)*	(0.563)*
Trade	0.020	-0.001	0.001	-0.000	0.001	0.002
	(0.008)**	(0.003)	(0.002)	(0.003)	(0.002)	(0.003)
Econ. Growth	-0.000	0.000	0.000	0.000	0.000	0.000
	(0.001)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)**
Resources	0.043	0.006	0.011	0.013	0.012	0.009
	(0.025)*	(0.009)	(0.009)	(0.009)	(0.009)	(0.009)
Capital Acct. Lib.	0.228	0.049	0.056	0.034	0.076	0.076
	(0.232)	(0.043)	(0.043)	(0.041)	(0.040)*	(0.041)*
Democracy	0.083	0.024	0.016	0.014	0.013	0.017
	(0.031)***	(0.015)	(0.010)	(0.011)	(0.010)	(0.010)*
Physical Integrity Rts	0.024	0.070	0.081	0.040	0.070	
	(0.075)	(0.031)**	(0.025)***	(0.028)	(0.025)***	
Education Level			0.186			
			(0.124)			
Political Risk				0.029		
				(0.007)***		
Conflict					-0.000	
					(0.000)**	
Contract and Property						0.760
						(0.451)*

Table 2.5: A Closer Look at Physical Integrity Rights, Contract and Property Rights, and FDI

	Model 12	Model 13	Model 14	Model 15	Model 16	Model 17
Expropriations						-0.061
						(0.023)***
Contract and Property X Expropriations						0.070
						(0.037)*
Constant	-56.207	-17.547	-12.469	-12.178	-15.232	-15.388
	(40.625)	(13.145)	(9.600)	(10.161)	(9.845)	(9.500)
Country FE	Yes	Yes	Yes	Yes	Yes	Yes
Time FE	Yes	Yes	Yes	Yes	Yes	Yes
R^2	0.64	0.70	0.71	0.71	0.70	0.71
N	569	1,738	2,298	2,210	2,293	2,274
Country Count	77	103	102	103	103	102

Dependent Variable = Log of FDI Inflows. Panel corrected standard errors in parentheses. * $p<0.1$; ** $p<0.05$; *** $p<0.01$

Table 2.6: Marginal Effect of Expropriation on Importance of Contract and Property Rights				
# of Expropriations	Effect of Contracts and Property on FDI	Std. Error	z	P > |z|
0	.76	.45	1.69	0.09
5	1.10	.44	2.51	0.01
10	1.45	.50	2.87	0.00
15	1.80	.62	2.90	0.00
20	2.15	.77	2.81	0.00
25	2.50	.93	2.70	0.00
30	2.85	1.09	2.61	0.00
35	3.20	1.27	2.53	0.00



To interpret Table 2.6 and Figure 2.2, imagine two countries with identical levels of contract and property rights protection (as well as similar levels on all other independent variables). One country has no history of expropriation and the other has ten past instances of expropriation. The effect of contract and property rights protection in the country with a history of ten expropriations would be nearly twice that of the country with no history of expropriation. Contract and property rights are three times as important in a country with approximately twenty expropriations and over four times as important in a country with thirty-five expropriations. This points to a history of expropriation having a powerful impact on the importance of the rule of law.

These findings suggest two things. First, investors' perceptions of a country may be shaped more by the country's history then its present conditions. This means investors may be basing their investment decisions on outdated or partial information. The survey results presented in the next chapter also support this conclusion by identifying personal relationships as an important source of information about a host-country. The views of business associates are likely to be colored by their own experience in the country. Depending on how long they have been invested they may place greater emphasis on a past act of expropriation that may no longer be a threat in a country. As a consequence of this thinking, host-countries may be losing out on investment not just because of their current rule of law but because of decisions made many years ago by governments no longer in power. My results suggest that developing strong property and contract protections are even more critical in countries with a history of expropriation.

Second, this finding furthers my contention that the rule of law reduces uncertainty. Countries with a history of expropriation may be more likely to expropriate again in the future.

However, investors really have no clear way of knowing. As a result, they look to the existence of certain rights and protections in order to reduce this uncertainty. Countries with weak contract and property rights offer investors no tangible assurances that their investments will be guarded against expropriation.

Diagnostics and Robustness Checks

Given the highly unequal distribution of FDI around the developing world it is possible that outlier countries are influencing the regression results. To check for this possibility I remove six of the largest FDI recipient countries (Brazil, China, India, Mexico, Singapore and Russia) and run the models a second time. As Tables 2.7 and 2.8 show, removing these countries does not alter the results in any meaningful way. This demonstrates the robustness of the relationship between the rule of law and FDI by demonstrating that the relationship is not being driven by any of the very large recipients of FDI.

Furthermore, the dependent variable used in the analysis does not control for country size, and this may be altering the results. Larger countries are likely to attract more FDI simply because they have larger economies and more capacity for investment. Typically, scholars use FDI as a percentage of GDP to control for the effect of market size on FDI. I chose not to use this measure because it obscures how much FDI a country actually receives. Instead FDI as a percentage of GDP gives a more accurate view of the importance of FDI to a host-country's economy. To control for the potential effects of size on FDI, Tables 2.9 and 2.10 include a variable for population size. The inclusion of this variable does not impact the rule of law variables, further demonstrating the robustness of the link between the rule of law and FDI.

Table 2.7: Rule of Law and FDI without Top Recipient Countries

	Model 18	Model 19	Model 20
Lagged DV	0.346	0.366	0.358
	(0.053)***	(0.051)***	(0.053)***
Log Econ. Development	-1.503	-1.662	-1.497
	(0.557)***	(0.498)***	(0.556)***
Log Market Size	1.010	1.293	1.217
	(0.601)*	(0.568)**	(0.593)**
Trade	0.001	0.002	0.001
	(0.003)	(0.003)	(0.003)
Econ. Growth	0.000	0.000	0.000
	(0.000)	(0.000)**	(0.000)
Resources	0.013	0.010	0.014
	(0.010)	(0.010)	(0.010)
Capital Acct. Lib.	0.073	0.087	0.088
	(0.042)*	(0.043)**	(0.043)**
Democracy	0.022	0.020	0.022
	(0.011)**	(0.010)**	(0.011)**
Rule of Law	0.251		
	(0.057)***		
Contract and Property		1.173	
		(0.478)**	
Corruption			0.066
			(0.058)
Constant	-13.515	-18.861	-17.772
	(10.201)	(9.702)*	(10.059)*
Country FE	Yes	Yes	Yes
Time FE	Yes	Yes	Yes
R^2	0.67	0.67	0.66
N	2,090	2,126	2,090
Country Count	97	96	97

Dependent Variable = Log of FDI Inflows. Panel corrected standard errors in parentheses.

* $p<0.1$; ** $p<0.05$; *** $p<0.01$

Table 2.8: Rule of Law and FDI without Top Recipient Countries cont.

	Model 21	Model 22	Model 23
Lagged DV	0.360	0.364	0.361
	(0.052)***	(0.052)***	(0.051)***
Log Econ. Development	-1.419	-1.367	-1.517
	(0.522)***	(0.539)**	(0.525)***
Log Market Size	1.087	1.088	1.145
	(0.597)*	(0.602)*	(0.573)**
Trade	0.001	0.002	0.002
	(0.003)	(0.003)	(0.003)
Econ. Growth	0.000	0.000	0.000
	(0.000)	(0.000)	(0.000)
Resources	0.013	0.012	0.013
	(0.009)	(0.009)	(0.009)
Capital Acct. Lib.	0.084	0.090	0.087
	(0.042)**	(0.044)**	(0.042)**
Democracy	0.017	0.022	0.009
	(0.010)*	(0.010)**	(0.014)
Physical Integrity Rts	0.086		
	(0.026)***		
Workers' Rights Somewhat Protected		0.070	
		(0.097)	
Workers' Rights Protected		0.090	
		(0.141)	
Judicial Independence			0.879
			(0.679)
Constant	-15.588	-15.598	-15.997
	(10.087)	(10.148)	(9.698)*
Country FE	Yes	Yes	Yes
Time FE	Yes	Yes	Yes
R^2	0.66	0.66	0.66
N	2,159	2,135	2,181
Country Count	97	96	97

Dependent Variable = Log of FDI Inflows. Panel corrected standard errors in parentheses.

* $p<0.1$; ** $p<0.05$; *** $p<0.01$

I argue that investors seek out countries with a strong rule of law because such countries have less uncertainty. Others may contend that the rule of law is important for investment because it helps prevent instability in the political system, something investors find unattractive. Thus, the real concept of interest or concern should be political stability. To control for the effect of political stability I use the same two measures (political risk and domestic conflict) used earlier to further investigate the relationship between physical integrity rights and FDI. Political risk (Tables 2.11 and 2.12) captures the overall level of instability in the political system, while the domestic conflict (Tables 2.13 and 2.14) measure captures the amount of domestic conflict that may destabilize the political system. As the models demonstrate, including these variables does not significantly alter the results, meaning political instability is not driving the relationship between FDI and the rule of law. The only exception is for physical integrity rights, which loses its significance when political risk is included in the model. All together, these models show that political stability is an important factor for investors. For each measure, as instability increases FDI decreases. Overall, this lends further support to my contention that a weak rule of law generates uncertainty that is qualitatively different from other types of risk that investors face. In particular, a weak rule of law threatens investors because it undermines confidence in the institutions designed to protect their investments.

Table 2.9: Controlling for Population Size			
	Model 24	Model 25	Model 26
Lagged DV	0.349	0.369	0.361
	(0.053)***	(0.051)***	(0.053)***
Log Econ. Development	-1.426	-1.588	-1.423
	(0.535)***	(0.485)***	(0.536)***
Log Market Size	0.946	1.228	1.149
	(0.587)	(0.556)**	(0.581)**
Trade	0.001	0.002	0.000
	(0.003)	(0.003)	(0.003)
Econ. Growth	0.000	0.000	0.000
	(0.000)	(0.000)**	(0.000)
Resources	0.014	0.011	0.015
	(0.009)	(0.009)	(0.009)
Capital Acct. Lib.	0.077	0.090	0.091
	(0.041)*	(0.042)**	(0.042)**
Democracy	0.021	0.019	0.021
	(0.010)**	(0.010)*	(0.011)*
Rule of Law	0.239		
	(0.054)***		
Population	0.000	0.000	0.000
	(0.000)***	(0.000)***	(0.000)***
Contract and Property		1.070	
		(0.443)**	
Corruption			0.065
			(0.054)
Constant	-12.570	-17.834	-16.725
	(9.950)	(9.458)*	(9.825)*
Country FE	Yes	Yes	Yes
Time FE	Yes	Yes	Yes
R^2	0.71	0.71	0.70
N	2,234	2,274	2,234
Country Count	103	102	103

Dependent Variable = Log of FDI Inflows. Panel corrected standard errors in parentheses.

* p<0.1; ** p<0.05; *** p<0.01

Table 2.10: Controlling for Population Cont.			
	Model 27	Model 28	Model 29
Lagged DV	0.362	0.366	0.363
	(0.051)***	(0.051)***	(0.051)***
Log Econ. Development	-1.343	-1.311	-1.459
	(0.509)***	(0.522)**	(0.509)***
Log Market Size	0.999	1.021	1.068
	(0.586)*	(0.590)*	(0.561)*
Trade	0.001	0.001	0.001
	(0.002)	(0.002)	(0.002)
Econ. Growth	0.000	0.000	0.000
	(0.000)	(0.000)	(0.000)
Resources	0.014	0.013	0.014
	(0.009)	(0.009)	(0.009)
Capital Acct. Lib.	0.087	0.093	0.089
	(0.041)**	(0.042)**	(0.042)**
Democracy	0.016	0.021	0.006
	(0.010)	(0.010)**	(0.014)
Physical Integrity Rts	0.086		
	(0.025)***		
Population	0.000	0.000	0.000
	(0.000)***	(0.000)***	(0.000)***
Workers' Rights Somewhat Protected		0.065	
		(0.091)	
Workers' Rights Protected		0.085	
		(0.133)	
Judicial Independence			1.021
			(0.662)
Constant	-14.145	-14.475	-14.677
	(9.857)	(9.901)	(9.479)
Country FE	Yes	Yes	Yes
Time FE	Yes	Yes	Yes
R^2	0.71	0.70	0.70
N	2,307	2,283	2,329
Country Count	103	102	103

Dependent Variable = Log of FDI Inflows. Panel corrected standard errors in parentheses.

* p<0.1; ** p<0.05; *** p<0.01

Table 2.11: Domestic Conflict, the Rule of Law, and FDI			
	Model 30	Model 31	Model 32
Lagged DV	0.342	0.361	0.353
	(0.054)***	(0.052)***	(0.054)***
Log Econ. Development	-1.075	-1.310	-1.072
	(0.527)**	(0.490)***	(0.524)**
Log Market Size	0.873	1.160	1.064
	(0.585)	(0.553)**	(0.578)*
Trade	0.001	0.002	0.001
	(0.003)	(0.003)	(0.003)
Econ. Growth	0.000	0.000	0.000
	(0.000)	(0.000)**	(0.000)
Resources	0.012	0.010	0.013
	(0.009)	(0.009)	(0.009)
Capital Acct. Lib.	0.068	0.081	0.080
	(0.040)*	(0.041)*	(0.041)*
Democracy	0.018	0.016	0.018
	(0.010)*	(0.010)	(0.011)*
Rule of Law	0.227		
	(0.055)***		
Domestic Conflict	-0.000	-0.000	-0.000
	(0.000)**	(0.000)***	(0.000)***
Contract and Property		0.901	
		(0.439)**	
Corruption			0.042
			(0.055)
Constant	-12.934	-17.818	-16.763
	(9.875)	(9.401)*	(9.762)*
Country FE	Yes	Yes	Yes
Time FE	Yes	Yes	Yes
R^2	0.71	0.71	0.71
N	2,216	2,260	2,216
Country Count	103	102	103

Dependent Variable = Log of FDI Inflows. Panel corrected standard errors in parentheses.

* $p<0.1$; ** $p<0.05$; *** $p<0.01$

Table 2.12: Domestic Conflict, the Rule of Law, and FDI cont.

	Model 33	Model 34	Model 35
Lagged DV	0.357	0.359	0.355
	(0.052)***	(0.052)***	(0.052)***
Log Econ. Development	-1.050	-0.976	-1.100
	(0.514)**	(0.532)*	(0.503)**
Log Market Size	0.977	0.939	1.002
	(0.582)*	(0.587)	(0.560)*
Trade	0.001	0.002	0.002
	(0.002)	(0.003)	(0.002)
Econ. Growth	0.000	0.000	0.000
	(0.000)	(0.000)	(0.000)
Resources	0.012	0.012	0.012
	(0.009)	(0.009)	(0.009)
Capital Acct. Lib.	0.076	0.079	0.077
	(0.040)*	(0.042)*	(0.041)*
Democracy	0.013	0.017	0.004
	(0.010)	(0.010)*	(0.014)
Physical Integrity Rts	0.070		
	(0.025)***		
Domestic Conflict	-0.000	-0.000	-0.000
	(0.000)**	(0.000)***	(0.000)***
Workers' Rights Somewhat Protected		0.090	
		(0.093)	
Workers' Rights Protected		0.097	
		(0.135)	
Judicial Independence			0.864
			(0.648)
Constant	-15.232	-14.585	-15.264
	(9.845)	(9.900)	(9.439)
Country FE	Yes	Yes	Yes
Time FE	Yes	Yes	Yes
R^2	0.70	0.70	0.71
N	2,293	2,269	2,311
Country Count	103	102	103

Dependent Variable = Log of FDI Inflows. Panel corrected standard errors in parentheses.

* p<0.1; ** p<0.05; *** p<0.01

Table 2.13: Political Risk, the Rule of Law, and FDI			
	Model 36	Model 37	Model 38
Lagged DV	0.341	0.351	0.343
	(0.053)***	(0.053)***	(0.053)***
Log Econ. Development	-1.377	-1.576	-1.372
	(0.537)**	(0.519)***	(0.534)**
Log Market Size	0.840	1.056	0.826
	(0.585)	(0.575)*	(0.573)
Trade	0.001	0.000	0.000
	(0.003)	(0.003)	(0.003)
Econ. Growth	0.000	0.000	0.000
	(0.000)	(0.000)**	(0.000)
Resources	0.013	0.011	0.014
	(0.009)	(0.010)	(0.009)
Capital Acct. Lib.	0.036	0.029	0.032
	(0.041)	(0.041)	(0.041)
Democracy	0.015	0.014	0.015
	(0.011)	(0.011)	(0.010)
Rule of Law	0.120		
	(0.061)**		
Political Risk	0.026	0.030	0.036
	(0.007)***	(0.006)***	(0.007)***
Contract and Property		0.979	
		(0.451)**	
Corruption			-0.053
			(0.062)
Constant	-11.258	-15.163	-11.040
	(9.845)	(9.735)	(9.609)
Country FE	Yes	Yes	Yes
Time FE	Yes	Yes	Yes
R^2	0.71	0.71	0.71
N	2,231	2,180	2,231
Country Count	103	102	103

Dependent Variable = Log of FDI Inflows. Panel corrected standard errors in parentheses.

* $p<0.1$; ** $p<0.05$; *** $p<0.01$

Table 2.14: Political Risk, the Rule of Law, and FDI cont.

	Model 39	Model 40	Model 41
Lagged DV	0.346	0.346	0.343
	(0.054)***	(0.054)***	(0.053)***
Log Econ. Development	-1.347	-1.261	-1.380
	(0.544)**	(0.566)**	(0.543)**
Log Market Size	0.871	0.790	0.865
	(0.605)	(0.616)	(0.581)
Trade	-0.000	0.000	0.000
	(0.003)	(0.003)	(0.003)
Econ. Growth	0.000	0.000	0.000
	(0.000)	(0.000)	(0.000)
Resources	0.013	0.013	0.014
	(0.009)	(0.009)	(0.009)
Capital Acct. Lib.	0.034	0.030	0.032
	(0.041)	(0.042)	(0.041)
Democracy	0.014	0.016	0.014
	(0.011)	(0.011)	(0.014)
Physical Integrity Rts	0.040		
	(0.028)		
Political Risk	0.029	0.032	0.034
	(0.007)***	(0.006)***	(0.006)***
Workers' Right Somewhat Protected		0.047	
		(0.093)	
Workers' Right Protected		0.093	
		(0.136)	
Judicial Independence			0.055
			(0.672)
Constant	-12.178	-10.900	-11.841
	(10.161)	(10.297)	(9.765)
Country FE	Yes	Yes	Yes
Time FE	Yes	Yes	Yes
R^2	0.71	0.70	0.71
N	2,210	2,187	2,231
Country Count	103	102	103

Dependent Variable = Log of FDI Inflows. Panel corrected standard errors in parentheses.

* $p<0.1$; ** $p<0.05$; *** $p<0.01$

I control for auto-correlation in the main analysis through the inclusion of a lagged dependent variable. Another option is to use the AR-1 correction to account for autocorrelation within the data. Tables 2.15 and 2.16 present the results with the AR-1 correction instead of the lagged dependent variable. As you can see there are no significant changes to the results.

The main analysis presents a fixed effects model that includes dummy variables for each country. Including these variables accounts for any possible unexplained country-specific factors that may affect FDI. While including fixed effects is a standard procedure, it presents an extremely conservative model. Additionally, including country fixed effects alters the way in which results are interpreted. When fixed-effects are included, the models present the results of changes *within* a country. Excluding the country dummies tells us about factors that affect changes in levels of FDI *between* countries. Tables 2.17 and 2.18 present the main rule of law models without fixed effects for country.

These results demonstrate the robustness of the findings for the rule of law and physical integrity rights. However, the contract and property rights variable is not significant in the model without fixed effects. This means some unexplained factor or factors make contract and property rights protection more important in some countries than in others. For instance, a history of expropriation (discussed above) appears to be a factor that alters the importance of contract and property rights. The fixed-effects model controls for this factor, while the random-effects model does not. The next chapter will focus on some of the factors that can potentially affect how investors view the rule of law in the developing world. In particular, the survey results highlight the potential importance of personal relationships when investing in countries with a weak rule of law. The impact of personal relationships on the rule of law and FDI will be explored in even greater depth in Chapter 4. Overall, these checks confirm the robustness of the

relationships found in the primary analysis. The rule of law is positively related to FDI and physical integrity rights and contract/property rights are two specific elements of the rule of law driving this relationship.

Table 2.15: Rule of Law and FDI with AR-1 Correction

	Model 42	Model 43	Model 44
Log Econ. Development	-2.319	-2.509	-2.362
	(0.776)***	(0.690)***	(0.782)***
Log Market Size	2.285	2.660	2.565
	(0.812)***	(0.749)***	(0.797)***
Trade	0.003	0.005	0.003
	(0.004)	(0.003)	(0.004)
Econ. Growth	0.000	0.000	0.000
	(0.000)	(0.000)	(0.000)
Resources	0.014	0.014	0.014
	(0.013)	(0.013)	(0.013)
Capital Acct. Lib.	0.125	0.145	0.142
	(0.058)**	(0.059)**	(0.059)**
Democracy	0.028	0.025	0.027
	(0.014)**	(0.013)*	(0.014)*
Rule of Law	0.287		
	(0.078)***		
Contract and Property		1.050	
		(0.597)*	
Corruption			0.088
			(0.080)
Constant	-36.650	-43.522	-42.170
	(13.644)***	(12.620)***	(13.330)***
Country FE	Yes	Yes	Yes
Time FE	Yes	Yes	Yes
R^2	0.43	0.44	0.42
N	2,235	2,275	2,235
Country Count	103	102	103

Dependent Variable = Log of FDI Inflows. Panel corrected standard errors in parentheses.

* p<0.1; ** p<0.05; *** p<0.01

Table 2.16: Rule of Law and FDI with AR-1 Correction cont.

	Model 45	Model 46	Model 47
Log Econ. Development	-2.309	-2.301	-2.381
	(0.710)***	(0.727)***	(0.721)***
Log Market Size	2.509	2.524	2.528
	(0.779)***	(0.791)***	(0.762)***
Trade	0.004	0.005	0.004
	(0.003)	(0.003)	(0.003)
Econ. Growth	0.000	0.000	0.000
	(0.000)	(0.000)	(0.000)
Resources	0.017	0.015	0.015
	(0.012)	(0.012)	(0.012)
Capital Acct. Lib.	0.146	0.149	0.138
	(0.058)**	(0.059)**	(0.059)**
Democracy	0.022	0.025	0.012
	(0.014)	(0.014)*	(0.018)
Physical Integrity Rts	0.081		
	(0.028)***		
Workers' Rights Somewhat Protected		0.052	
		(0.107)	
Workers' Rights Protected		0.115	
		(0.145)	
Judicial Independence			1.217
			(0.958)
Constant	-41.226	-41.311	-40.981
	(13.072)***	(13.262)***	(12.798)***
Country FE	Yes	Yes	Yes
Time FE	Yes	Yes	Yes
R^2	0.43	0.42	0.43
N	2,308	2,284	2,330
Country Count	103	102	103

Dependent Variable = Log of FDI Inflows. Panel corrected standard errors in parentheses.

* $p<0.1$; ** $p<0.05$; *** $p<0.01$

Table 2.17: Rule of Law and FDI with Random Effects for Country

	Model 48	Model 49	Model 50
Lagged DV	0.498	0.522	0.509
	(0.049)***	(0.046)***	(0.049)***
Log Econ. Development	-0.149	-0.082	-0.105
	(0.047)***	(0.048)*	(0.047)**
Log Market Size	0.493	0.470	0.487
	(0.054)***	(0.052)***	(0.054)***
Trade	0.005	0.005	0.005
	(0.001)***	(0.001)***	(0.001)***
Econ. Growth	0.000	0.000	0.000
	(0.000)	(0.000)	(0.000)
Resources	0.001	-0.001	-0.000
	(0.004)	(0.004)	(0.004)
Capital Acct. Lib.	0.017	0.012	0.019
	(0.031)	(0.033)	(0.031)
Democracy	0.031	0.022	0.023
	(0.008)***	(0.007)***	(0.008)***
Rule of Law	0.159		
	(0.033)***		
Contract and Property		0.043	
		(0.292)	
Corruption			0.074
			(0.047)
Constant	-9.403	-9.078	-9.414
	(1.074)***	(1.066)***	(1.099)***
Time FE	Yes	Yes	Yes
R^2	0.67	0.68	0.67
N	2,234	2,274	2,234
Country Count	103	102	103

Dependent Variable = Log of FDI Inflows. Panel corrected standard errors in parentheses.

* $p<0.1$; ** $p<0.05$; *** $p<0.01$

Table 2.18: Rule of Law and FDI with Random Effects for Country cont.

	Model 51	Model 52	Model 53
Lagged DV	0.507	0.514	0.514
	(0.047)***	(0.047)***	(0.047)***
Log Econ. Development	-0.164	-0.096	-0.098
	(0.045)***	(0.043)**	(0.057)*
Log Market Size	0.541	0.487	0.479
	(0.057)***	(0.053)***	(0.052)***
Trade	0.005	0.005	0.005
	(0.001)***	(0.001)***	(0.001)***
Econ. Growth	0.000	0.000	0.000
	(0.000)	(0.000)	(0.000)
Resources	0.000	-0.001	-0.001
	(0.004)	(0.004)	(0.004)
Capital Acct. Lib.	0.010	0.012	0.013
	(0.030)	(0.030)	(0.030)
Democracy	0.020	0.020	0.019
	(0.007)***	(0.007)***	(0.009)**
Physical Integrity Rts	0.081		
	(0.020)***		
Workers' Rights Somewhat Protected		0.114	
		(0.079)	
Workers' Rights Protected		0.135	
		(0.122)	
Judicial Independence			0.179
			(0.349)
Constant	-10.436	-9.380	-9.170
	(1.173)***	(1.099)***	(1.054)***
Time FE	Yes	Yes	Yes
R^2	0.67	0.66	0.67
N	2,307	2,283	2,329
Country Count	103	102	103

Dependent Variable = Log of FDI Inflows. Panel corrected standard errors in parentheses.

* $p<0.1$; ** $p<0.05$; *** $p<0.01$

Further Evidence - Investor Survey

This section presents the results of an original survey of CEO's from U.S.-based firms that engage in FDI. The survey helps us better understand the regression results by focusing more closely on the investors themselves. Focusing on investors generates insights into the relative importance of the rule of law for FDI, as well as the FDI process more generally. Regression analysis is the dominant analytic method for assessing the determinants of FDI in both political science and economics. The regression analysis treats all investors the same, without fully accounting for the vast differences in investors themselves. This survey is a small step in the process of bringing investors back into our analysis of the FDI process by specifically asking them about what factors they consider important when deciding to invest, how they define the rule of law, how they mitigate the uncertainty associated with a weak rule of law, and how they measure the rule of law in developing countries.

The results of the survey reaffirm some of the findings presented earlier; begin to answer some of the questions raised by the quantitative analysis; and raise new questions, which will be pursued later in the dissertation. The survey confirms the importance of the rule of law and especially contract and property rights protection for FDI. The results also support the view that political stability and the rule of law impact FDI in different ways.

Survey Methodology and Diagnostics

The statistical analysis demonstrated a connection between the rule of law and FDI. It also indicated that investors prioritize contract, property, and physical integrity rights as the most important aspects of the rule of law. To further clarify which aspects of the rule of law investors consider the most important I administered a survey to U.S.-based CEOs with overseas operations. Contact information was obtained from InfoUSA for U.S.-based firms with overseas

affiliates. This search yielded a list of 3965 contacts. Of the 3965 contacts, 2291 included an email address and 1674 did not. CEOs without an email address received a paper version of the survey via the U.S. Postal Service. CEOs with an email address received an email asking them to take the survey via the website Qualtrics. In order to be sure there were no systematic differences between the email group and the no email group I took the mean number of employees, the mean assets, and the mean sales for each group. I then used an independent samples t-test to test the null hypothesis that the difference between each set of means was zero. In each case, the t-tests rejected the null hypothesis at the 95% confidence level. As a result, I feel confident in assuming that there are no systematic differences between the two groups.

Of the 3965 surveys administered, seventy-seven emails and one hundred four paper surveys were returned as undeliverable. Seventy-three CEOs completed the survey for a response rate of two percent. This response rate is obviously very low. However, low response rates are typical when surveying CEOs. For instance Staats and Biglaiser (2011) reported a response rate of nine percent for a survey of U.S.-based CEOs with investment in Latin America. Likewise other studies have reported response rates of fourteen (Pearce and Zahra 1991), thirteen (Martinez, Esperanca, and de la Torre 2005), and six percent (MIGA 2002).

Low response rates are potentially problematic because they open a study up to bias if there are significant differences between those that respond and those that do not. In order to check for this possibility Table 2.19 compares the characteristics of responding firms with the entire population in terms of industry, assets, employees, sales, and ownership type. This comparison gives me reason to believe those responding to the survey are not significantly different from those not responding. First, the percentage of respondents from each industry roughly mirrors the percentages found in the population. Manufacturing firms make up the

largest percentage of firms investing abroad, at thirty-seven percent, and likewise make up the largest percentage of survey respondents, at thirty-one percent. Overall, seventeen of the nineteen different industries in the sample are within five percentage points of their proportion in the population. The two industries that differ are manufacturing, which is under-represented in the sample by six percent, and information, which is over-represented in the sample by six percent.

Second, while nine of the nineteen different industries did not respond to the survey these industries collectively make up only nine percent of the total population. This means the overall impact of these industries on the survey results was likely to be limited. However, this does present the possibility for some bias in the survey results if these omitted groups differ greatly in their responses from those already recorded. Third, the percentage of public companies taking the survey is also within five percentage points of the proportion of public companies in the sample. This makes it less likely that differences in ownership type will introduce bias into the survey results.

Previous work on the relationship between FDI and human rights found that different types of FDI respond differently to different levels of human rights (Blanton and Blanton 2009). This suggests that rather than looking at individual industries, for the purposes of explaining FDI decisions, it may make more sense to focus on types of FDI. Table 2.20 links different industrial sectors with different types of FDI. I use the same difference of means t-test to check for differences between these types of FDI and again there are no significant differences in their responses. This suggests that investors across industries tend to think the same way about FDI decision-making. This also mitigates the potential non-response bias from the industries that have not responded to the survey. These industries are all market-seeking and we would expect

that their responses would be similar to the other market-seeking firms that did respond to the survey.

Table 2.19: Survey vs. Population Comparisons		
NAIC Classification	Survey Respondents	Population
Agriculture, Forestry, Fishing, and Hunting	0	11 (0.2%)
Mining, Quarrying, and Oil and Gas Extraction	2 (2.74%)	21 (2%)
Utilities	0	22 (0.9%)
Construction	1 (1.36%)	23 (0.1%)
Manufacturing	25 (34.24%)	1469 (37%)
Wholesale Trade	5 (6.85%)	42 (5%)
Retail Trade	7 (9.59%)	264 (7%)
Transportation and Warehousing	1(1.36%)	74 (2%)
Information	10 (13.7%)	386 (10%)
Finance and Insurance	8 (10.96%)	382 (10%)
Real Estate and Rental and Leasing	0	51 (1%)
Professional, Scientific, and Technical Services	6 (8.22%)	571 (14%)
Management of Companies and Enterprises	0	116 (3%)
Administrative and Support and Waste Management and Remediation Services	1(1.36%)	112 (3%)
Educational Services	1 (1.36%)	21 (0.5%)
Health Care and Social Assistance	0	32 (0.8%)
Arts, Entertainment, and Recreation	0	14 (0.3%)
Accommodation and Food Services	0	45 (0.1%)
Other Services	0	50 (0.1%)
Anonymous Submissions	6 (8.22%)	NA
Percent Public	49%	56%
Median Employees (parent company)	688	700
Median Sales Millions of USD	378	394
Median Assets Millions of USD	878	1180

Table 2.20: Industrial Sectors and Type of FDI

Sector	Type of FDI
Oil	Resource-seeking
Mining	Resource-seeking
Food	Market-seeking
Fabricated Metals	Market-seeking
Chemical	Market-seeking
Finance	Market-seeking
Wholesale Trade	Market-seeking
Services	Market-seeking
Electrical	Efficiency-seeking
Industrial Machinery	Efficiency-seeking
Transportation	Efficiency-seeking

Source: Blanton and Blanton 2010

I also look more closely at the characteristics of the firms responding to the survey to see if there are any significant differences with regard to sales, employees, and assets. These factors may impact how a firm makes investment decisions. Given the wide variance in these numbers I focus on the median as my measure of central tendency to avoid outliers potentially biasing the results. This analysis further strengthens my belief that the survey respondents are not significantly different from those who do not respond.

The firms responding to the survey have nearly the same number of employees as the population. This indicates there should not be any bias in the results stemming from how large a company is in terms of employees. However, there are notable differences between those taking the survey and the population in terms of average sales and assets. To explore this more closely I selected a subset of the survey respondents with average sales and assets roughly equal to the population averages. I then compared the mean responses of these population-proxies with the mean responses of the remaining survey respondents on each question. For example, I averaged the score for response one to Question 2 for the population-proxies and then for the remaining surveys. Then I employed a t-test to examine whether the means are statistically different from one another.

In terms of sales, the population-proxy responses were only significantly different for one of the forty-four total responses. The population subset ranked controlling corruption as a more important part of their definition of the rule of law than the rest of those surveyed. The population-proxy group scored this factor at 4.18 and the remaining surveys scored it at 3.29, on a 1-5 scale. Likewise, only two of the forty-four total responses were significantly different between the subset for total assets and the remaining survey responses. Here, the asset population-proxy group ranked the need to keep pace with competitors as a less important factor when making FDI decisions than the other respondents (2.1 compared to 3.25, on a 1-5 scale). Similarly, the asset population-proxy group placed less importance on a history of investing in a region. In this case the average score for the subset matching the population's assets was 2.55 compared with 3.5 for the other respondents, on a 1-5 scale.

The fact that only three responses were significantly different between the population-proxies and the rest of the respondents gives me further confidence that the results of the survey

are not biased. Never the less, the extremely low response rate means the results presented here cannot be seen as conclusive. Rather they point to new questions and variables, and offer another piece of evidence that, when combined with the rest of the dissertation, develops a more complete picture of the FDI process.

Survey Questions

The survey asks business leaders six questions relating to FDI and the rule of law. The first question asks whether or not the respondent's firm engages in FDI in the developing world. Question 1 is designed to reveal if firms not invested in the developing world differ from firms already invested in the developing world. In particular, the question should reveal if these groups differ in terms of overall factors considered important for investment, how they define the rule of law, how they mitigate the risk of investing in a country with a weak rule of law, and what sources of information they use to learn about a country's rule of law. This also provides me with a potential opportunity to explain negative cases or why a firm decides not to invest in a developing country.

Question 2 asks respondents to rank the importance of sixteen different factors when their firm is deciding to invest in the developing world. Respondents are given five response categories to choose from: 1 "Not at all important", 2, 3 "Somewhat Important", 4, 5 "Very Important". This question tests whether the factors the literature considers important are actually important to investors and not a statistical anomaly. Additionally, Question 2 includes some response categories that are not easily measured by statistical analysis. The response options were: government respects the rule of law; political stability; personal relationships with potential business partners; GDP growth, level of democracy, GDP, GDP per capita, large population, history of investment in the country, history of investment in the region, need to keep

pace with competitors also investing in the country, access to low-cost labor; bilateral investment treaty, location is close in proximity to existing FDI locations, trade, and amount of natural resources.

Question 3 focuses on how investors define the rule of law. It asks respondents to identify the importance of eleven different factors commonly associated with the rule of law. Like Question 2, respondents are given five response categories to choose from 1 “Not at all important”, 2, 3 “Somewhat Important”, 4, 5 “Very Important”. This question identifies what rule-of-law elements actually matter to investors. This information helps us better understand which institutions in a potential host country actually impact FDI. Additionally, it advances the study of the rule of law by linking specific elements of the rule of law to FDI. For those interested in promoting the rule of law abroad, having a clear understanding of what investors mean when they say ‘the rule of law matters’ will help them design of programs to promote the rule of law and economic development. The response options were: contract rights are recognized and enforced; property rights are recognized and enforced; relevant laws are easy to identify and understand; government complies with court decisions; citizens obey the law; relevant laws change infrequently; lack of corruption; judicial independence; courts treat people equally; civil and political rights are upheld; and judicial review power.

Survey Results: Questions 1 and 2

T-tests confirm that there are not any significant differences in the responses of those that invest in the developing world and those that do not. This suggests that all firms view the same factors as important when deciding to invest and have a similar perception about the rule of law and factors that might mitigate the risk of investing in a country with a weak rule of law.

The results of Question 2 are listed in Table 2.21. This table orders the responses based on their average rating to give a sense of which factors are most important and which factors are least important. Table 2.21 demonstrates a wide range in average scores between the most important and least important factor suggesting that respondents did consider their responses. Had they not taken the task seriously, I would expect there to be less variability in the results, as respondents would rank all factors the same. Furthermore, the online survey tracks the time it takes respondents to complete the survey and on average it took respondents six and a half minutes to finish. This again points to real consideration on the part of the respondents.

The rule of law and political stability are the two most important factors. T-tests confirm the scores for these factors are higher than any others. The rule of law ranked as the most important factor to investors with an average score of 4.42, on a scale of 1 -5. It also had the smallest standard deviation, pointing to the consensus among the respondents that the rule of law is the most important factor. Political stability was the second most important factor, with an average score of 4.38 and the second smallest standard deviation. These results confirm recent research pointing to the importance of institutions as determinants of FDI. The importance of political stability may explain why the statistical analysis found the level of democracy to be a significant predictor of FDI. Democracies may be more stable than authoritarian regimes. This also supports the models that identified the positive effect of the two measures of political stability on FDI.

Interestingly, respondents gave ‘personal relations with potential business partners’ an average score of 3.85. This makes it more important than eleven of the sixteen factors. This result highlights the important role that relationships can play in the FDI process and suggests that relationships are actually more important than some economic factors, like rate of economic

growth and level of economic development, traditionally assumed to determine FDI locations. Questions 4, 5, and 6 will look more closely at why personal relations are so important.

The more traditional predictors of FDI all cluster together below personal relations. Factors like GDP, GDP per capita, and GDP growth as well as institutional factors, like the level of democracy, all have relatively similar scores ranging from 3.51 for democracy to 3.26 for GDP per capita. The statistical analysis found GDP, GDP per capita, and level of democracy all influence FDI. However, the results indicated that GDP per capita was negatively associated with FDI. Both the survey and statistical analysis demonstrate the continued importance of macro-economic factors and democracy for FDI. At the same time, the results suggest that scholars need to take the role of personal relations in FDI more seriously.

Below the more traditional determinants of FDI are factors such as a history of investing in the region, a history of investing in the country, a need to keep pace with competitors also investing in the country, access to low-cost labor, and the presence of a bilateral investment treaty. The first two factors, dealing with a history of investing in the country or region, were designed to test the path-dependent nature of FDI. As the above analysis showed, prior FDI is a strong predictor of future FDI. However, the survey results suggest this is of less importance to investors. One possible explanation for this may be that investors do not let their own history of investment alter future investment decisions, but they may respond to patterns of investment by other firms. For instance, a CEO of an electronics-manufacturing firm told me that his firm only considers investment locations with an existing 'ecosystem' for his industry (Interview 2). By this he meant that his firm only considers locations where his industry is already established. This indicates to his firm a suitable investment environment. As a consequence, his investment decisions are driven by a history of investment, just not by his firm.

Table 2.21: Mean Level of Importance of Country Characteristics When Deciding to Engage in FDI.					
Factor	Mean	St. Dev	N	Min	Max
Government Respects the Rule of Law	4.42	0.76	73	1	5
Political Stability	4.38	0.89	73	1	5
Personal Relations with Potential Business Partners	3.85	1.06	73	1	5
Level of Democracy	3.51	1.06	73	1	5
GDP	3.45	1.37	33	1	5
GDP Growth	3.35	0.97	72	1	5
GDP per Capita	3.26	1.09	72	1	5
History of Investment in the Country	3.10	1.16	72	1	5
History of Investment in the Region	3.10	1.08	72	1	5
Large Population	3.08	1.08	73	1	5
Bilateral Investment Treaty	3.03	1.28	37	1	5
Need to Keep Pace with Competitors Also Investing in the Country	3.01	1.16	73	1	5
Access to low-cost labor	2.93	1.27	72	1	5
New Location is Close in Proximity to Existing FDI Locations	2.53	1.25	72	1	5
Trade as a Percentage of GDP	2.44	1.04	71	1	5
Amount Nat. Resources	2.25	1.20	72	1	5

I included the question regarding a need to keep pace with other firms to test a hypothesis based on a population ecology model of FDI (Peters 2005, 111). Under this view, there are a limited number of resources in any one environment and individuals (or in this case firms) must compete for control of these resources. If this theory applies to FDI, firms would be choosing investment locations, at least in part, to keep pace with other firms investing in the same location. However, the results seem to suggest this is not a key factor. Interestingly, a t-test reveals the smaller-asset group felt keeping pace with competitors was a more important factor than the larger-asset group did. This indicate that larger firms do not feel any need to keep pace with the competition but that smaller firms do feel a need to keep pace with the larger firms. If true, this may expose the smaller firms to greater risk. This is potentially significant because smaller firms may not be as equipped to deal with the consequences of investing in a country with a weak rule of law.

According to the survey, firms also seem to place less emphasis on access to low-cost labor, undermining the popular belief that firms engage in FDI in order to access cheap labor. While low-cost labor is important, it is not the most important factor. Additionally, interviews with investors suggest the importance of this factor may continue to decline as developing economies continue to evolve. Some CEOs noted that labor costs are beginning to level out across the developing world, making them less inclined to uproot investment for only a marginal improvement in wages. However, many also predict China will lose out on FDI in the future as wages, particularly in low-end manufacturing, continue to increase. This suggests labor costs will continue to play an important role in FDI decisions (Interview 2; Interview 3; Interview 6)

Likewise, bilateral investment treaties (BITs) appear to play a limited role in FDI decisions. There is a fairly large body of work on the importance of BITs for FDI, with scholars

on both sides. Theoretically, BITs can help take the place of domestic rule of law or democratic institutions by providing legal assurances directly to investors. However, the survey shows BITs are neither the most nor least important factor.

Finally, a location near existing FDI locations, a country's level of trade, and the amount of natural resources in a country received the lowest scores. The proximity question, like the history questions discussed above, was included to test the path dependent nature of FDI. Again, this result suggests investors do not let existing FDI determine future FDI. The trade variable was intended to capture a country's openness to trade. Firms do not seem to consider how much a country trades to be a significant economic determinant of FDI. Lastly, a country's natural resource wealth is the least important factor. This makes sense since most firms investing abroad are not interested in natural resources. Only resource-seeking firms, like oil companies, are expected to care about natural resources and this result confirms this belief.

Survey Results: Question 3

Both the statistical analysis and the survey find the rule of law is an important factor for investors. However, what investors mean by the rule of law remains unclear. The regression results suggest investors care about physical integrity rights and contract and property protection. Question 3 looks more closely at what investors mean when they say the rule of law is the most important factor. Table 2.22 ranks the responses in order from most important to least important. The survey demonstrates recognizing and protecting contract (4.10) and property rights (4.07) are clearly the most important aspects of the rule of law for investors. T-tests confirm average scores for these two elements are higher than all the other rule-of-law elements.

The survey results point to little difference between the remaining rule-of-law elements. Investors view laws that are easy to identify (3.85) and government compliance with court

decisions (3.80) as more important than four of the eleven elements, but the average scores for most elements are not statistically different from one another. The one exception is judicial review power (2.97), which investors clearly ranked as the least important element of the rule of law. This is very interesting because of the important role judicial review can play in judicial power and compliance. Perhaps this reflects an understanding among investors that compliance and rights protection takes place outside of courts. In fact, the average score for judicial independence ranked lower than seven of the eleven rule-of-law elements. This means investors want the government and citizens to comply with court decisions, but they do not consider two court characteristics related to judicial power to be important parts of their view of the rule of law. These results are also in line with the statistical analysis that found both workers' rights and judicial independence insignificant. This raises a question: how do investors guarantee their version of the rule of law if not through the courts? Questions 4 and 5, discussed in the next chapter, will help to shed some light on this question.

The survey results help to confirm the findings of the regression analysis. Like the quantitative analysis, the survey showed that the rule of law is an important factor for FDI and that contract and property rights are the most important elements of the rule of law for FDI. The rule of law was ranked higher than economic factors like GDP and GDP per capita, as well as political factors like the level of democracy. Contract and property rights were clearly the highest ranked rule-of-law elements, scoring almost .20 points higher than the third-highest factor. Additionally, these two elements have among the lowest standard deviations for their responses, which suggests greater consensus among the respondents on the importance of these elements.

Table 2.22: Relative Importance of Different Rule-of-Law Elements for FDI					
Rule-of-Law Element	Mean	Standard Deviation	N	Min	Max
Contract Rights are Recognized and Enforced	4.10	0.93	71	1	5
Property Rights are Recognized and Enforced	4.07	0.83	71	1	5
Relevant Laws are Easy to Identify and Understand	3.85	0.83	71	2	5
Government Complies with Court Decisions	3.80	1.12	70	1	5
Relevant Laws Change Infrequently	3.73	1.03	71	1	5
Citizens Obey the Law	3.72	0.97	71	1	5
Lack of Corruption	3.72	1.09	71	1	5
Judicial Independence	3.55	1.14	71	1	5
Courts Treat People Equally	3.44	1.25	71	1	5
Civil and Political Rights are Upheld	3.44	1.20	72	1	5
Judicial Review Power	2.97	1.19	71	1	5

Conclusion

This chapter began to establish the relationship between the rule of law and FDI. The results of the regression analysis confirmed Hypothesis 1, that the rule of law is positively associated with FDI when controlling for other dominant explanations. This analysis demonstrates the importance of legal institutions for FDI, which have largely been ignored in the literature on FDI. Comparatively the rule of law did not impact FDI as much as certain economic factors such as market size and economic growth. However, the analysis shows that the rule of law does play a role in the FDI process. This means that FDI decisions are not entirely about economic conditions, policies, or regime type.

The regression analysis also confirmed Hypothesis 2, that specific rule-of-law elements drive the relationship between the rule of law and FDI. In particular, the analysis showed that protecting physical integrity rights and contract/property rights are positively associated with FDI. Furthermore, by controlling for the effects of democracy, the analysis shows that the benefits of the rule of law do not necessarily flow from democratic governance. The economic successes of Singapore and Chile demonstrate the benefits authoritarian regimes can enjoy when they successfully improve their respect for the rule of law.

In particular, the finding that improving contract and property rights protection increases FDI suggests authoritarian governments can increase FDI by making changes that do not necessarily improve the lives of their citizens. Taking this a step further, if FDI leads to economic growth, which in turn leads to political stability, authoritarian regimes can maintain control without sacrificing significant political power. Conversely, the regression analysis found that improving physical integrity rights improves FDI. This is important because these rights, unlike contract and property rights, directly affect all citizens. The impact of these different rule-

of-law elements on FDI represents both the promise and the peril of the global economy. On the one hand, the result for contract and property rights highlights the unequal nature of the global economy, where benefits are doled out to a select few and the masses get left behind. On the other hand, the link between physical integrity rights and FDI suggests the promises of the global economy. By engaging with the world, countries make positive changes that help lead not just to economic growth but to positive changes in governance which are capable of enhancing citizens' lives in a variety of different ways.

Ultimately, the results in this chapter raise the question of why countries with a weak rule of law still attract FDI. By controlling for economic factors, the regression analysis suggests that some other factors must be leading investors to choose countries with a weak rule of law. If investors simply looked for the best economic opportunity then the rule of law variables would never be significant. I contend investors use personal relationships to substitute for a weak rule of law. These relationships reduce uncertainty by reducing an investor's need for the formal legal system and by providing them with another mechanism for compliance.

Chapter 3: How Investors Contend with a Weak Rule of Law

Introduction

The quantitative analysis in the previous chapter confirmed that the rule of law is a significant factor in FDI. The chapter also demonstrated that contract and property rights protection is the most important element of the rule of law for FDI. At the same time, the forgoing analysis reveals the paradox that while the rule of law is important, a number of countries attract FDI despite having a weak respect for the rule of law. This chapter begins explaining why firms choose to invest in a country despite a weak rule of law. To answer this question, this chapter combines a statistical analysis along with more responses to the investor survey introduced in the last chapter.

This chapter examines three possible explanations for why a firm may choose to invest in a country with a weak rule of law. First, the economic opportunity may outweigh the potential risks associated with a weak rule of law. Second, the country may provide certain institutional assurances that help to mitigate the uncertainty associated with a weak rule of law. These include bilateral investment treaties (BITs), special economic zones (SEZs), and preferential trade agreements (PTAs). These institutional arrangements create alternative commitments to investors that reduce the negative effects of weak domestic institutions. These institutions provide third-party enforcement mechanisms that allow investors to by-pass poor domestic institutions. Third, investors may use personal relationships with business partners and the host-country government to help mitigate the uncertainty created by a weak rule of law.

To test the first two of these hypotheses I use regression analysis with the same panel data used in the previous chapter. Additionally, this chapter looks more closely at FDI by the

United States using data from the U.S. Department of Commerce's Bureau of Economic Analysis (BEA) of U.S. investment in developing countries. This analysis clearly shows that formal rule-of-law substitutes, like bilateral investment treaties, do not increase FDI in countries with a weak rule of law. However, the results do show that economic opportunity, in particular level of economic development and market size, increase FDI in countries with a weak overall respect for the rule of law and weak contract and property rights protection. The statistical analysis failed to find a factor capable of substituting for weak physical integrity rights protection. Finally, I find support for the importance of personal relations in countries with a weak rule of law.

However, statistics are not the ideal way to capture personal relationships because these relationships occur at the firm and individual level. In order to further examine how personal relationships relate to FDI I look at the results of the investor survey. While the first part of the survey looked at the factors investors consider important for investing in developing countries and how investors define the rule of law, the second half of the survey examines how investors deal with investing in countries with a weak rule of law and how they gain information about a country's respect for the rule of law. The survey provides more evidence of the important role personal relationships, both with business associates and government officials, can play in mitigating the uncertainty associated with a weak rule of law. The survey results also support the finding of the quantitative analysis that investors do not use BITs to mitigate a weak rule of law.

Data

Dependent Variable

I use data on U.S. FDI stock in developing countries taken from the U.S. Bureau of Economic Analysis from 1980 to 2010. This data set yields data on: Argentina, Barbados, Bermuda, Brazil, Chile, China, Colombia, Costa Rica, the Czech Republic, Dominican Republic, Ecuador, Egypt, Honduras, Hong Kong, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Nigeria, Panama, Peru, Philippines, Poland, Russia, Saudi Arabia, Singapore, South Africa, Taiwan, Thailand, Turkey, the United Arab Emirates, and Venezuela.

The dataset is weighted towards countries with higher levels of U.S. investment in order to guard the confidentiality of firms. This has two effects: 1) the countries that are missing from the dataset are non-random, meaning there could be some systematic factor that is causing these countries to receive low-levels of U.S. FDI. 2) Countries in the Western Hemisphere are over represented, accounting for 15 of the 28 countries in the dataset. This is likely due to the proximity of these countries to the United States, as distance between host country and country of origin tends to be a strong determinant of level of FDI due to transportation costs. Despite these limitations, the BEA dataset is the best data available that fits my analytic goals. In order to test how bilateral agreements and personal relationships impact FDI I need dyadic FDI data and the BEA dataset is the only one available on U.S. FDI to specific countries.

Independent Variables — Formal Substitutes

To measure formal substitutes for the rule of law I gathered data on BITs in force between the United States and a host country. The United States has forty BITs in force with countries around the world. Additionally, the United States includes what are essentially BITs as chapters in some preferential trade agreements (PTA). For instance, the North American Free Trade Agreement (NAFTA) contains a BIT chapter. All total, through PTAs the United States is party to ten additional BITs. I use the UNCTAD's database of international investment

agreements (UNCTAD 2014), the United States' Office of Trade Agreements Negotiations and Compliance (TANC 2014), and the World Banks' Global Preferential Trade Agreements Database (World Bank 2014) to identify BITs and PTAs with BIT provisions. The dataset excludes agreements, which are signed but not in force because they have no effect until they are in force.

I created several variables to capture these different agreements. The first variable is simply a dummy variable indicating whether or not a country has a bilateral investment treaty signed with the United States. This variable excludes countries that have a BIT via a PTA because investors may not see these two types of agreements in the same way. The second dummy adds in all countries that have a BIT provision inside a PTA. BITs should increase FDI and if they substitute for a weak rule of law their positive impact on FDI should increase as the rule of law decreases.

Existing research into BITs suggests investors lack knowledge about BITs. As a result, BITs do not appear to have an impact on FDI levels. To help control for this possibility I create a variable to capture the number of years a BIT has been in force. The logic behind this variable is that the longer a BIT exists the more likely investors are to know about its provisions. Thus, the older the BIT the greater its positive impact on FDI.

The arbitration provisions of BITs are not all equal. Allee and Peinhardt (2010) identify a range of possibilities including vague statements calling for international arbitration or the creation of ad-hoc arbitration panels. The authors argue the most stringent provision is to require arbitration before the International Centre for the Settlement of Investment Disputes (ICSID), an international non-governmental organization designed to hear investment disputes (Allee and Peinhardt 2010, 4). The authors create an ordinal variable measuring the strength of BIT

arbitration provisions where a zero means the ICSID is not mentioned in the treaty, a one means the ICSID is one of two options for arbitration, and a two means the ICSID is the only arbitration option. I also assign a zero to every country that does not have a BIT with the United States and follow the same coding criteria to incorporate BITs located in PTAs. The United States has only two BITs that do no list the ICSID as an arbitration option, thirty-one BITs where the ICSID is one of the possible arbitration options, and twelve BITs where the ICSID is the only possible arbitration venue. The previous non-relationship between BITs and FDI may be the result of not taking the strength of arbitration provisions into account. Therefore, I expect that increases in BIT strength will be positively associated with FDI. If BITs substitute for domestic institutions then we can expect the impact of BITs on FDI to increase as the rule of law decreases.

Countries may also create SEZs to make up for the weak rule of law. Data on SEZ is also difficult to obtain. No database exists with information on the number of SEZs in a country over time. However, in 2006 the International Labor Organization (ILO) assembled data on all the different types of SEZs around the world (Boyenge 2007). I use this data to test the impact of SEZs on FDI. The dataset includes a count of the number of SEZs in a country as well as the number of export processing zones (EPZs), and other zones designed to promote FDI. The analysis of SEZ will be cross-sectional rather than time-series because the data are only available for one year.

To measure immigrants I take the stock of host-country immigrants (in thousands) living in the United States from the OECD and divide it by the total population of the United States for each year. This gives me the percentage of immigrants in the United States from each host-country. This is a conservative measure of the impact of ethnic networks since children of immigrants would be counted as U.S. citizens (and thus excluded from my measure) but could

still have access to the same sorts of connections as their immigrant parents. The other option would be to measure immigrant flows into the United States but flows do not capture the immigrants already living in the United States that may have already established business ties back in the host-country. Thus, I believe the stock of immigrants living in the United States is the best measure.

Control Variables

I use the same set of control variables used in Chapter 2 to control for other possible determinants. These include the measures for market size (GDP), economic development (GDP per capita), economic growth (GDP growth), capital account openness, reliance on resource wealth, and level of democracy. For this analysis I also add in a variable measuring how far away a country is from the United States (Weidman, Kuse, and Gleditsch 2010). Distance is considered one of the 'gravity' factors that affect FDI location. The farther a host country is from the home country the greater the cost to the investor. Thus, I expect the greater the distance between a host-country and the United States, the lower the level of FDI. The variables for market size, economic development, and economic growth will all also be used to test whether or not investors use economic opportunity to mitigate the uncertainty of a weak rule of law. These economic variables are expected to be positively associated with FDI and their effect should be strongest when the rule of law is weakest.

The Rule of Law

Chapter 2 examined five different elements of the rule of law and an aggregate measure of the concept. This chapter focuses only on the variables with a statistically significant impact on FDI in Chapter 2: contract and property rights protections, physical integrity rights, and the

aggregate rule of law measure. I will use interaction terms to test if the impact of the substitutes on FDI changes at different levels of the rule of law.

Results

To test these relationships I use OLS regression with panel corrected standard errors to correct for heteroskedasticity. The data once again call for the inclusion of fixed-effects for time and country as well as a lagged dependent variable to account for autocorrelation within the data. Additionally, the data on SEZs are only available for 2006. As a result these models are estimated with OLS regression and no fixed effects. I begin the analysis by looking at the direct effect of the different substitutes on FDI without any of the rule-of-law variables.

Table 3.1 looks at the direct effect of the possible formal rule-of-law substitutes on FDI levels. The results for BITs suggest they have a limited impact on FDI. First, the indicator variable identifying countries with a BIT (Model 1) fails to obtain statistical significance. Likewise, the strength of the BIT (Model 3) does not seem to have an impact on FDI, as the measure for ICSID arbitration is not statistically significant. However, the time a BIT has been in force is negatively associated with FDI and statistically significant. This counterintuitive finding suggests BITs may hurt investment. Model 2 shows that for every additional year a BIT is in force FDI between the host-country and the United States decreases by one percent.

Table 3.2 looks at the impact of SEZs, EPZs, and other types of zones on FDI. These data are only available for 2006, but the results suggest a minimal impact of these institutions on FDI. The number of SEZs does not have a statistically significant relationship with FDI, but the number of export processing zones and the total count of all types of zones each have a statistically significant relationship with FDI. However, the association between variable is negative. Model 5 shows that each additional EPZ a country creates is associated with a 0.5

percent reduction in FDI. Model 6 shows a small impact for the total number of zones and FDI. For each additional export zone a country creates FDI decreases by only 0.01 percent. A closer look at the data suggests a reason for this relationship. Different countries use different definitions for EPZs. For example, China essentially transformed entire cities into EPZs with their own set of rules for businesses. Other countries, like Mexico with its *maquiladora*, create areas within which businesses are subject to special rules. Finally, other countries designate specific businesses as EPZs regardless of their location. Bangladesh employs this type of EPZ program and as a result the ILO data lists 5341 EPZs in the country, by far the most in the dataset. At the same time Bangladesh has below average FDI from the U.S. In 2007 U.S. FDI to the developing world averaged $6.2 billion, but Bangladesh only received $218 million. This means Bangladesh may be driving the negative relationship. To test this I remove Bangladesh from the dataset and run Models 6 and 7 again (output not shown). As a result, the number of EPZs and the total number of zones lose their statistical significance. Table 3.2 suggests that the number of export zones does not impact U.S. FDI to the developing world in 2006.

These initial findings cast doubt on the ability of formal substitutes to help countries attract FDI. However, by only examining the direct effect of these variables Table 3.1 does not tell us anything about the relationship between these variables and the rule of law. For instance, theory suggests BITs will be most effective at increasing FDI in countries with a weak rule of law. To test for this relationship the remainder of the chapter interacts the different formal substitutes with contract and property rights, physical integrity rights, and the rule of law to see whether the effect of these variables changes at different levels of the rule of law. If these variables substitute for the rule of law they should have the greatest impact on FDI at low levels of the rule of law and this effect should diminish as the rule of law improves.

Table 3.1: Direct Effect of Formal Substitutes on U.S. FDI to Developing World

	Model 1	Model 2	Model 3
Lagged US FDI	0.721	0.708	0.717
	(0.078)***	(0.080)***	(0.079)***
Log Econ. Development	0.199	0.265	0.212
	(0.123)	(0.136)*	(0.127)*
Log Market Size	0.075	0.022	0.064
	(0.156)	(0.162)	(0.158)
Trade	0.001	0.001	0.001
	(0.001)	(0.001)	(0.001)
Econ. Growth	0.000	0.000	0.000
	(0.000)	(0.000)	(0.000)
Resources	0.001	0.001	0.001
	(0.002)	(0.002)	(0.002)
Capital Acct. Lib.	0.010	0.008	0.009
	(0.008)	(0.008)	(0.008)
Democracy	0.000	0.000	0.000
	(0.001)	(0.001)	(0.001)
BIT w/ US	-0.022		
	(0.017)		
Distance from US	-0.000	-0.000	-0.000
	(0.000)*	(0.000)**	(0.000)*
BIT Length		-0.009	
		(0.003)***	
ICSID One Option			0.005
			(0.025)
ICSID Only Option			-0.084
			(0.030)***
Constant	-0.917	-0.085	-0.730
	(3.027)	(3.112)	(3.061)
R^2	0.93	0.93	0.93
N	1,957	1,957	1,957
Countries	102	102	102

Dependent Variable = Log of US FDI. Standard errors in parentheses.

+ significant at 10%; * significant at 5%; ** significant at 1%

Table 3.2: Direct Effect of SEZs, EPZs, and other Types of Zones on U.S. FDI to the Developing World in 2007

	Model 4	Model 5	Model 6
Lagged US FDI	0.977	0.963	0.981
	(0.042)***	(0.041)***	(0.041)***
Log Econ. Development	-0.018	-0.029	-0.028
	(0.030)	(0.027)	(0.028)
Log Market Size	0.069	0.086	0.077
	(0.033)**	(0.030)***	(0.030)**
Trade	0.001	0.001	0.001
	(0.001)	(0.001)	(0.001)
Econ. Growth	-0.000	-0.000	-0.000
	(0.000)	(0.000)	(0.000)
Resources	0.000	-0.000	0.000
	(0.002)	(0.002)	(0.002)
Capital Acct. Lib.	0.009	0.015	0.006
	(0.020)	(0.019)	(0.020)
Democracy	0.009	0.010	0.009
	(0.005)*	(0.005)*	(0.005)*
BIT w/ US	-0.002	-0.006	0.019
	(0.050)	(0.047)	(0.050)
Special Econ. Zones	0.006		
	(0.022)		
Distance from US	-0.000	-0.000	-0.000
	(0.000)	(0.000)	(0.000)
Export Processing Zones		-0.005	
		(0.002)**	
All Types of Zones			-0.000
			(0.000)*
Constant	-1.318	-1.496	-1.478
	(0.490)***	(0.435)***	(0.447)***
R^2	0.98	0.98	0.98
N	60	60	60

Dependent Variable = Log of US FDI. Standard errors in parentheses.

+ significant at 10%; * significant at 5%; ** significant at 1%

Formal Institutions, the Rule of Law, and FDI

Existing literature suggests countries sign formal agreements like BITs or create special areas like SEZs, in order to attract investment by circumventing failing domestic institutions. Tables 3.1 and 3.2 did not find a relationship between these institutions and FDI. However, if these institutions act as substitutes for the rule of law their effect should vary based on a country's respect for the rule of law. To test this I interact each of the formal substitutes with the different rule of law variables and then use graphs to examine if a relationship exists between the two sets of variables. If these formal institutions substitute for the rule-of-law the graphs should show that the institutions' positive impact on FDI is greatest at lower levels of the rule of law. Furthermore, as the rule of law increases the impact of the institutional substitutes should decrease.

I begin by looking at whether or not the BITs increase FDI when the rule of law is weak. Figure 3.1 shows that the impact of BITs on FDI decreases as contract and property rights increase. However, the overall change in the impact of BITs on FDI does not change much, moving from 0 to 1 on the contract property right scale. Thus, statistically it appears BITs substitute for contract and property rights but substantively the impact is quite small. The opposite relationship holds for physical integrity rights. Figure 3.2 shows that as these rights improve BITs become more important for FDI. This suggests BITs do not substitute for these rights. Once again, the substantive impact of this change is very small. In Figure 3.3 we see that there is almost no change in the way BITs affect FDI as a country's overall respect for the rule of law increases. Taken together these results provide very little support for the idea that BITs substitute for the rule of law.

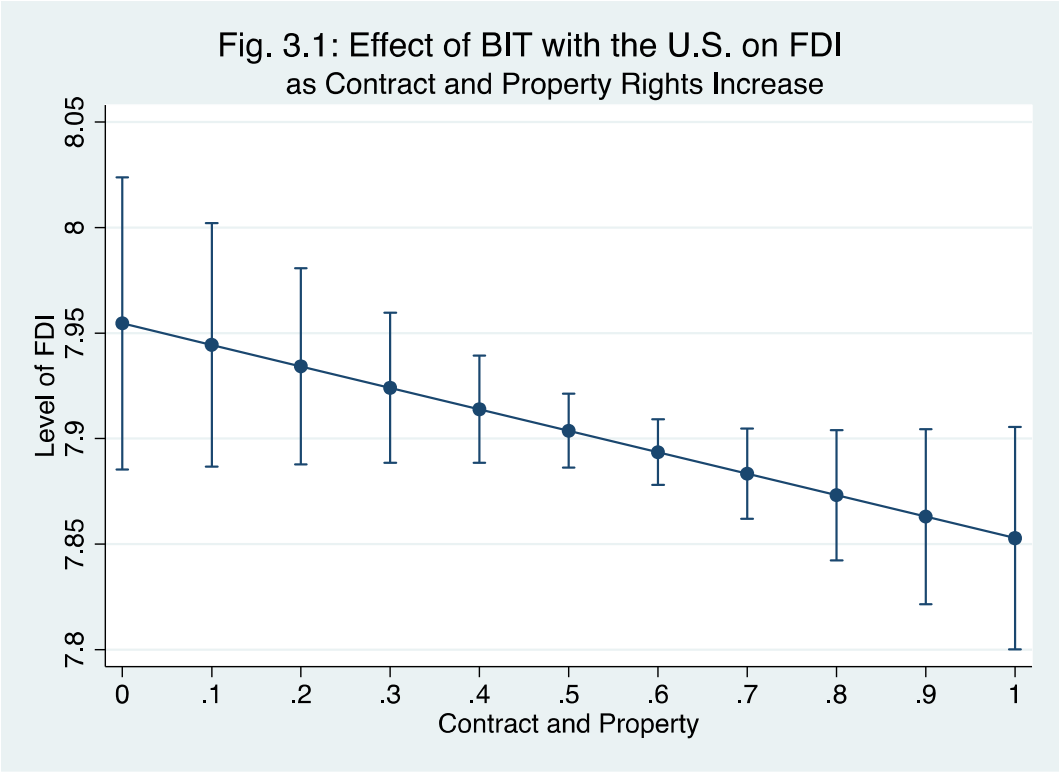


Fig. 3.1: Effect of BIT with the U.S. on FDI
as Contract and Property Rights Increase
Level of FDI
8.05
8
7.95
7.9
7.85
7.8
0
.1
.2
.3
.4
.5
.6
.7
.8
.9
1
Contract and Property

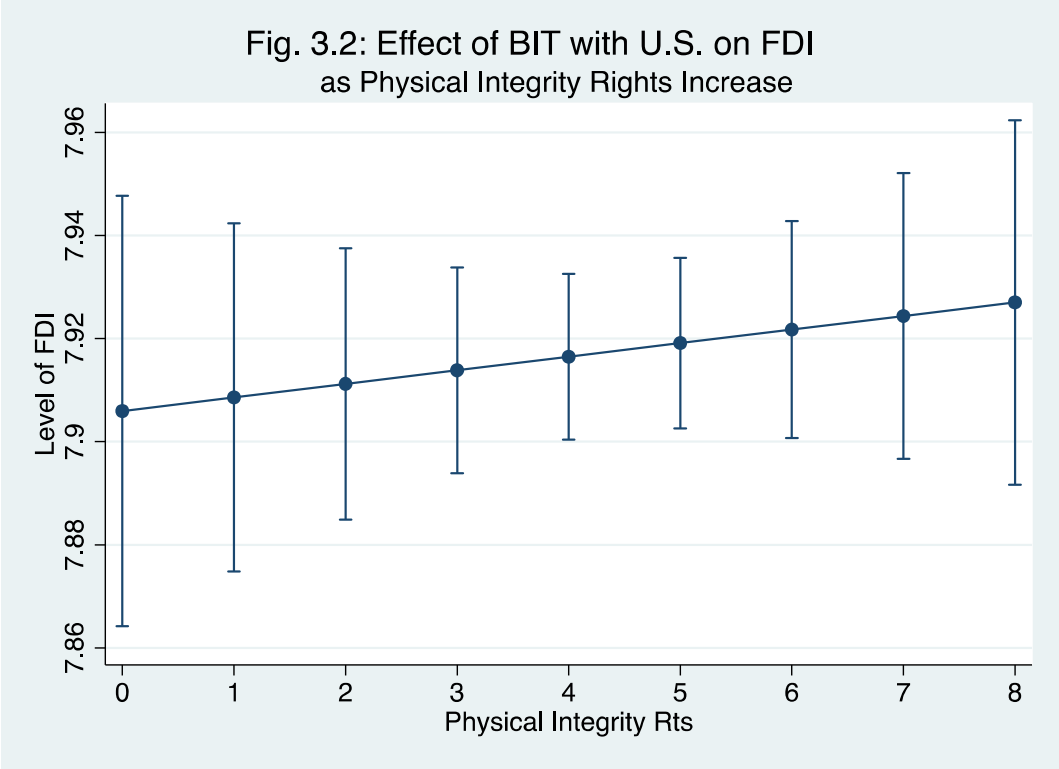


Fig. 3.2: Effect of BIT with U.S. on FDI
as Physical Integrity Rights Increase
Level of FDI
7.96
7.94
7.92
7.9
7.88
7.86
0
1
2
3
4
5
6
7
8
Physical Integrity Rts

Having a BIT with the U.S. does not appear to help mitigate a weak rule of law. This may be because investors are not fully aware that the BIT exists or perhaps they want to see if the BIT delivers on its promise before they invest. Figures 3.4, 3.5, and 3.6 illustrate the relationship between the length of time a BIT has been in force, the rule of law, and FDI. As contract and property rights improve, the impact of an average length BIT becomes increasingly negative. This contradicts the theory that BITs can substitute for the rule of law and indicates that BITs may actually hurt FDI. Figure 5.7 shows a similar relationship between BITs and physical integrity rights. Again, BITs drag FDI lower as rights protection increases. Finally, Figure 5.8 reverses this trend. Here, improving respect for the rule of law makes the impact of BITs on FDI less negative. However, at no level of the rule of law do BITs have a positive relationship with FDI. This may be the result of shifts in U.S. investment over time. Those countries that saw large amounts of investment earlier in the time period may have seen their share of investment decrease over time, while other countries that do not have BITs with the United States, like China, saw their share increase. It is also possible that the U.S.'s motivation for signing a BIT is not to increase investment in the host-country. Signing these sorts of agreements may be part of a larger strategy to strengthen political ties between allies. Host-countries may also sign the agreements because they are seeking better treatment for their own investors in the United States and do not actually care about investment in their own country. Overall, my analysis indicates that dreams of using BITs to increase FDI are unlikely to come true as the length of time a BIT is in force does not positively relate to FDI.

Fig. 3.3: Effect of BIT with U.S. on FDI
as Respect for the Rule of Law Increases

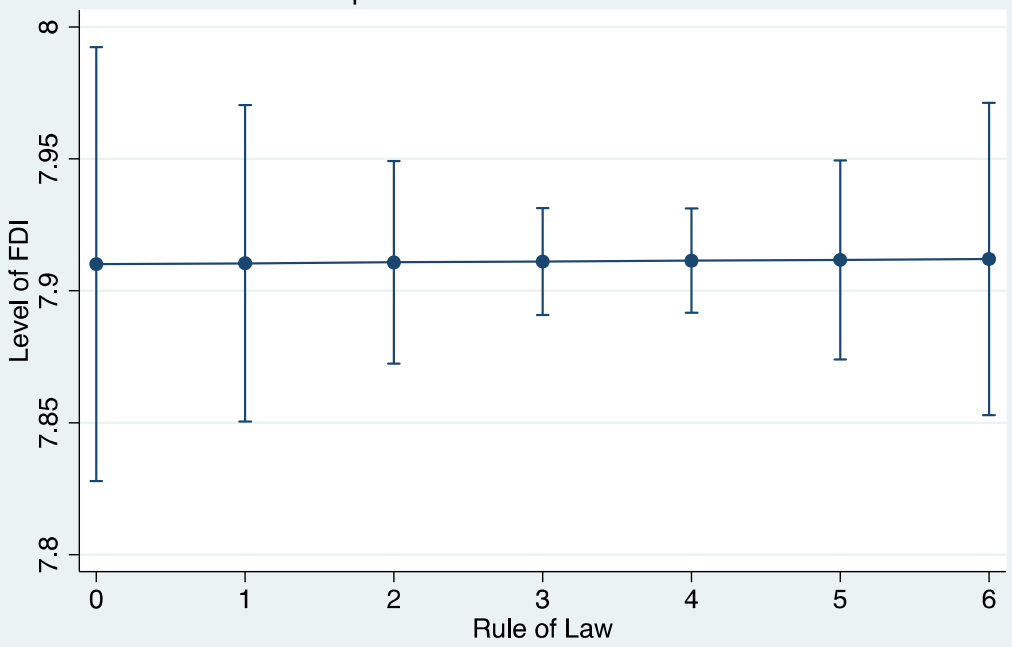
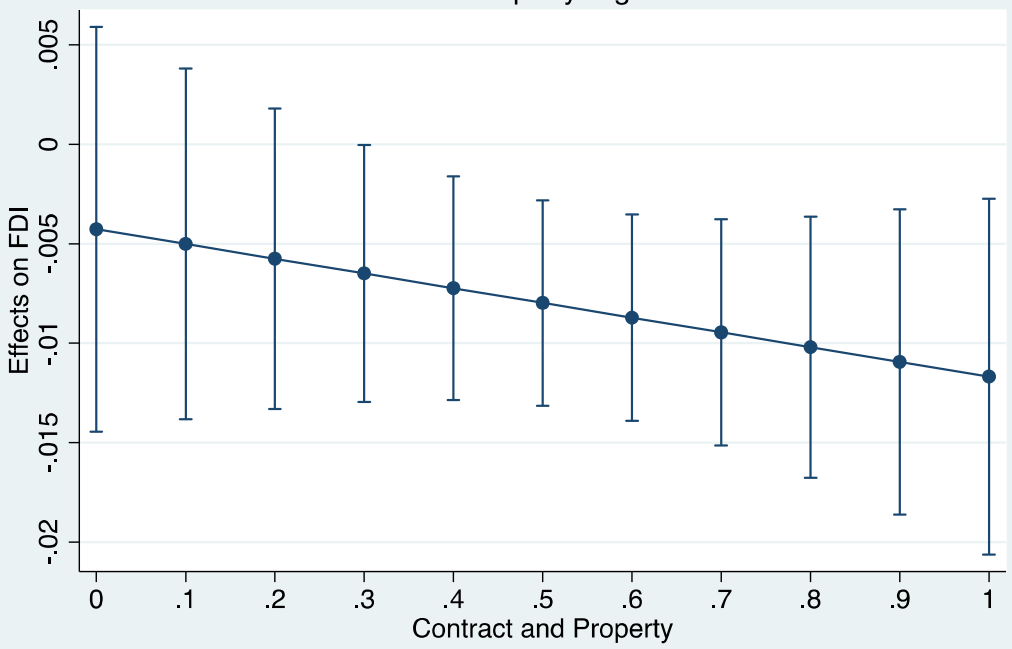


Fig. 3.4: Effect of Time BIT In Force on FDI
as Contract and Property Rights Increases



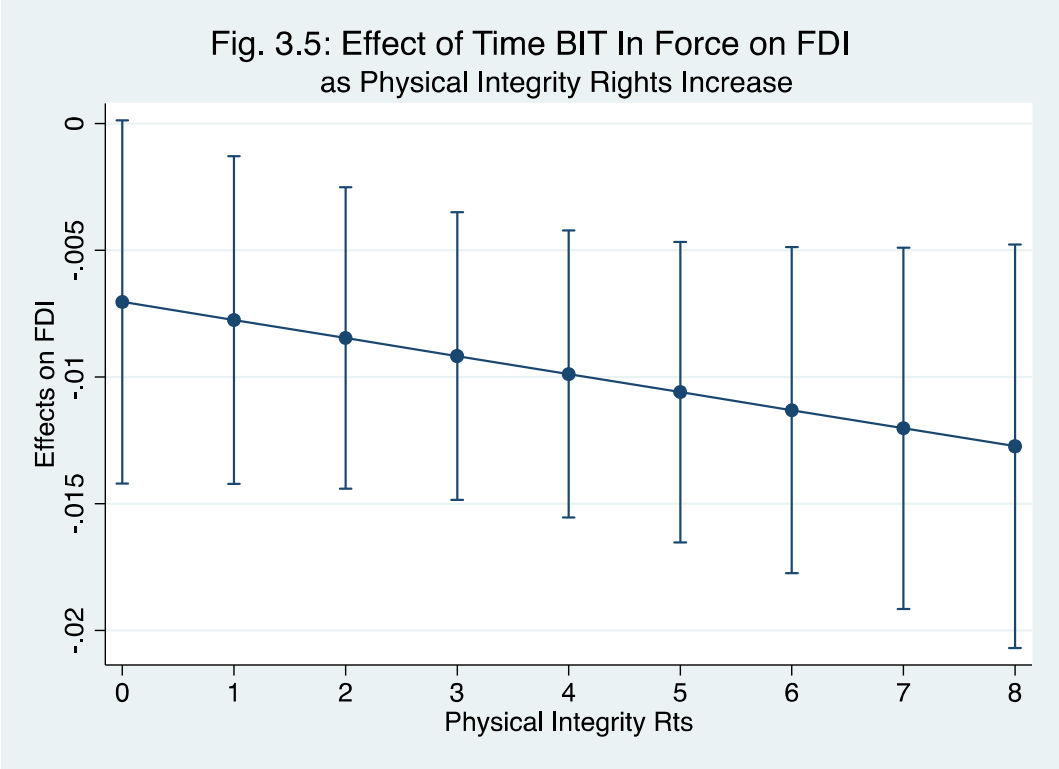


Fig. 3.5: Effect of Time BIT In Force on FDI
as Physical Integrity Rights Increase
Effects on FDI
0
-.005
-.01
-.015
-.02
0
1
2
3
4
5
6
7
8
Physical Integrity Rts

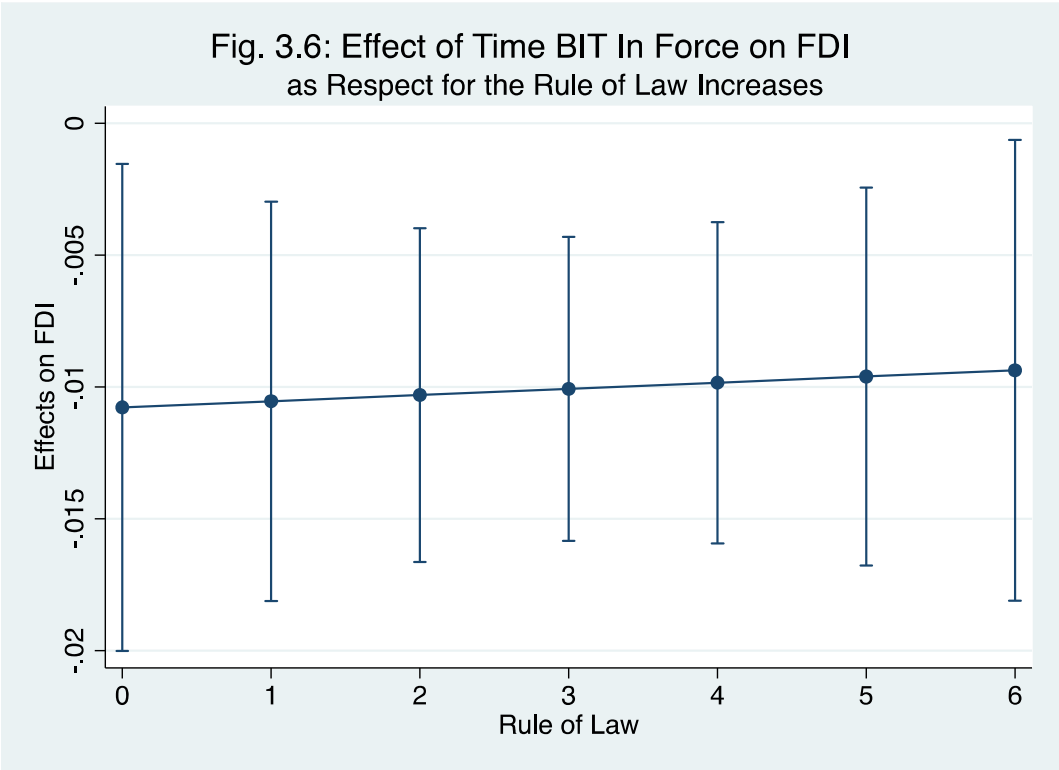


Fig. 3.6: Effect of Time BIT In Force on FDI
as Respect for the Rule of Law Increases
Effects on FDI
0
-.005
-.01
-.015
-.02
0
1
2
3
4
5
6
Rule of Law

Fig. 3.7: Effect of BIT Strength on FDI
as Contract and Property Rights Increase

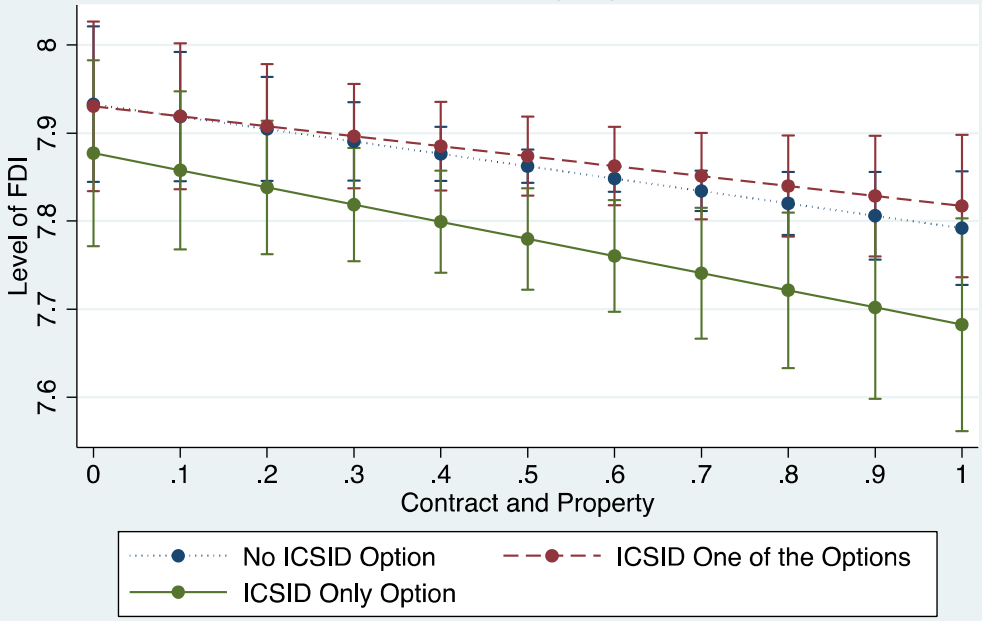
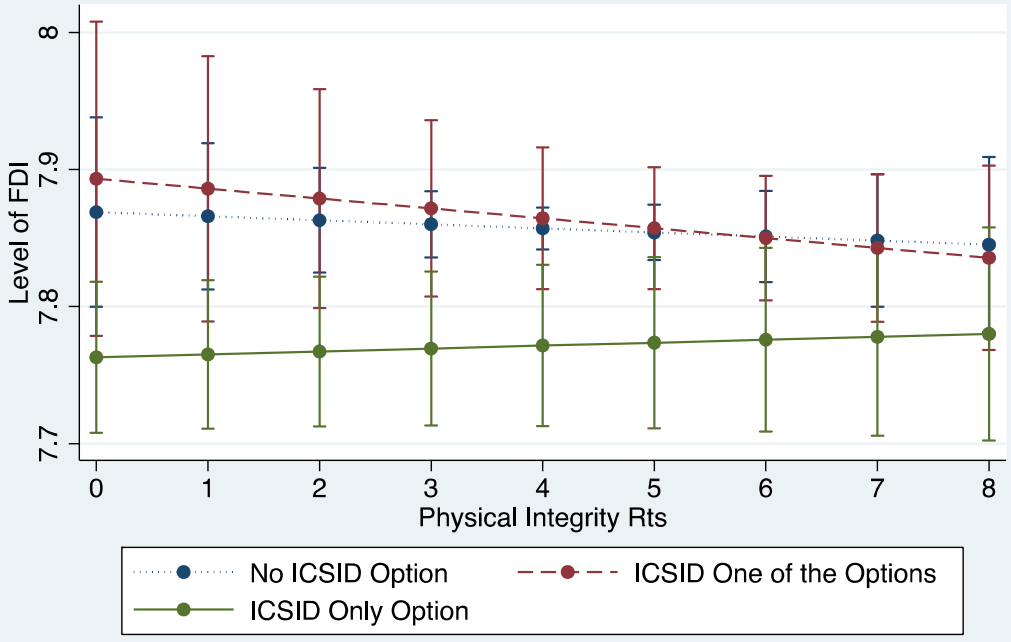


Figure 3.8: Effect of BIT Strength on FDI
as Physical Integrity Rights Increase



It is possible a BIT's arbitration provisions could affect FDI. Arbitration through the ICSID is considered the best option, but many BITs contain other less well developed arbitration options. As a result, strong BITs may do a better job substituting for a weak rule of law than weak BITs. Figure 3.7 shows that the strongest BITs have a smaller impact on FDI than other types of BITs, regardless of the level of contract and property rights. This means strong BITs are not substitutes for contract and property rights since countries with weaker BITs actually have higher levels of FDI than those with stronger BITs. Similarly, Figure 5.9 illustrates that strong BITs do not substitute for a country's overall respect for the rule of law. At low levels of the rule of law the three types of BITs are not statistically different from one another. This means BITs exert the same influence on FDI at these low levels. As the rule of law improves the impact of a strong BIT decreases, while the impact of the other types increases. As a result, strong BITs become less important as the rule of law improves, which supports the idea of substitution. However, I conclude there is no substitutive relationship between strong BITs and the rule of law because at the lowest levels of the rule of law BIT strength does not change FDI.

Investors may also turn to the provisions found in SEZs and other types of EPZs to help mitigate the uncertainty associated with a weak rule of law. Figures 5.10, 5.11, and 5.12 show that at all levels of contract and property rights, physical integrity rights, and the rule of law the impact of SEZs on FDI is not statistically different from zero. EPZs (Figures 5.13, 5.14, and 5.15) and the total number of all export zones (Figures 5.16, 5.17, 5.18) also have no impact on FDI. This again suggests that investors do not use formal institutions as a substitute for the rule of law.

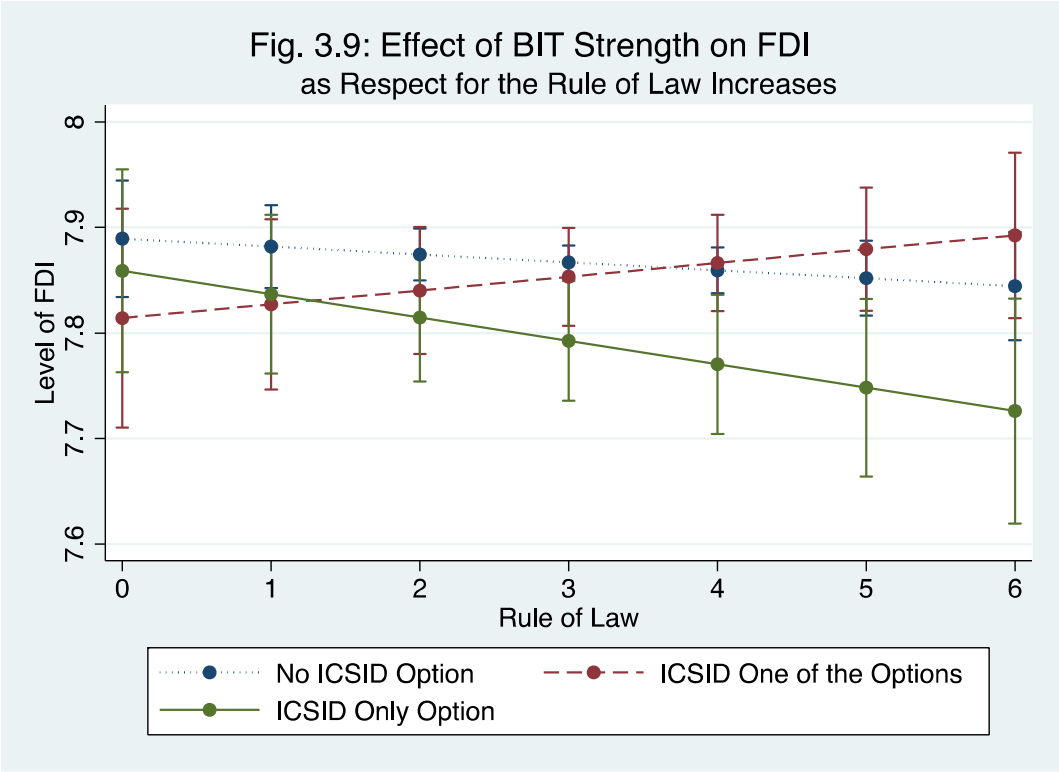


Fig. 3.9: Effect of BIT Strength on FDI
as Respect for the Rule of Law Increases
Level of FDI
7.6
7.7
7.8
7.9
8
0
1
2
3
4
5
6
Rule of Law
No ICSID Option
ICSID One of the Options
ICSID Only Option

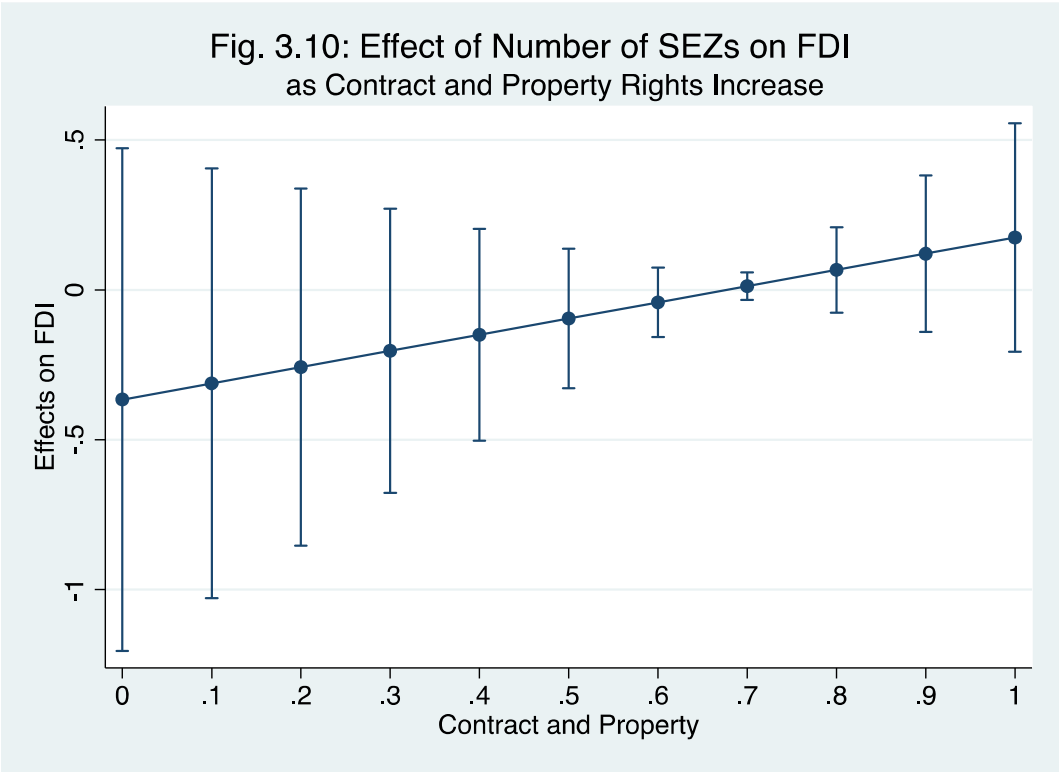


Fig. 3.10: Effect of Number of SEZs on FDI
as Contract and Property Rights Increase
Effects on FDI
-1
-.5
0
.5
0
.1
.2
.3
.4
.5
.6
.7
.8
.9
1
Contract and Property

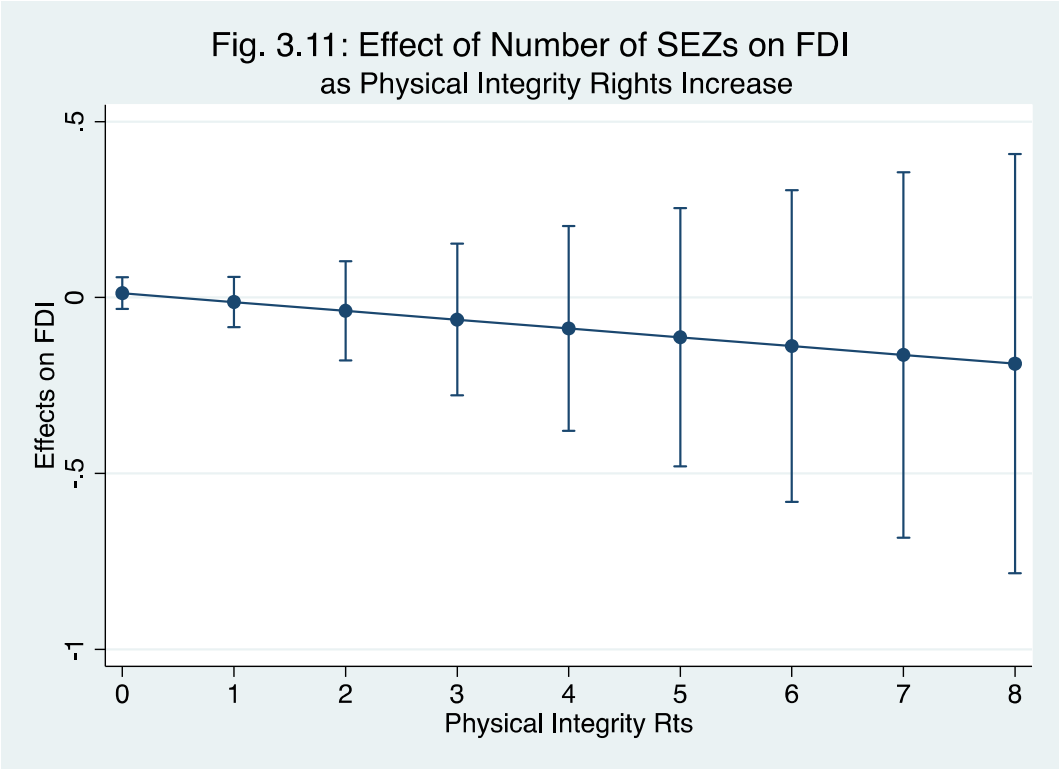


Fig. 3.11: Effect of Number of SEZs on FDI
as Physical Integrity Rights Increase
Effects on FDI
.5
0
-.5
-1
0
1
2
3
4
5
6
7
8
Physical Integrity Rts

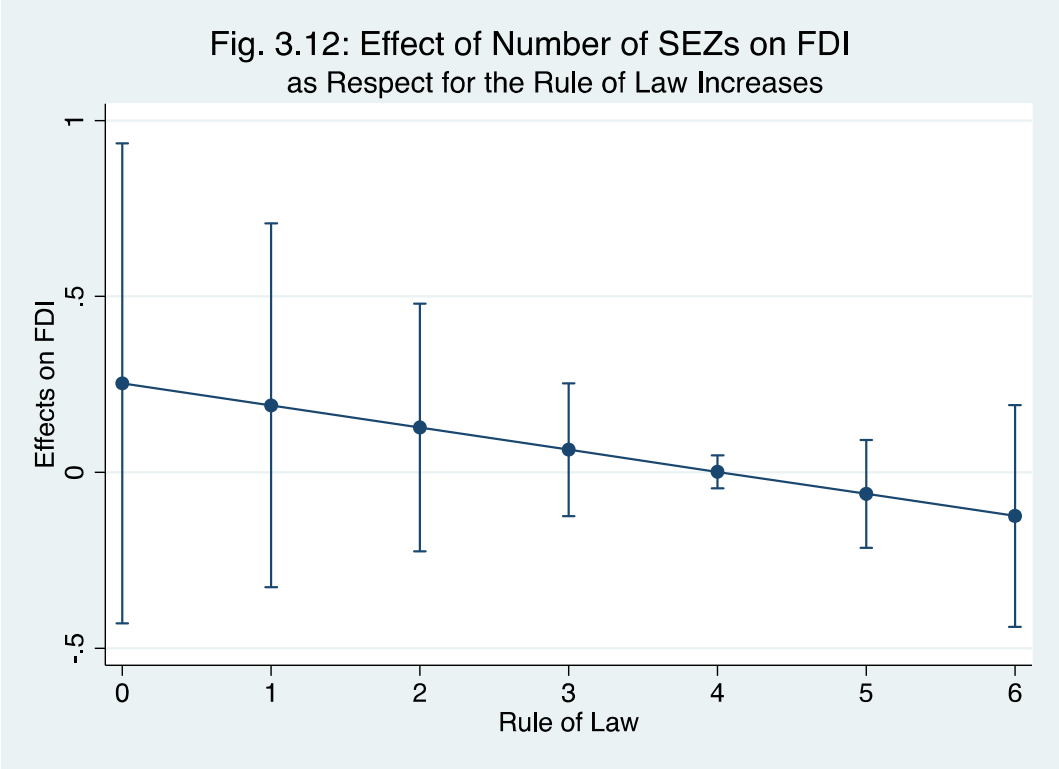


Fig. 3.12: Effect of Number of SEZs on FDI
as Respect for the Rule of Law Increases
Effects on FDI
-.5
0
.5
1
0
1
2
3
4
5
6
Rule of Law

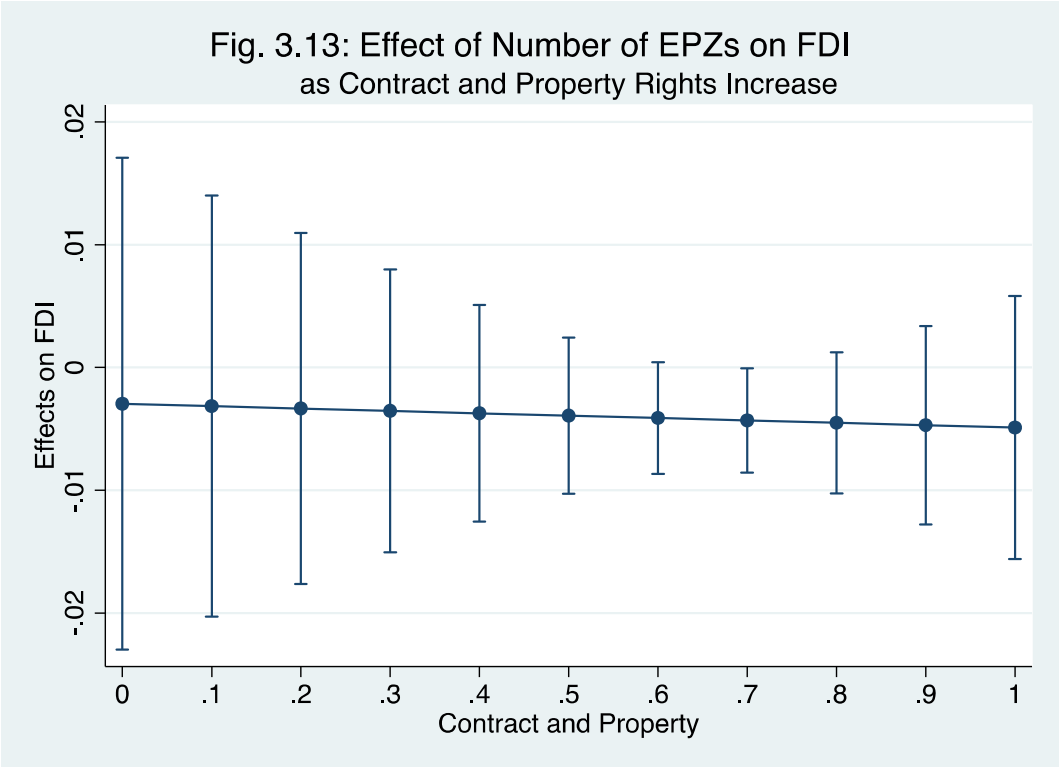


Fig. 3.13: Effect of Number of EPZs on FDI
as Contract and Property Rights Increase
Effects on FDI
-.02
-.01
0
.01
.02
0
.1
.2
.3
.4
.5
.6
.7
.8
.9
1
Contract and Property

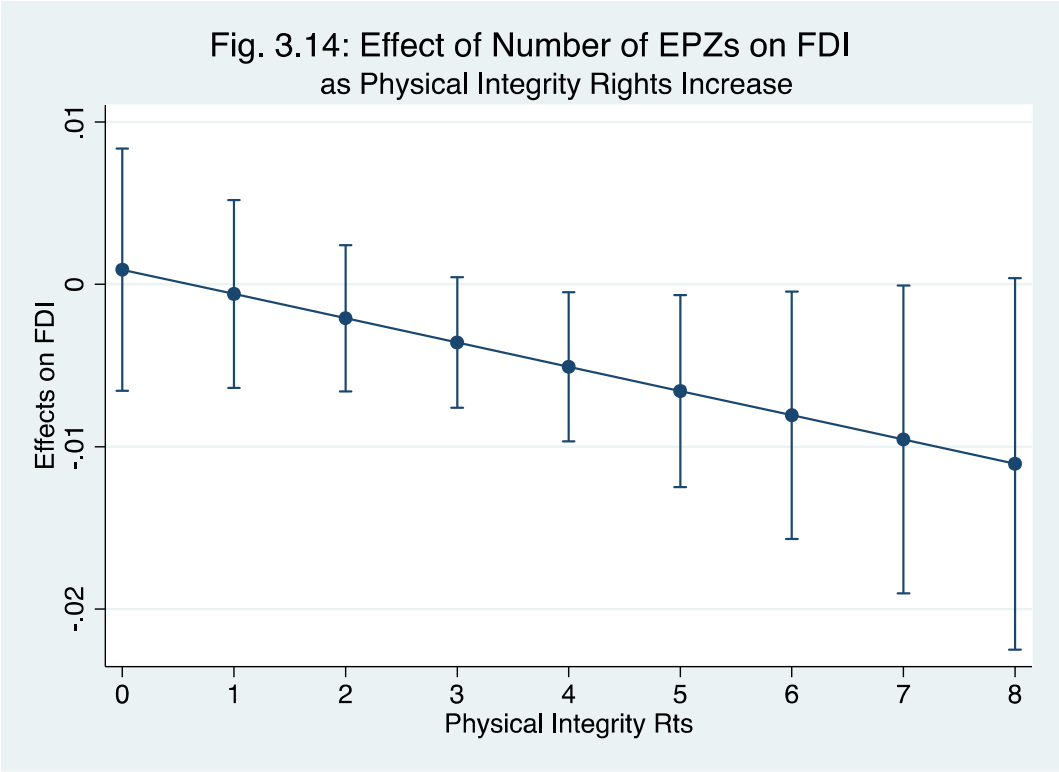


Fig. 3.14: Effect of Number of EPZs on FDI
as Physical Integrity Rights Increase
Effects on FDI
.01
0
-.01
-.02
0
1
2
3
4
5
6
7
8
Physical Integrity Rts

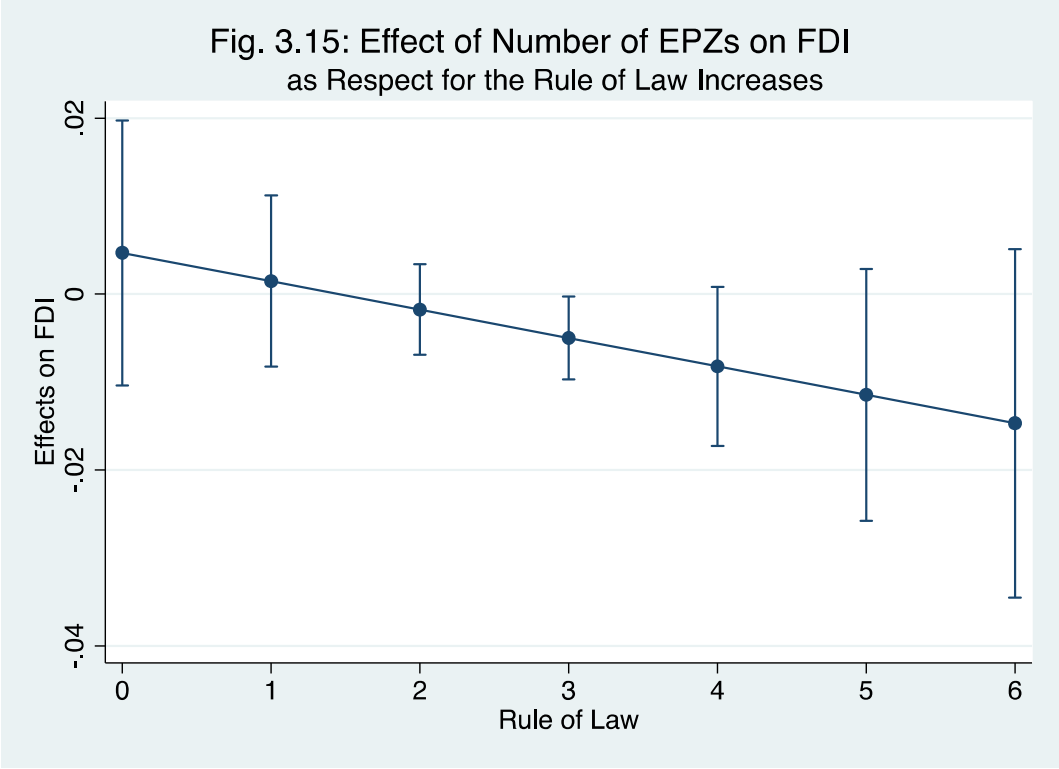


Fig. 3.15: Effect of Number of EPZs on FDI
as Respect for the Rule of Law Increases
Effects on FDI
.02
0
-.02
-.04
0
1
2
3
4
5
6
Rule of Law

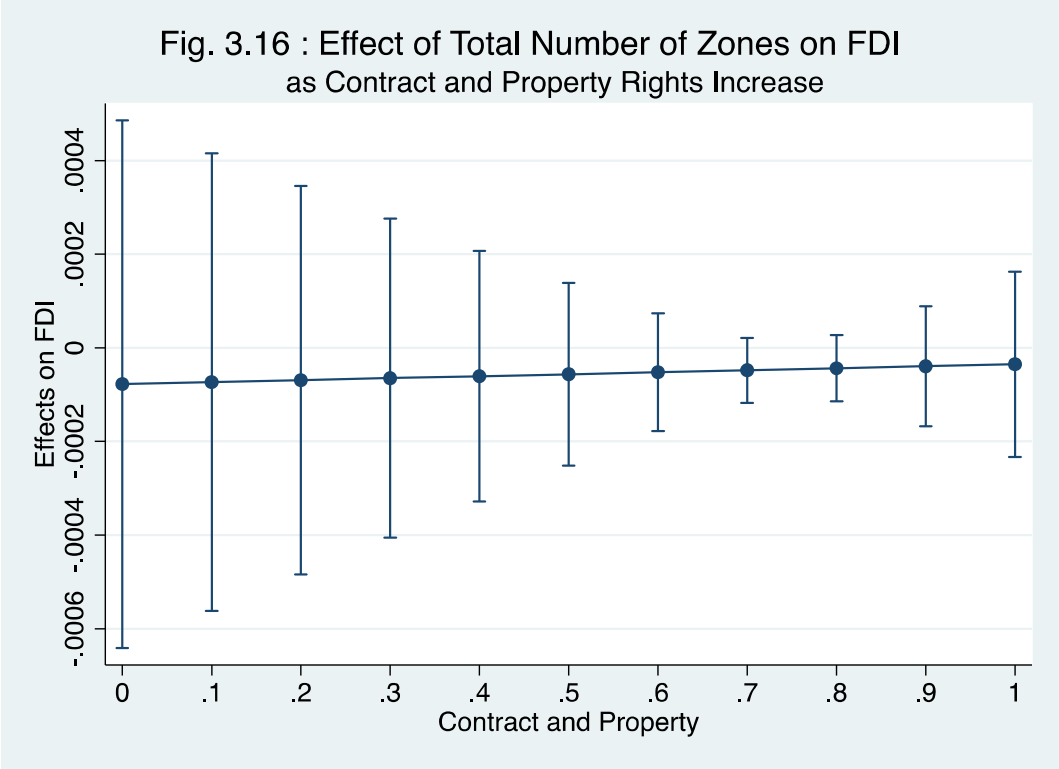


Fig. 3.16 : Effect of Total Number of Zones on FDI
as Contract and Property Rights Increase
Effects on FDI
-.0006
-.0004
-.0002
0
.0002
.0004
0
.1
.2
.3
.4
.5
.6
.7
.8
.9
1
Contract and Property

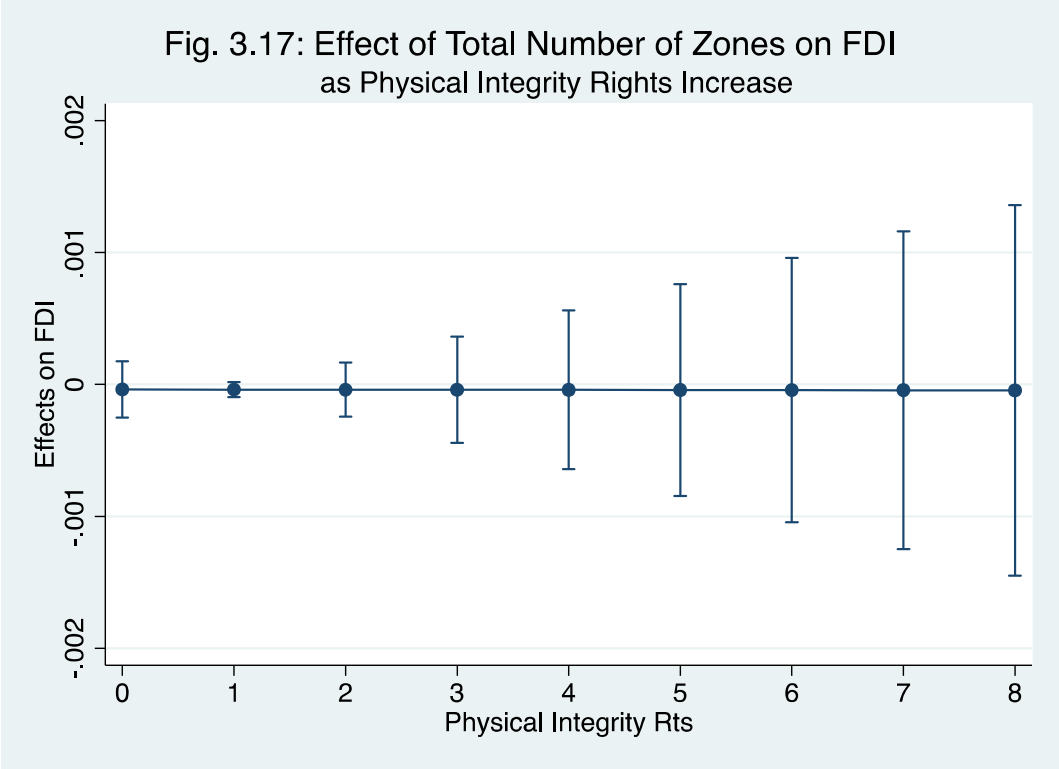


Fig. 3.17: Effect of Total Number of Zones on FDI
as Physical Integrity Rights Increase
Effects on FDI
-.002
-.001
0
.001
.002
0
1
2
3
4
5
6
7
8
Physical Integrity Rts


Fig. 3.18: Effect of Total Number of Zones on FDI
as Respect for the Rule of Law Increases
Effects on FDI
-.001
-.0005
0
.0005
.001
0
1
2
3
4
5
6
Rule of Law

Economic Opportunity, the Rule of Law, and FDI

Host-countries with a weak rule of law may still attract FDI because they present too good of an economic opportunity for investors to pass up. To test this theory I interact the rule-of-law variables with measures for economic development, market size, and economic growth. The following graphs show how low levels of the rule of law affect FDI as the economic opportunity increases.[4] If this theory is correct, I expect low levels of the rule of law to have a negative impact on FDI when the economic opportunity is poor and a positive impact or no impact when the opportunity is high.

I begin by looking at whether high levels of economic development can overcome low levels of the rule of law. The graph in Figure 5.19 demonstrates that a low level of contract and property rights protection does not influence FDI, no matter the level of economic development. Similarly, Figure 5.20 shows low respect for physical integrity rights does not alter FDI even as the level of economic development varies. However, Figure 5.21 tells a different story. At low levels of economic development poor respect for the rule of law negatively impacts FDI. However, as economic development increases, the relationship between the rule of law and FDI becomes positive. This is the first evidence that investors consider certain economic situations worth the risk of investing in a country with a weak rule of law.

Investors may also be willing to overlook a weak rule of law if the host-country offers a large market for investors to see their goods. Figure 5.22 demonstrates that investors see a large market as mitigating weak respect for contract and property rights. The graph shows that weak rights protection in small markets negatively impacts FDI, but in large markets the same level of rights protection is positively related to FDI. Conversely, market size (Figure 5.23) does not

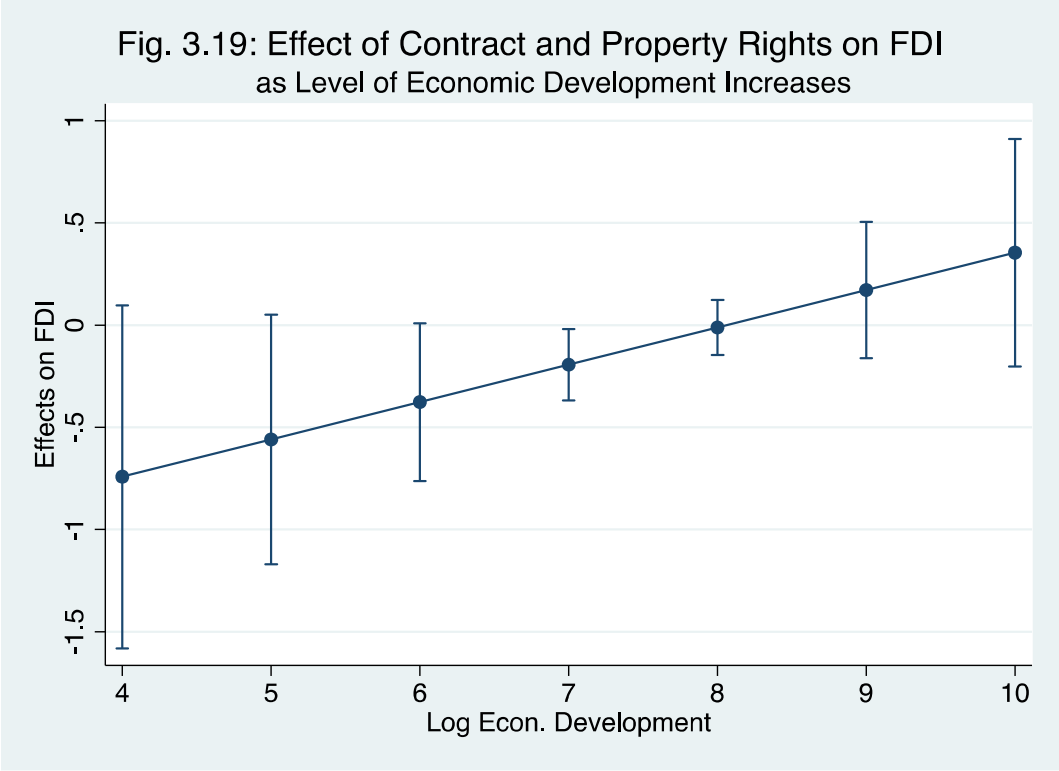
[4] For these graphs contract and property rights are held at .25; physical integrity rights at 2, and respect for the rule of law at 2. All other variables are held at their means.

change the relationship between physical integrity rights and FDI. This suggests investors do not see market size as mitigating the risk associated with weak protection of physical integrity rights. Finally, in Figure 5.24 we see investors are willing to overlook a weak respect for the rule of law if the market is large enough. In small markets a weak rule of law is negatively associated with FDI, but as the market grows the impact of a weak rule of law turns positive. Thus, for both contract/property rights protection and overall respect for the rule of law investors appear willing to risk a weak rule of law if the host-country offers a large enough market.

Growing economies may also attract investors and make them willing to overlook a weak respect for the rule of law. However, Figures 5.25, 5.26, and 5.27 illustrate that high levels of economic growth cannot help a country overcome a weak respect for the rule of law. The impact of the rule-of-law variables on FDI does not change as economic growth improves. To summarize, high levels of economic development can mitigate weak levels of the aggregate rule of law measure and large markets can mitigate weak contract and property rights protection as well as weak levels of the aggregate rule of law measure. Economic opportunity does not mitigate the risk of weak physical integrity rights protection, and economic growth does not help investors overcome weak levels of any of the rule-of-law measures.

The preceding analysis tested two hypotheses to explain why countries with a weak rule of law still receive FDI, despite the rule of law being an important determinant of FDI. The first hypothesis examined the possibility that host-countries can mitigate the uncertainty of a weak rule of law through the use of formal institutions as substitutes for the rule of law. Here the results are the most straight forward. Formal institutions such as BITs and SEZs do not change the importance of the rule of law for FDI. This finding is robust across all specifications of the

variables and joins other works calling into question the ability of these institutions to attract FDI.



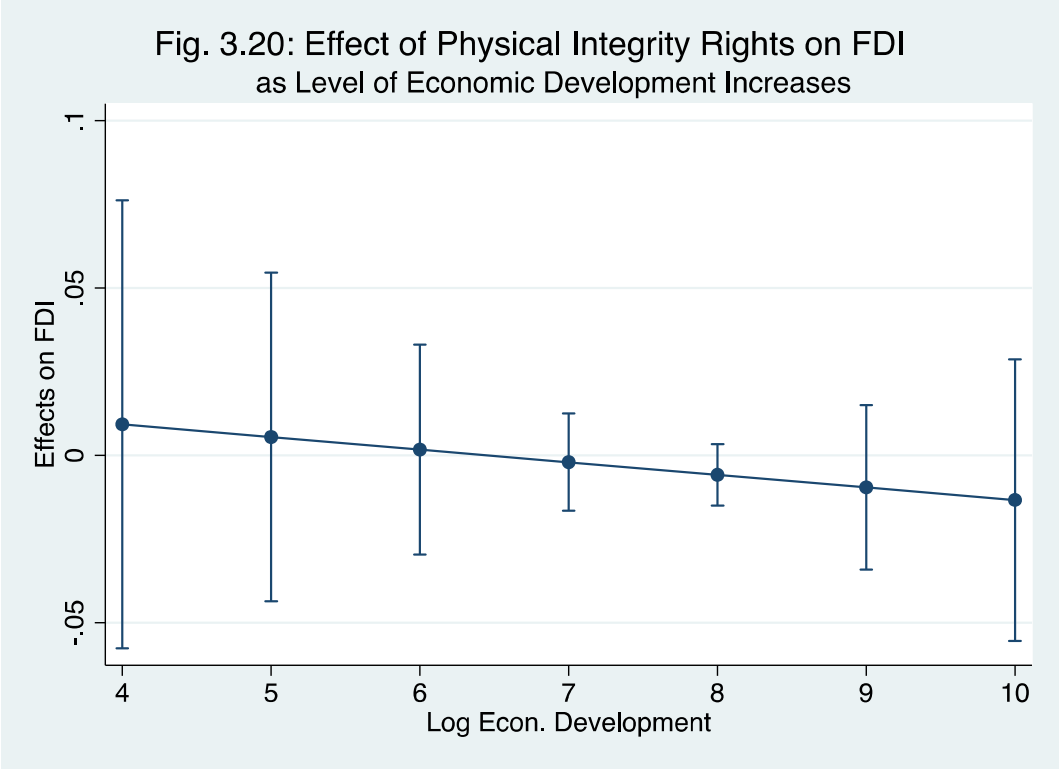


Fig. 3.20: Effect of Physical Integrity Rights on FDI
as Level of Economic Development Increases
Effects on FDI
-.05
0
.05
.1
4
5
6
7
8
9
10
Log Econ. Development

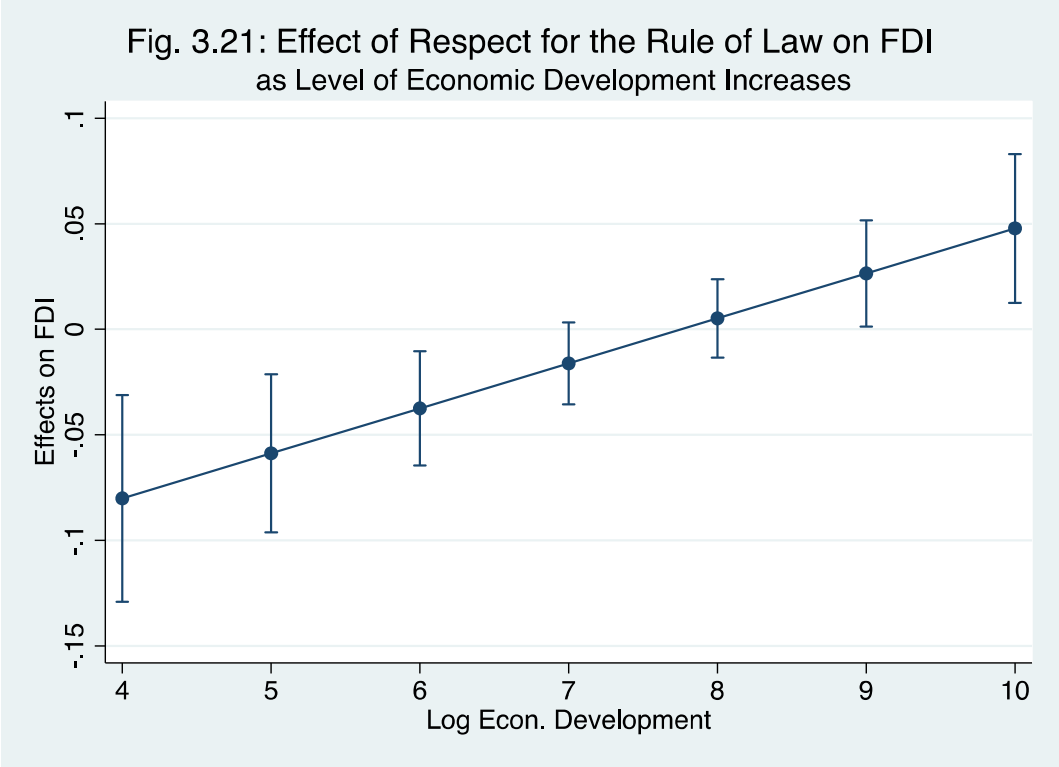


Fig. 3.21: Effect of Respect for the Rule of Law on FDI
as Level of Economic Development Increases
Effects on FDI
-.15
-.1
-.05
0
.05
.1
4
5
6
7
8
9
10
Log Econ. Development

Fig. 3.22: Effect of Contract and Property Rights on FDI
as Market Size Increases

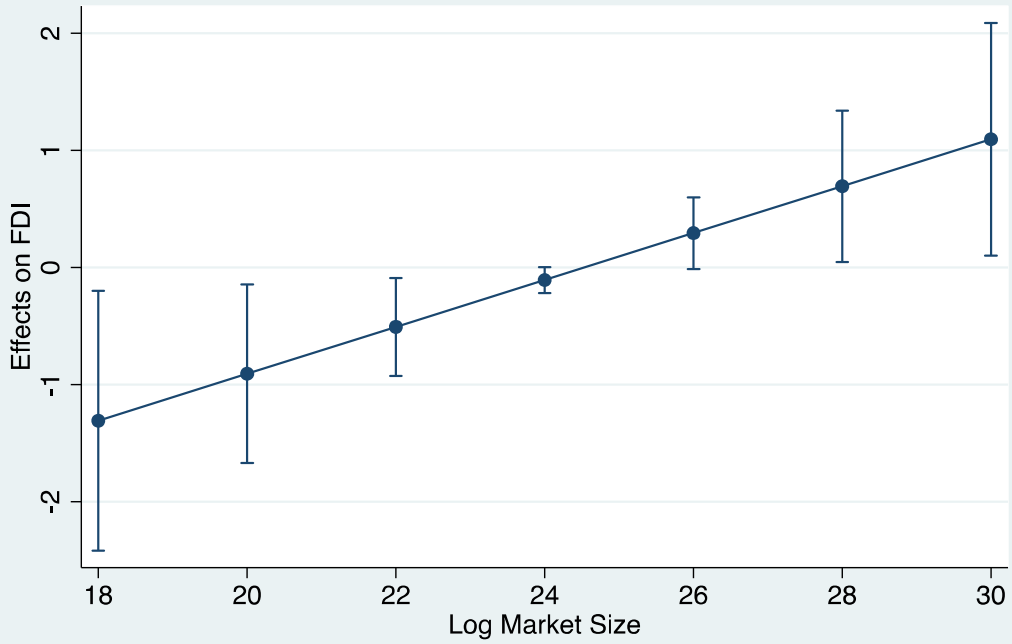


Fig. 3.23: Effect of Physical Integrity Rights on FDI
as Market Size Increases

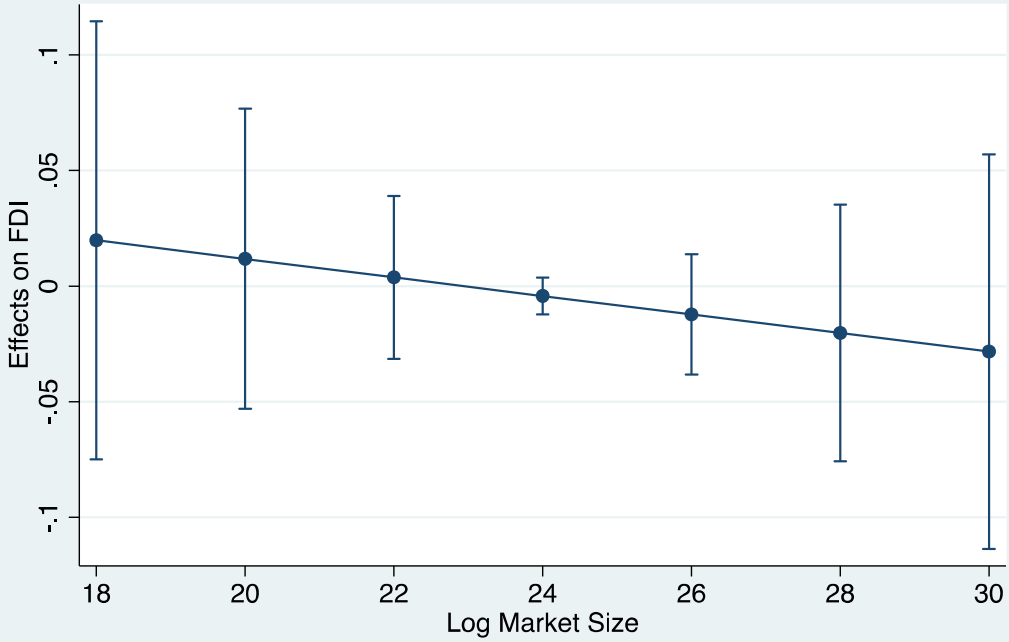


Fig. 3.24: Effect of Respect for the Rule of Law on FDI
as Market Size Increases

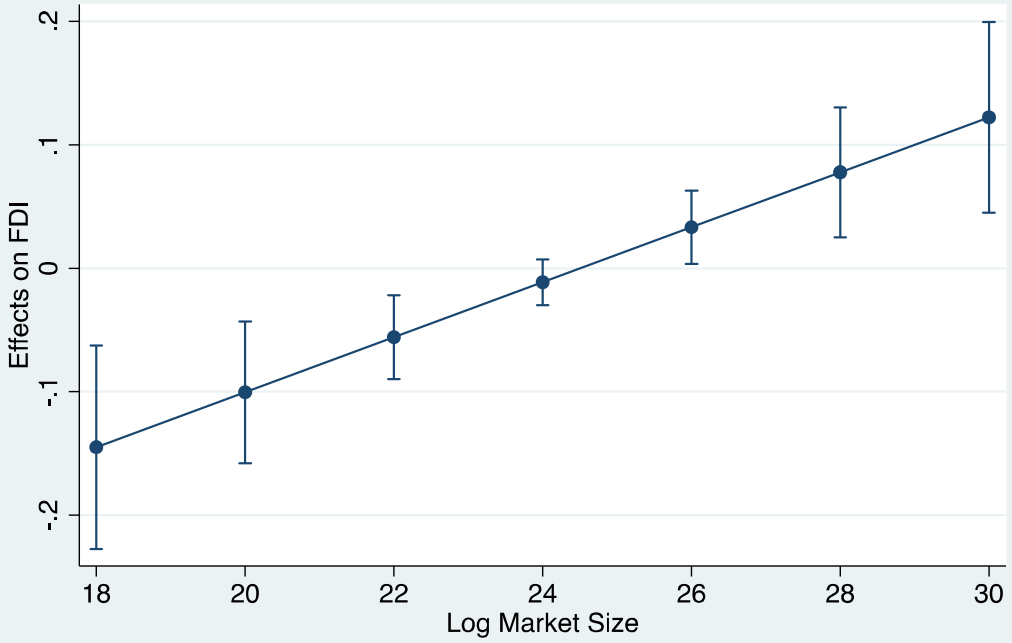


Fig. 3.25: Effect of Contract and Property Rights on FDI
as Economic Growth Increases

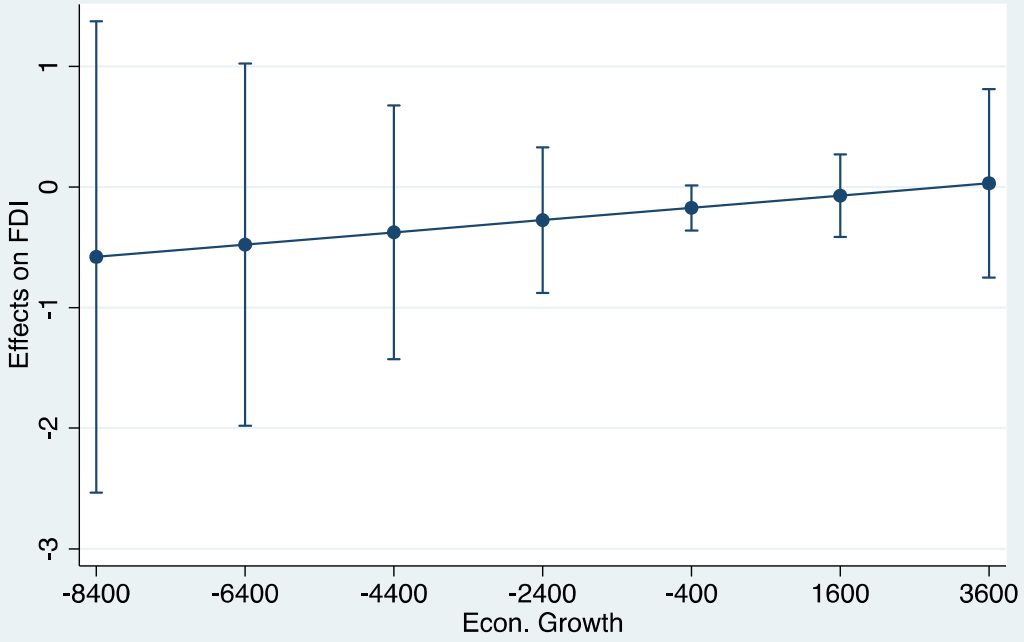


Fig. 3.26: Effect of Physical Integrity Rights on FDI
as Economic Growth Increases

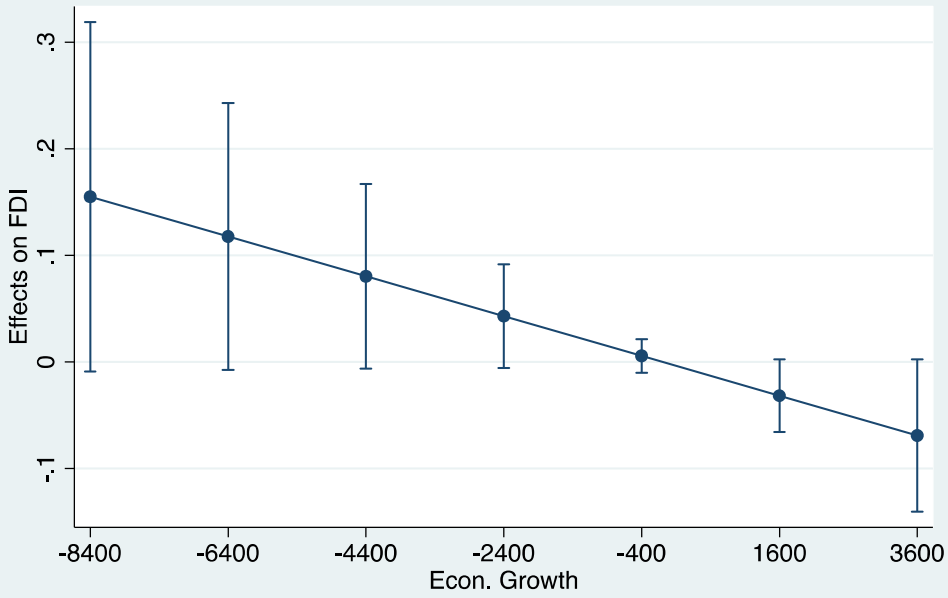
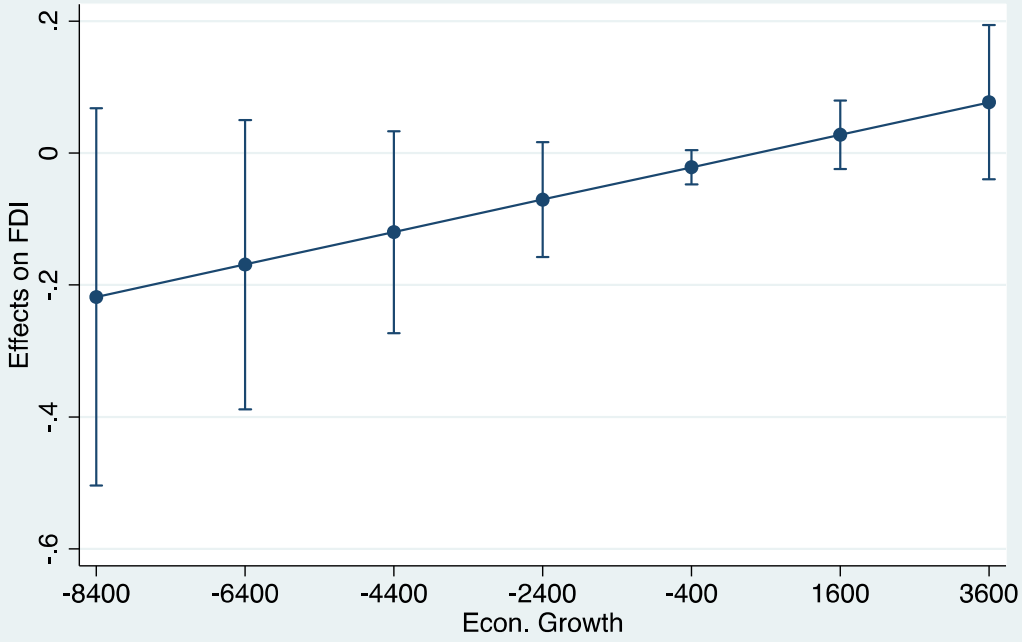


Fig. 3.27: Effect of Respect for the Rule of Law on FDI
as Economic Growth Increases



Personal Relationships, the Rule of Law, and FDI

Table 3.3 examines how personal relationships will affect FDI by interacting the immigrant variable with contract and property rights, physical integrity rights, and the rule of law in different models. To look more closely at the relationship I present the marginal effect of a one-unit change in a country's respect for the rule of law on the importance of the immigrant variable. Figure 3.28 shows that the positive relationship between immigrants in the U.S. and FDI increases as contract and property rights protection diminishes in a host-country. At very low levels of property rights protection, the density of host-country immigrants in the U.S. has a very large positive impact on FDI. If a country were to completely lack contract and property rights having just a 2.2% immigrant population in the U.S. would increase FDI by ten percent. However, by the time contract and property rights protection reaches 0.70 on a 0 to 1 scale, the same level of immigrants living in the U.S. would only increase FDI by 1.6%. At any higher levels of contract and property rights protection the immigrant variable stops altering the level of FDI. If immigrant networks help establish personal relationships between investors and businesses in the host-country, this finding indicates personal relationships may substitute for contract and property rights protection in countries where these rights are lacking.

Figure 3.29 looks at the relationship between immigrant density and FDI as physical integrity rights increase. Here we see that at low levels of rights protection immigrant density is not statistically significant. Once physical integrity rights hit a four on a zero to eight scale immigrant density begins to exert a positive influence on FDI and the effect size diminishes as rights protection increases. This does not support the hypothesis that personal relations can substitute for weak physical integrity rights.

Table 3.3: The Relationship between the Rule of Law, Personal Relations, and FDI in the Developing World – Host-Country Immigrants in the U.S.

	Model 8	Model 9	Model 10
Lagged US FDI	0.346	0.405	0.402
	(0.202)*	(0.187)**	(0.188)**
Log Econ. Development	0.187	0.283	0.321
	(0.333)	(0.342)	(0.425)
Log Market Size	0.473	0.298	0.251
	(0.263)*	(0.264)	(0.290)
Trade	0.004	0.004	0.004
	(0.003)	(0.003)	(0.003)
Econ. Growth	-0.000	-0.000	-0.000
	(0.000)	(0.000)	(0.000)
Resources	-0.001	0.001	0.001
	(0.003)	(0.003)	(0.004)
Capital Acct. Lib.	0.004	0.005	0.002
	(0.010)	(0.011)	(0.011)
Democracy	0.008	0.009	0.009
	(0.005)	(0.005)**	(0.005)*
Contract and Property	-0.294		
	(0.149)**		
Immigrants	10.016	1.257	1.321
	(3.220)***	(0.989)	(1.071)
Contract and Property x Immigrants	-12.011		
	(3.920)***		
Distance from US	-0.000	-0.000	-0.000
	(0.000)	(0.000)	(0.000)
Physical Integrity Rts		0.011	
		(0.021)	
Physical Integrity Rts x Immigrants		-0.047	
		(0.117)	
Rule of Law			0.031
			(0.033)
Rule of Law x Immigrants			-0.091
			(0.247)
Constant	-6.861	-4.211	-3.466
	(4.378)	(4.331)	(4.620)
Country Fixed Effects	Yes	Yes	Yes
Time Fixed Effects	Yes	Yes	Yes
R^2	0.92	0.91	0.91
N	860	868	866
Countries	75	75	75

Dependent Variable = Log of US FDI. Standard errors in parentheses. + significant at 10%; * significant at 5%; ** significant at 1%

Fig. 3.28: Effect of Immigrant Density on FDI
as Contract and Property Rights Increase

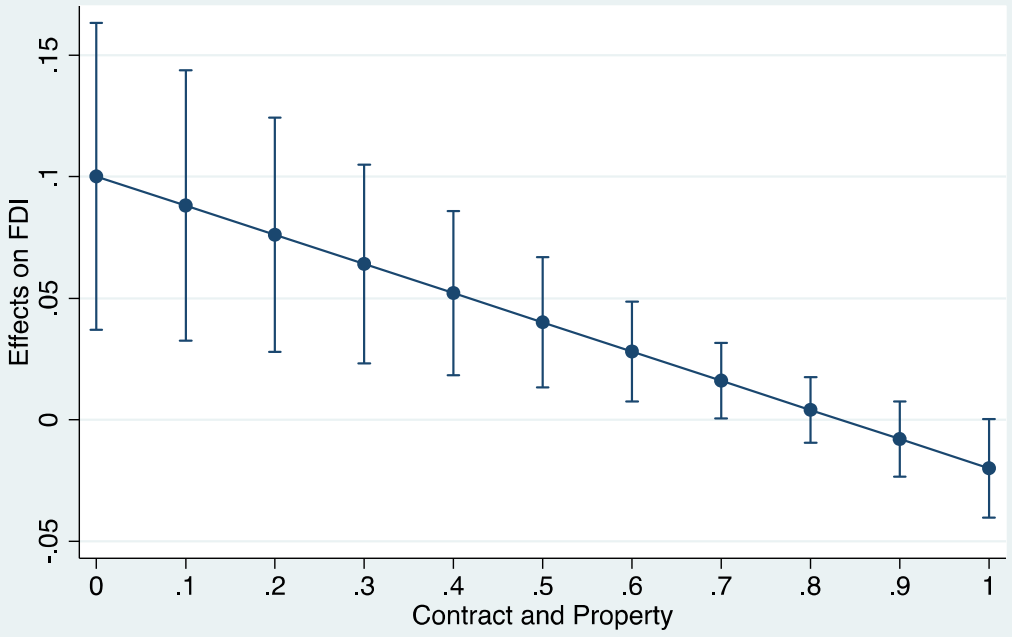
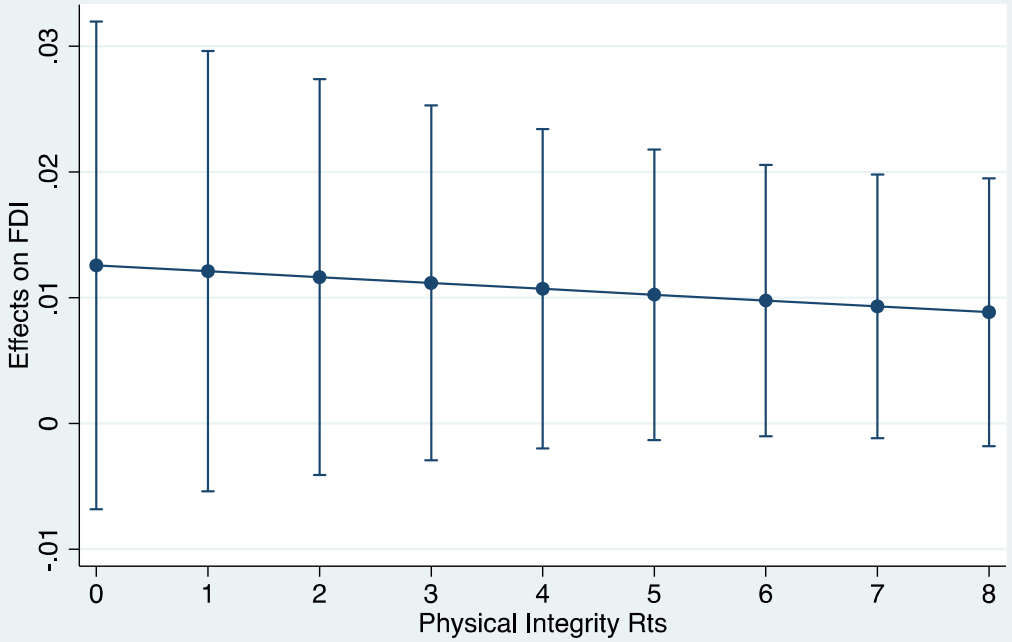
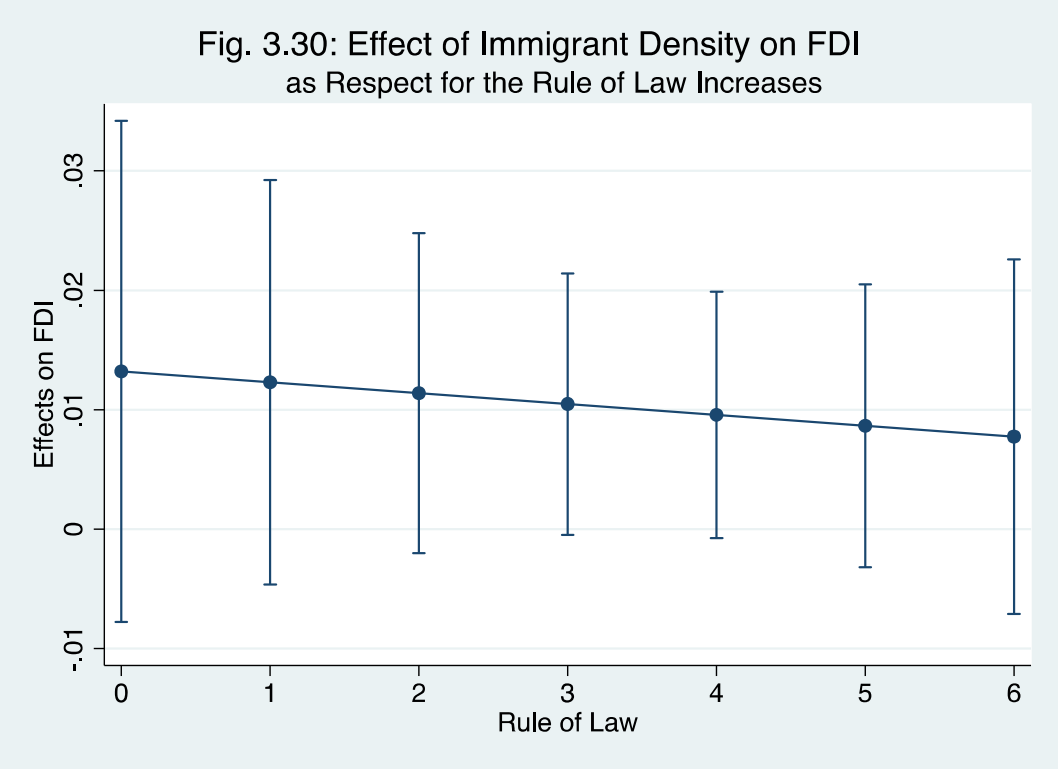


Fig. 3.29: Effect of Immigrant Density on FDI
as Physical Integrity Rights Increase



A similar relationship exists in Figure 3.30 when we look at immigrant density and the overall respect for the rule of law. At low levels of the overall rule-of-law measure, immigrant density does not alter FDI. At two, three, and four on a zero to six scale immigrant density does have a positive and diminishing impact on FDI, but the effect does not diminish by much. In a country with a rule of law score of 2 having 2.2% immigrant density in the U.S. means only a 1.2 % increase in FDI. This only decreases by .03% in a country with a score of 4. There does not appear to be much of a relationship between the overall rule of law and immigrant density.



Now I return to the survey results to further explore the importance of personal relationships. Questions 4 and 5 investigate factors that can potentially mitigate the risk of investing in a country with a weak rule of law. Respondents are given three options: soes not mitigate risk, might mitigate risk, or very likely to mitigate risk. Question 4 focuses on factors related to the host-country government such as: a joint venture with a host country firm; a strong relationship with the host-country government; access to a special economic zone; and the

existence of a bilateral investment treaty. This question tests existing theories that focus on the importance of these factors as an explanation for why certain developing countries with a weak rule of law still attract FDI. Question 5 asks respondents about factors not related to the government that may still mitigate the risk of a weak rule of law. These factors are: familiarity with the country's way of doing business; access to trusted business partners; experience investing in other countries with a weak rule of law; a high potential return on the investment; and access to an alternative to the country's legal system for dispute resolution. This question incorporates work in sociology and business that focuses on the importance of informal institutions for attracting FDI (e.g. Bandelj 2008; Fu 2000; Xin and Pearce 1996).

Finally, Question 6 explores the ways investors evaluate a potential host-country's rule of law. The question lists nine different sources of information and respondents are given five response categories to choose from: 1 "Not at all important", 2, 3 "Somewhat Important", 4, 5 "Very Important". Respondents were asked to rate the importance of news reports, political risk agency reports, in-house counsel, the host-country's investment promotion agency, non-governmental organization reports, in-house political risk assessment reports from contacts within the host country, credit rating agency score, and investment insurance rating.

Questions 4 and 5

Questions 4 and 5 focus on factors that investors can use to help mitigate the risk of investing in a country with a weak rule of law. Question 4 explores factors related to the government and Question 5 explores factors not related to the government. For both questions respondents were asked to identify whether a factor " (1) does not mitigate risk"; " (2) might mitigate risk"; or is " (3) very likely to mitigate risk". These questions are intended to help

explain why countries with a weak rule of law still manage to attract investment. Table 3.4 displays the combined results for these questions.

Two factors not related to the government, access to business partners you trust (2.61) and a familiarity with doing business in a country (2.49), ranked the highest overall. A strong relationship with the host government (2.17) is also an important mitigating factor. These results are interesting because they demonstrate the importance of experience and informal relations when operating in the context of a weak rule of law. Political scientists and economists studying FDI do not often consider the importance of informal relations. The importance of relationships as a mitigating factor may help to explain why investors value contract and property rights but not judicial independence and judicial review. These firms may see these rights as important but realize that the courts themselves are not capable of ensuring compliance. Instead, they rely upon personal relations to ensure their protection.

A high potential return on investment is the lowest ranked factor at 1.74 on a scale of 1 − 3. This seems to undermine, to some extent, the popular view that investors can look past a deficient rule of law if the potential return is great enough. Instead, it appears investors look for other ways to protect themselves from the potential negative consequences of doing business in a country with a weak rule of law. It is simply not worth the risk to invest in a country with a weak rule of law regardless of benefits. As one CEO explained, any potential benefits of investing in a weak rule of law country, like cheaper labor, are offset by the increased cost of doing business in a country with a weak rule of law (Interview 4).

CEOs assigned BITs an average score of 1.90, ranking them lower than personal relations as a possible mitigating factor. This again supports the view that investors do not rely on BITs as a substitute for the rule of law in a country. In my interviews, investors, to the extent they

talked about BITs, did so in regards to other benefits besides dispute resolution, such as tax breaks or uniform financial regulation. It appears that investors do not consider BITs as a tool to help them with the rule of law. This may further confirm Yackee's (2008) conclusion that investors are not fully aware of BITs, or at least not aware of all their provisions, making them a less important part of the FDI process.

Question 6

The survey's final question explores what sources of information investors use to monitor a country's rule of law. By understanding how investors get information about the rule of law I hope to better understand how much the rule of law factors into investor decision-making. It is possible that investors claim to care about certain aspects of the rule of law, but because of the way investors gather information they may not actually be able to obtain information on the aspects they care about. As a consequence, investors may base their decisions on partial or inaccurate information. Alternatively, investors may undertake an in-depth information gathering process, which provides detailed information about all the elements investors consider important. Respondents were asked to indicate the importance of each potential source of information about the rule of law. Respondents were given five choices: 1 "Not at all important", 2, 3 "Somewhat Important", 4, 5 "Very Important". Table 3.5 reports the average score for each source and is ordered from most important to least. The different sources can be broken into four rough categories.

Table 3.5 shows reports from contacts in the host country are by far the most important source of information about a country's rule of law, with an average score of 4.13. Host-country contacts are the only source of information with an average score over four and also the only source with standard deviation under one, indicating consensus about the importance of this

factor. Once again the survey reveals that personal connections play a central role in the decision-making process. Here, personal connections color the information investors obtain about a host country. Depending on the quality of the information, a reliance on personal connections may have potentially negative consequences if investors rely upon inaccurate information.

The second group includes news reports (3.53), in-house political risk assessment (3.50), and in-house counsel (3.47). The clustering of these sources suggests that investors prioritize their own understanding of a host-country over outside assessments. It is interesting to note that formalized in-house political risk assessment is not considered the norm in international business (Khattab, Anchor and Davies 2008, 689). The survey does not reveal if firms engage in a formalized in-house process of risk assessment, but the results at the very least indicate a strong preference for in-house over outside assessments. The high score for reports from country contacts further bolsters this conclusion. Like news reports, information from country contacts can be assessed by the firm and filtered through whatever process a firm uses to assess the rule of law.

All the sources of information in the third cluster are third parties designed to provide a firm with information about a host country. Investment insurance companies, political risk agencies, and credit rating agencies all represent unbiased sources of information about a country's rule of law. Their rankings suggest that investors value these sources of information, but still prefer to have their own information more.

Table 3.4: Factors that Can Mitigate the Risk of Weak Rule of Law					
Factor	Mean	Standard Deviation	N	Min	Max
Access to Business Partners You Trust	2.61	0.52	72	1	3
Your Firm is Familiar with the Country's Way of Doing Business	2.49	0.53	72	1	3
Strong Relationship with Host Country Government	2.17	0.71	71	1	3
Joint Venture	2.07	0.61	72	1	3
Access to Special Economic Zone	1.96	0.69	70	1	3
Access to an alternative to the country's legal system for dispute resolution	1.94	0.76	72	1	3
Existence of Bilateral Investment Treaty	1.90	0.67	71	1	3
Experience Investing in Other Countries with a Weak Rule of Law	1.84	0.71	70	1	3
High Potential Return on Investment	1.74	0.69	72	1	3

Table 3.5: Relative Importance of Different Sources of Information about a Country's Rule of Law					
Source	Mean	Standard Deviation	Min	Max	N
Reports from Contacts within the Host Country	4.13	0.78	72	1	5
News Reports	3.53	0.99	72	1	5
In-House Political Risk Assessment	3.50	1.08	72	1	5
In-House Counsel	3.47	1.09	72	1	5
Political Risk Agency Reports	3.14	1.06	72	1	5
Investment Insurance Rating	3.13	1.12	72	1	5
Credit Rating Agency Score	2.93	1.05	72	1	5
Non-governmental Organizations Reports	2.75	1.04	72	1	5
Host Country Investment Promotion Agency	2.46	1.01	72	1	5

Finally, host-country investment promotion agencies (2.46) were the lowest scoring source of information. This low score is interesting because the business literature suggests

investment promotion agencies are most effective at promoting investment when they help provide firms with information about the host-country. In particular, the literature highlights the benefit of these agencies when they help deliver hard-to-obtain information about a host county, such as the rule of law (Lim 2008, 43). The results of the survey may undermine the findings of this literature by suggesting that investors do not actually consider these agencies as important sources of information.

Question 6 contained the only responses where firms already invested in the developing world differed from firms not invested in the developing world. These groups differed on the importance of host country investment promotion agencies and credit rating scores. In both cases the firms not already invested in the developing world placed greater importance on these factors than the firms already in the developing world. This is interesting because it suggests firms not in the developing world are more reliant on host governments than firms that already invest in developing countries. This may suggest that investment promotion agencies do play a role in attracting FDI through the dissemination of information, but only to firms not already invested in their country. Once firms begin engaging in FDI in the developing world they may establish other sources of information and no longer need the investment promotion agency as much.

Additionally, firms that only invest in developed countries place a greater emphasis on credit rating scores than firms that invest in developing countries. Again this may be revealing that firms without a history in the developing world place a greater emphasis on formal sources of information. Both of these results may demonstrate that investors without experience in the developing world place a greater emphasis on information in general. Indeed, firms without experience in the developing world rated every source of information as more important than

firms with experience in developing countries. The differences in these two categories could indicate that those firms with a history in these countries have learned that these sources are not as important as others.

The regression analysis leaves one unanswered question: why do countries with a weak rule of law still attract FDI? Likely there is some unexplained factor mitigating the uncertainty associated with a weak rule of law. Questions 4 and 5 suggest personal relationships are the top way investors contend with a weak rule of law. Investors ranked access to trustworthy business partners, a familiarity with a country's way of doing business, and a strong relationship with host-country government as the top ways in which they mitigate the uncertainty associated with a weak rule of law. These factors all touch on personal relationships. Furthermore, Questions 4 and 5 show that personal relations were more important than formal substitutes for the rule of law such as BITs and SEZs.

This raises the question of how personal relationships mitigate the uncertainty associated with a weak rule of law. I hypothesize that personal relationships mitigate uncertainty by substituting for the rule of law and do so in two ways. First, investors reduce the risk that their partner will go back on a deal by only doing business with those they trust. Under this arrangement, as long as there are no problems there is no need to involve the courts. Partners adhere to agreements because it is the right thing to do, not because they are necessarily afraid of legal consequences. Under this view, business relationships are regulated by the 'logic of appropriateness', which provides investors with predictability, stability, and protection. The country's overall weak rule of law does not matter because the investors have found their own rule of law through the use of personal relationships.

Second, if a partner does renege on a deal then investors can fall back on their government connections to help deal with the issue. One CEO described to me a problem his firm had with a partner in India that demonstrates the importance of government connections in countries with a weak rule of law (Interview 1). The local partner did not like the terms of the arrangement between the local partner and the U.S. firm. In order to gain leverage to renegotiate the deal, the local partner turned to local government officials to shut down operations. The U.S. firm then turned to its own connections higher up in the Indian government to help reopen operations and hold the local partner to the original agreement. The CEO preferred this process over the country's notoriously slow judicial system. In this case, the U.S. firm obtained the rule of law through the use of their connections without using formal institutions. This demonstrates the important role that personal connections can play in substituting for the rule of law in environments where the rule of law is weak.

The survey also points to the overall importance of personal relationships throughout the FDI process. Throughout the survey investors consistently scored personal relations as important. Personal relations appear to be an important source of information for investors about potential host-countries. The reliance on personal relations highlights the subjective and personal nature of the FDI process. One implication of this view of the FDI process is that investors may be making investments based upon partial or inaccurate information. This means they may be opening themselves up to unknown risk or alternatively missing out on important opportunities. Viewing the FDI process as subjective suggests investors assessments of countries and conditions is colored by their own experience or the experience of others. This undermines the traditional view of FDI decision making as an objective cost-benefit analysis.

Conclusion

This chapter's goal was to begin clarifying why countries with a weak rule of law still attract FDI, and to develop a more complete understanding of the relationship between the rule of law and FDI. The chapter finds that investors use personal relations to mitigate poor contract rights protection and use economic opportunity to offset weak contract and property rights and overall respect for the rule of law.

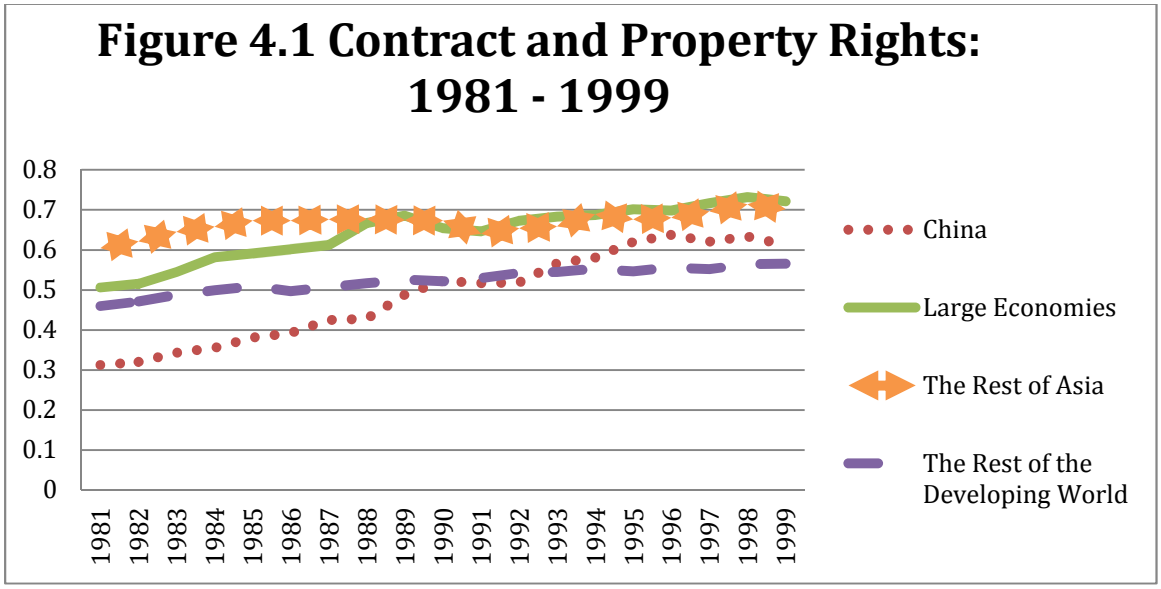
The findings in this chapter support the view that personal relations can help investors mitigate a weak rule of law. This chapter helps to clarify that this substitutive relationship only holds for contract and property rights. The survey suggested economic opportunity did not mitigate a weak rule of law, but the results of this chapter suggest otherwise. The investors' words generally imply that they see a weak rule of law as problematic and costly. However, at the same time investors appear constrained in their choices of where to invest. If they are going to invest abroad they need to invest somewhere that makes sense from a business standpoint. Either it gives them access to a new market or a way to produce goods at a lower cost. There are only so many countries that fit the business needs of a MNC. As a result, they may not necessarily be using economic opportunity to make up for a weak rule of law, but rather choosing the country in spite of its weak rule of law. In this sense market-seeking and efficiency-seeking FDI may be more like resource-seeking FDI than originally thought. Resource-seeking firms are constrained in their investment location decisions by the availability of natural resources. As a result, these firms tend to invest in more risky countries than other types of investment. Market-seeking and efficiency-seeking firms may be similarly constrained by market size and level of economic development. This could mean these firms also have little choice but to invest in countries with a weak rule of law.

Physical integrity rights appear to be a special case among the rule of law elements. Chapter 2 showed them to be an important predictor of FDI levels and this chapter has shown that personal relations, formal institutions, and economic opportunity are all capable of overcoming a weak rule of law. Overall, this chapter finds that personal relations can substitute for weak contract and property rights protection and that formal institutions do not substitute for the rule of law. Statistical analysis is not the ideal method of analysis for answering questions involving personal relationships. As a result, the case study will play closer attention to how personal relationships are formed and how they relate to the rule of law and FDI.

Chapter 4: The Rule of Law and FDI in China

Introduction: The Rule of Law and FDI in the 1980s

In 1979, at the start of the reform period, China suffered from a complete lack of legal institutions and laws considered central to FDI and economic growth. Chinese law schools had not produced new lawyers since the 1950, the Cultural Revolution had removed many qualified judges from the bench (Lo and Tian 2009, 2; Peerenboom 2002, 347), and the country lacked laws dealing with contracts, property, companies, and banking (See Clarke 2007 for a summary of legal reforms). As a result China's contract and property rights were very weak (See Figure 4.1).



During the 1980s China worked to reform laws relating to investment and economy. Initially, under the Joint Venture Law of 1979 China only allowed FDI in the form of joint-ventures with Chinese companies, typically state-owned enterprises (SOEs). However, during the early 1980s China enacted a series of laws that would create three forms in which foreign investment enterprises (FIEs) could take in China: equity joint ventures (1979); contractual

(cooperative) joint ventures (1988), and wholly foreign-owned enterprises (1986) (Potter 1996; 163). These laws helped to establish the basic framework of FDI in China by delineating the different types of FIEs and their relationships to domestic firms.

At the same time China spent much of the 1980s working to establish the basic laws necessary to regulate an open economy. In 1981 China passed the Economic Contract Law, allowing individuals to engage in contracts for the first time and authorizing the People's Courts to enforce contracts. This was augmented in 1985 by the Foreign Economic Contract Law, which dealt with contracts by foreign national and entities. In 1986 China enacted the General Principles of Civil Law. This law combined existing laws in an attempt to create an overarching civil code dealing with economic and personal relations between individuals. The law was an important first step in filling the legal vacuum relating to economic law and "supplied a foundation for further elaboration of the various branches of law required for a market economy" (Lubman 1999; 179). However, property and contract rights remained unclear and unevenly enforced during the 1980s due to the large number of laws, their vague nature, and the weakness of legal institutions. Figure 4.1 shows China's contract and property rights during the 1980s to be below the average for the developing world, other Asian countries, and other similarly sized economies. At the same time Western foreign investors were very wary of entering the Chinese market during the initial reform period. As a result, by the start of the 1990s over half of FDI into China came from Hong Kong, while countries like the United States accounted for only 7% (Wei 1996). Yet this situation would begin to change dramatically during the 1990s as China witnessed a surge in FDI despite only modest improvement in its respect for the rule of law. This raises the question of how China was able to attract FDI during this period despite a weak rule of law.

Building off the insights of the previous chapter, I argue investors chose to invest in China, in spite of its weak rule of law, because they could use personal relationships to reduce the uncertainty created by a weak rule of law. Additionally, the economic opportunity China presented to investors played a key role in mitigating the risk of a weak rule of law. To examine these theories I compare two time periods in Chinese history and use process tracing to map the process by which investors decide to invest in China.

Case Selection and Methods

This chapter compares two periods of Chinese history, which I select using the logic of the least-likely case. This means, given the importance of the rule of law for FDI, China is a least-likely candidate for FDI because of low-levels of both contract/property rights protection and physical integrity rights. However, China does have high levels of FDI, suggesting some other factor drives FDI into the country. Selecting China allows me to explore more closely what factors substitute or compensate for the rule of law allowing China to attract FDI.

Specifically the chapter will focus on the periods from 1990 to 1999 and then from 2000 to 2010. The first period begins after the Tiananmen Square protests when the Chinese government reaffirmed its commitment to economic reform at the Fourth Plenum of the 13th Party Congress (Vogel 2011, 643). This period includes the fastest period of growth in China's FDI and conversely, some of the country's lowest levels of contract, property, and physical integrity rights. This makes it an ideal time period to investigate why countries with a weak rule of law are still able to attract FDI. The second time period begins just before China joined the World Trade Organization (WTO) in 2001 and culminates in 2010 when China and the world began to bounce back from the financial crisis of 2008. During this time period China made substantial improvements to its rule of law and made many important policy changes as a part of

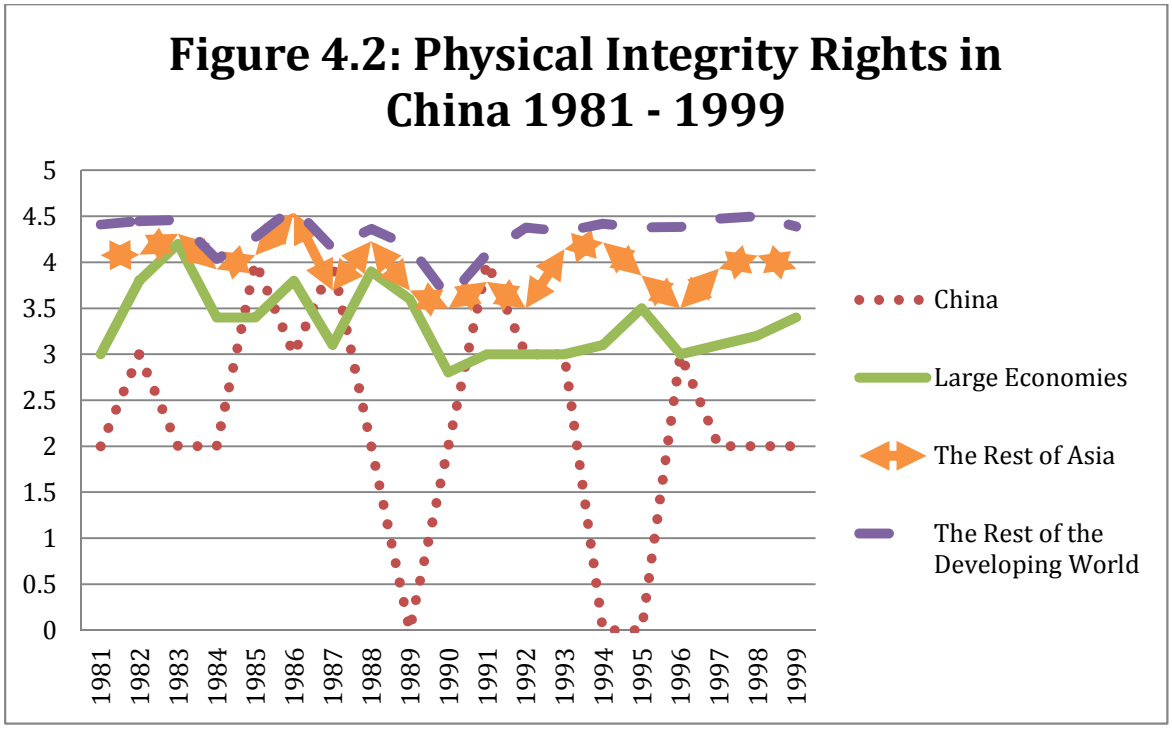
their ascension to the WTO. These changes, as the analysis below demonstrates, reduced the importance of personal relationships for FDI in China as investors came to rely more on the formal legal system and China's economic opportunity continued to grow.

The chapter uses process tracing to examine the causal mechanism linking the rule of law to FDI. Process tracing is an ideal method for identifying mechanisms and explaining relationships because it allows researchers to follow the process by which one or multiple variables interact with one another over time to produce a given outcome (Dessler 1991). Presently, scholars believe contract and property rights increase FDI by providing investors with a credible commitment that their investment will be secured over the long term. This chapter traces how investors navigate FDI in countries with a weak rule of law. Process tracing is also well suited for examining the interacted causal process, which I hypothesize links FDI, the rule of law, and personal relationships. This type of detailed analysis allows the researcher to explore a variety of different relationships between independent variables and the final outcome (George and Bennett 2005, 214). The data gathered from the interviews, primary literature, and secondary sources represent causal-process observations in that they provide information about the mechanisms linking personal relationships to FDI (Collier, Brady, and Seawright 2004, 252). Process tracing allows me to connect these causal process observations into a causal story that clarifies the mechanisms underlying the statistical relationships. In this way the case study builds upon the results of statistical analysis in order to generate a complete theory about the relationship between the rule of law, FDI, and personal relationships.

Weak Rule of Law

Figure 4.2 shows during the 1990s China's protection of contract and property rights was below the averages for the rest of the countries in its region as well as countries with similar-

sized economies. The weakness in Chinese rule of law stemmed from a lack of professional legal services and a lack of adequate institutions. The Chinese legal profession was decimated by the Cultural Revolution which saw many lawyers targeted as capitalist and anti-state for their support of criminal defendants and business interests (Peerenboom 2002, 347). It was during this period that nearly all law schools in China were closed. As a result, at the start of the Reform Period, China faced a severe shortage of legal professionals with only 2000 lawyers in China in 1982 (People's Daily 2002). These professionals were needed to draft contracts, represent clients, and help businesses navigate China's evolving regulatory and legal environment.



It took time to grow China's legal profession, particularly because the government excluded foreign legal firms until after China joined the WTO in 2001. Nevertheless the number of law firms and lawyers began to increase in the 1990s from about 50,000 in 1990 (Gelatt 1990, 767) to 80,000 in 1995 (U.S. State Department 1996), and by 1999 the legal profession had

grown to over 110,000 lawyers (U.S. State Department 2000). However, these numbers remained well below the number needed to service an economy and population as large as China's. By comparison the number of lawyers in the United States during these three years were 755,694; 896,140; and 1,000,440 respectively (ABA 2013). The dearth of legal professionals left investors searching for other sources of information and advice about the Chinese legal system.

China's weak legal institutions contributed to its poor rule of law during the 1990s. Despite important first steps taken during the 1980s, China entered the 1990s still lacking much of the basic legal framework needed for economic growth. In particular China's contract law remained weakly institutionalized and poorly enforced (Bersani 1992; Mora 1995; Rushford 1999; Seidlitz and Murphy 1998) and property rights remained vague (Lubman 1999, 116-117). For instance, the General Principles of Civil Law passed in 1986 represented the first steps towards recognizing property rights, but not when they conflicted with state and societal interests (Potter 2001, 62). In 1993 the Economic Contract Law was revised to expand the range of parties who could contract and to make the terms of contracts more fixed. These reforms were further advanced in the Contract Law of 1999, which for the first time spelled out specific rules and not just general principles relating to fifteen specific types of contracts.

China's rule of law was weak for much of the 1990s as the country worked to build a modern legal system from scratch. This resulted in a tremendous amount of change as the CCP created legislation that served as the framework for a modern economy. These rules along with efforts to improve legal infrastructure (lawyers, judges, etc.) improved the country's rule of law during the 1990s. However, for most of this time period investors were still forced to deal with a weak rule of law.

The Problematic Nature of a Weak Rule of Law

A weak rule of law is problematic for all members of society, but it is especially problematic for business. A weak rule of law increases uncertainty by making future planning more difficult, making contract and property rights less secure, and increasing the cost of doing business. Foreign investment entails a great deal of sunk costs that commit investors to a country for a long period of time. In order to manage their business properly investors must be able to plan for the future. A weak rule of law, particularly weak contract and property rights, undermines future planning because investors are not sure of the safety of their investment. As one investor noted, "without the rule of law you are out there alone. The United States government isn't going to help you. You chose to invest in China, you're on your own" (Interview 7). This in turn leads to increases in the cost of doing business.

A weak rule of law is problematic because it makes contract and property rights less secure. Typically in a modern economy, with complex transactions and economic relations, impartial third parties are responsible for the enforcement of contract and property rights (North 1990, 46). For the most part the government performs these duties ensuring that contracts are enforced and that property rights are respected. These two tasks are sometimes at odds with one another since governments employ their monopoly on the use of force to enforce contracts, which also gives them the power to take property if they deem it necessary. Thus, in developed economies additional institutions like laws, constitutions, and courts exist to provide investors with a 'credible commitment' that the government's power is limited (North and Weingast 1989; Smith and Farrales 2010). In countries with a weak rule of law these rights become uncertain, either because there are no assurances the government will enforce contracts and/or because investors fear a lack of limits on the power of the government.

Finally, insecure contract and property rights make it more difficult for investors to plan for their future and this leads to increases in the cost of doing business. Costs increase because investors cannot accurately gauge future costs. China's inefficient enforcement of contract and property rights during the 1990s meant investors needed to commit extra money to legal fees as lawyers fought weak Chinese courts to ensure the enforcement. In China these unknown added costs made doing business more difficult (Interview 2).

The uncertainty of weak contracts leads to a number of negative results. For one, investors are more likely to delay investing in a country when contract protection is weak (Dixit and Pindyck 1994). This hurts both the developing economy, which is deprived of the investment, and the investor that loses out on potential profits. Investors are also less likely to engage in research and development (R&D) in countries with weak contract enforcement (Lu and Ng 2010). Poor contract enforcement limits R&D spending because firms fear that if a partner does not uphold their end of a contract the firm will not be able to recoup losses. Investors are also concerned that poor contract enforcement will lead to payment and delivery delays because offenders have no third-party forcing them to comply. Fear of such delays directly reduces investment in countries with a weak rule of law (Cungu et al. 2008). This problem is especially acute for manufactures who operate on tight margins; these investors strive to only produce goods 'just-in-time' to customers in order to reduce waste and maximize profits. However, a weak rule of law can complicate this process. For instance, to save on storage cost firms will not hold raw materials or component parts on hand for a very long time. As a result, they rely upon timely delivery of these inputs from suppliers in order to meet demand. A weak rule of law, in the form of poor contract enforcement, can complicate this process as firms cannot be certain that suppliers will deliver goods on time. This forces businesses to keep extra inputs

and outputs on hand (increasing costs) in order to deal with the unpredictable circumstances created by a weak rule of law.

A lack of adequate property rights protections also creates uncertainty that can negatively impact investment. Expropriation by the government is a primary concern of investors. Without strong property rights protections investors are left to worry that the government will take their investment. This causes investors to delay investment, under-invest, or invest in less advanced technologies in order to off-set the insecurity of their investment in the future (Li 2009). Fortunately for investors, expropriations are increasingly rare. However, investors have replaced their fear of expropriation with concern about the enforcement of intellectual property (IP) rights.

IP rights protect the designs, technologies, and processes that firms use in the production process along with outputs like software, movies, and drugs. Protection of these rights is notoriously poor in developing countries, in part because host-country economies can benefit from IP theft when IP is taken from a foreign firm and used by a domestic firm. Firms respond to weak IP protection the same as they do to the threat of expropriation: reducing or delaying investment or investing in less advanced technology. Investors also take extra (more costly) steps to protect against IP theft. Many Chinese factories, for instance, require their workers to walk through metal detectors on their way in and out of work to help combat theft and firms employ extra attorneys to help fight violations of IP rights. In all, a weak rule of law is extremely problematic for investors.

How Investors Cope with a Weak Rule of Law

Given the uncertainty created by the weak rule of law, it makes sense that investors would look for ways to reduce uncertainty or at least off-set the risks associated with the uncertainty. Personal relationships have always played an important role in FDI in China with

many early investors relying upon connections within China in order to establish their businesses. This process continued during the 1990s as investors used personal relationships to provide them with information, predictability, and stability.

In China, the word *guanxi* means relationships or social connection between two people. Once a *guanxi* connection is established people can ask one another for favors regularly (Wang 1994, 1-2). *Guanxi* is central to not only to Chinese social relations but business relations as well (Solinger 1989). In fact, a number of 'doing business' texts that offer advice to would-be investors in China, make reference to *guanxi* and the importance of personal relationships for business in China. *Guanxi* serves as the basis for informal arrangements between business partners and government officials in China. Once these relationships are established investors can use them to help navigate China's weak rule of law.

Personal relationships remove the need for the formal legal system, providing government support if contracts are not respected, and by providing investors with increased information about how to behave in a country with a weak rule of law. This helps to reduce investors' uncertainty by assuring investors they do not need to access the legal system, providing them with assurance that contracts will be enforced even if the legal system is weak, and by increasing information in a context where rules are unclear.

Personal relationships with government officials and business partners increase investors' information. Investors seek out these relationships because they provide them with better access to market and governmental information (Bjorkman and Kock, 1995; Davies et al 1995). Furthermore, in surveys foreign firms reported making more of an effort to establish personal relationships than their counterparts in SOEs (Xin and Pearce 1994). This increase in information helps investors to reduce their uncertainty about the market.

Personal relationships help investors avoid the formal legal system by providing them with trustworthy business partners who will not renege on agreements (Zhou and Poppo 2010). A weak rule of law can result in poor enforcement of contract and property rights. This hurts businesses by making their investments less secure over the long-term. By only doing business with partners who will not violate these rights investors avoid having to engage with the poor legal system (Fu 2000). Such an arrangement is not as secure as one in which a third party enforces these rights, but when third party enforcement does not exist or is inconsistent a trusted business partner is an advantage.

Investors also benefit from personal relationships with government officials. On the one hand, personal relationships can help investors gain preferential contracts, access to markets, and other special privileges that can amount to corruption (Faccio 2006; Khwaja and Mia 2005). On the other hand, investors can also benefit from personal relationships in ways that help them to obtain an equivalent of the rule of law. When contract/property rights are not being honored, investors can turn to their connections with the government for help (Park and Luo 2001). For instance, businesses may turn to government connections when they know of a violation of IP rights. Friendly government officials can expedite the process of holding the violator accountable before the law (Interview 5).

Evidence Investors Establish PRs

Personal relationships are a central feature of the Chinese business culture and during the 1990s many businesses sought to establish personal relationships or based their decision to invest, at least in part, on the existence of personal relationships within China. Evidence that investors establish personal relationships can be found in the types of FIEs firms chose to establish in China and the country of origin for FDI.

The type of FIE a company establishes in China can help illustrate the importance of personal relationships when the rule of law is weak. As previously mentioned, China allows three forms of FIE: equity joint ventures; contractual joint ventures, and wholly foreign-owned enterprises. Equity joint ventures (EJV) and contractual (cooperative) joint ventures (CJV) are similar in that they both allow foreign investors to join with a Chinese firm, while in a wholly foreign-owned enterprise (WFOE) the foreign investor assumes total control. EJV's require profit, risk, and control to be divided evenly based upon equity shares invested by the parties. This means if a U.S. firm invests in 45% of an EJV it assumes 45% of the risk. Alternatively, CJV's allow for parties to divide risk, profit, and control according to contracted terms that may not match the equity of the investment. Both EJV's and CJV's allow foreign firms to tap into the connections, expertise, and managerial experience of Chinese firms in order to help navigate the Chinese market, but must share in profits (Folta 2005). Conversely, in a WFOE, foreign investors assume all the risk of an investment themselves and do not get access to local expertise, but reap all the rewards themselves.

By comparing what types of FIE's foreign firms establish we can get a sense of what type of risk investors are willing to assume and what sorts of benefits they value most. If investors value personal relationships more than profit we would expect them to establish EJV's or CJV's, particularly during the 1990s when the rule of law was weak. During the 1980s, when China was first opening, the rule of law was extremely weak, and with many central institutions still being developed investors established almost four times the number of joint ventures than WFOE's, reflecting a desire to reduce uncertainty by pairing with a domestic firm (Beamish 1993, 30). In the 1990s, joint ventures remained the most popular type of FIE, until 1999. Table 4.1 compares joint ventures and WFOE's in the mid to late 1990s (the only periods for which

data are available). Here you can see the dominance of joint ventures during the middle of the decade and the rise of WFOE's as China's rule of law improved during the later part of the 1990s. Joint ventures provide investors with market information, help with the local culture, and give them a better understanding of business practices (Calantone and Zhao 2001, 4). Additionally, recall from the investor survey that investors viewed joint ventures as one of their preferred ways to mitigate the risk of a weak rule of law. Taken together this evidence suggests that investors form personal relationships when the rule of law is weak.

Table 4.1: Number of Joint Ventures vs. Wholly Owned Foreign Enterprises 1990s

Year	Joint Ventures	WOFEs
1994	34524	13007
1997	14830	5031
1998	10110	9673
1999	8706	8201

Source: Chinese Statistical Yearbook Various Years

The origin of FDI into China also suggests the importance of personal relationships when the rule of law is weak. Relational ties serve as one of the main bases for personal relationships between foreign business people and host-country government officials or business partners. For instance, the CEO of an electronic manufacturer stated the personal connection the firm's original CEO had to a town in China was the only reason his firm established a business in the country in the 1980s. In fact, the company based its operations in the CEO's home town where they were able to draw upon the CEO's knowledge of the Chinese market and his connections with local businesses and governmental officials. This CEO believed these connections allowed the firm to operate successfully in China as a WFOE during the 1980s and 1990s when most foreign firms were choosing joint ventures.

This experience is not unique and many of the first foreign investors in China were ethnic Chinese located in Hong Kong and Taiwan. For example, from 1979 − 1993 sixty-eight percent of FDI came from Hong Kong, eight percent from Taiwan, and seven percent from the United States (National Bureau of Statistics China). The number for Hong Kong actually masks investment that is 'recycled' from the mainland. Many Chinese entrepreneurs on the mainland will route their investment through an overseas location, like Hong Kong or Macau, in order to take advantage of some of the benefits foreign firms enjoy in certain industries (Xiao 2004). Ethnic Chinese firms around South East Asia are better able than non-Chinese owned firms to tap into personal relationships on the mainland in order to successfully operate in an environment with a weak rule of law (Weidenbaum and Hughes 1996, 147 − 150). It was not until the 1990s and the 2000s that investment from non-Asian countries began to increase along with the country's respect for the rule of law.

Finally, investors reported seeking out personal relationships to help them with their investment in China. Every investor I spoke with who operated in China stressed the importance of finding trustworthy business partners because of the risk of investing in China. Investors noted that trusted business partners allowed them to avoid the legal system (Interview 8) and facilitated better enforcement of existing rules and contracts by the government (Interview 3; Interview 6).

Economic Opportunity and FDI in China

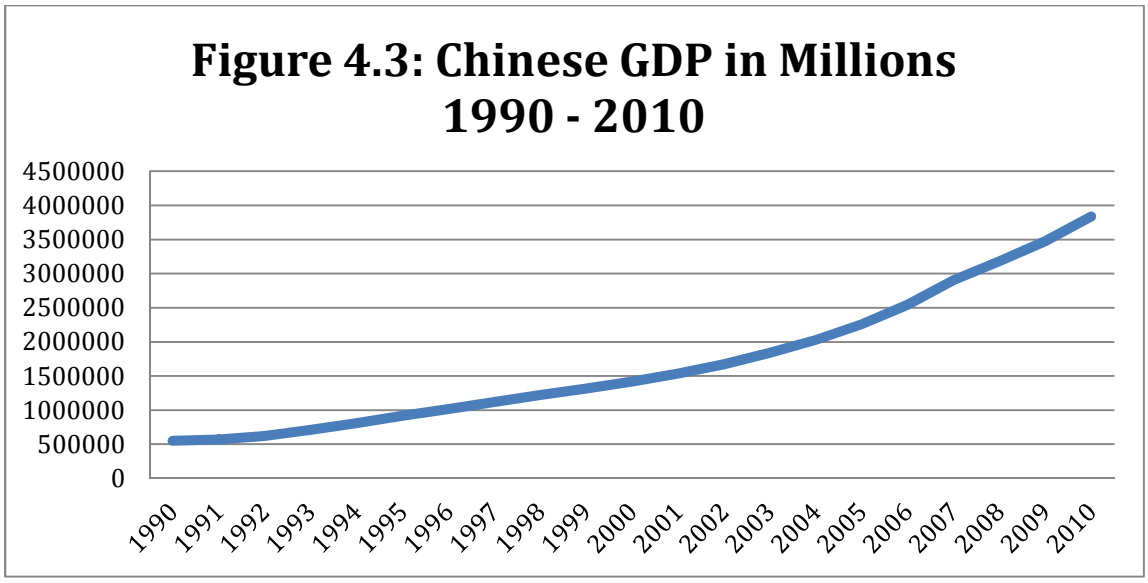
At the same time, many saw China's economic potential as worth the risk of investing in a country with a weak rule of law. As Chapter 1 notes, typical explanations of FDI focus on investors as cost-benefit maximizers. When deciding on locations they compare countries on factors that may increase costs or increase returns on investment. A weak rule of law and the

resulting uncertainty are two examples of costs. I contend that, for some investors, the uncertainty associated with a weak rule of law makes it difficult to accurately gauge costs and benefits and thus discourages investment. However, for other investors the benefits may be so great they overwhelm the uncertainty of costs.

China in the 1990s offered investors two exciting characteristics: a large pool of cheap labor and a massive untapped market of consumers. In 1990 the average manufacturing wage in China was only $610 a year (Banister 2005, 35). Wages would steadily increase throughout the 1990s (a trend that continues to this day), but would remain well below wages in developed countries making China a popular destination for FDI from efficiency-seeking firms from around the world. Part of the reason China's wages are so low is the extremely large size of its labor force. In fact, China boasts the world's largest working-age population. In 1995 there were over 750 million people living in China between the ages of 15 and 59 (United Nations 2013). By comparison India, the next largest country, had 550 million working-age people in 1995. Additionally, during the 1990s China had a huge surplus labor force, as people migrated from rural China into growing cities like Shenzhen and Shanghai in search of work (Das and N'Diaye 2013). Surplus labor is critical to low production costs because as long as there are more workers than jobs employers do not need to raise wages to attract workers. Instead, excess rural-labor places downward pressure on wages (Lewis 1954). These three factors: a large working age population, a surplus of labor, and the resulting low wages, made China an attractive investment option during the 1990s for foreign investors seeking efficiency gains in the production process.

China's large untapped market also provided an excellent investment opportunity. In 1990 China's population stood at 1.1 billion people but was largely untapped (WDI Online). Its

nominal GDP (a standard measure for the size of a country's market) stood at $3.5 billion, the eleventh largest in the world (WDI Online). Yet China's GDP per capita in 1990 was only $314 making it the 21st lowest GDP per capita in the world (WDI Online). For investors, this meant the Chinese market represented a huge opportunity for growth, which China delivered on throughout the 1990s. China's GDP grew by an average of 9.6% between 1990 and 1999 (Figure 4.5). Between 1993 and 1997 the Chinese economy expanded on average by 12% each year and after 1991 GDP growth never dipped lower than 7.8%. This phenomenal growth rate attracted investors to China who saw this growth as a chance for them to profit from China's large and expanding market.



In addition to macroeconomic conditions like market size, labor force, and wages that investors find attractive, China enacted a number of policy reforms designed to attract FDI. In particular, SEZs were the main vehicle through which China implemented policy reform designed to attract FDI. In fact China pioneered the use of SEZs as a tool for attracting FDI. China's SEZs were established in waves beginning in 1980 when, under Deng Xiaoping's leadership, China designated four cities, Shenzhen, Zhuhai, Shantou, and Xiamen as special

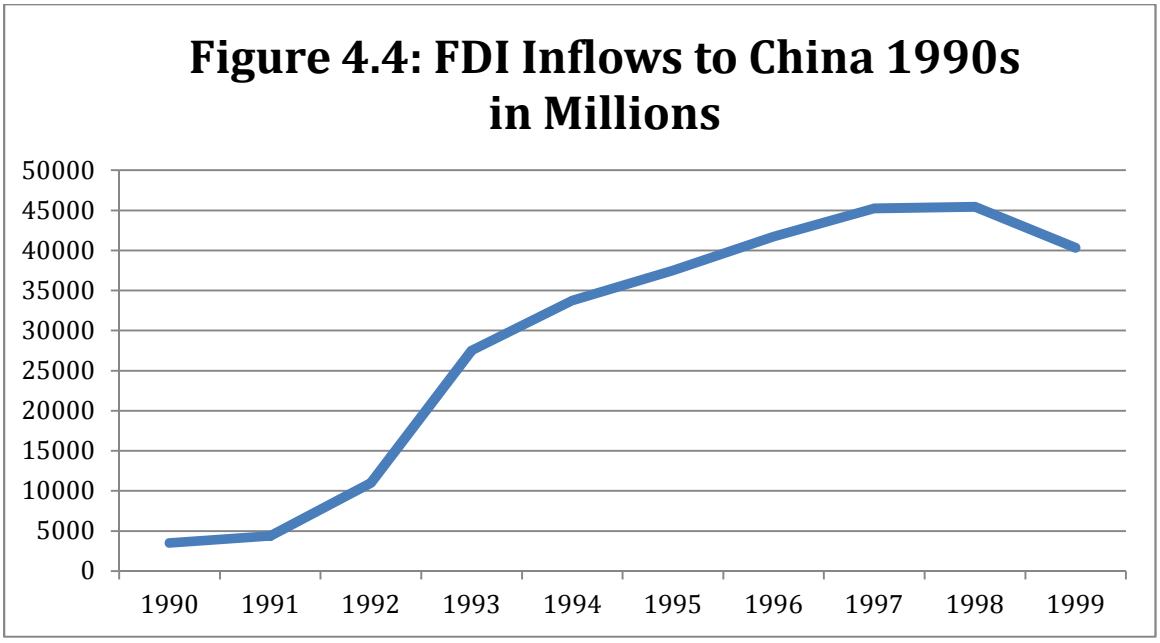
economic zones. These cities were huge economic successes and in 1984 fifteen more cities were added to the list of SEZs[5] as a part of China's efforts to develop costal areas. In 1985, China created large SEZs in three regions around the deltas of the Pearl, Min, and Yangzi Rivers. The government designed these larger SEZs to build upon existing development centered in cities within these delta regions in order to cluster economic development, leverage existing infrastructure, and take advantage of the strategic locations.

SEZs serve an important role in China's economic reform and development process by acting as a testing ground for policy changes. SEZs were the first places to allow foreign investment and have continued to be the first locations where certain sectors are opened to foreign investors. The SEZ in Shenzhen, for instance, was the first place to allow foreign electronics manufacturers into China. More recently officials have promised that the Shanghai Free Trade Zone will serve as the first market open to service industries such as legal, medical, and telecommunication services (Guardian 2013). They also typically offer investors a range of incentives that help to make them more attractive. SEZs offer investors reduced income tax rates, zero customs duties, lower local fees, improved land-use rights, and more reliable infrastructure. For instance, in the 1990s firms located in the SEZs along China's coast enjoyed income tax rates of only 24% compared to 33% for those located outside a SEZ (Luo 1998, 121). Additionally, foreign firms located in a SEZ typically did not have to pay to import goods (Wang 2013, 136). These benefits have made SEZs very popular with foreign investors. SEZs attract more investment than other locations in the country and have been a central part of China's economic development (Cheng and Qwan 2000; Du et al. 2008; Litwack and Qian 1998; Wang 2013).

[5] Shanghai, Tianjin, Dalian, Qingdao, Yantai, Weifai, Lianyungang, Nantong, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjang and Beihai.

FDI Inflows to China Increase in 1990s

Finally, FDI into China grew at a substantial rate during the 1990s despite a weak rule of law because investors used personal relationships to reduce uncertainty and because the country's economic opportunity outweighed the risks of a weak rule of law. Figure 4.6 shows the increase in FDI into the country during the 1990s. As the graph makes clear FDI in China increased substantially during this period and FDI became a more important part of China's overall economy. In 1992 and 1993, FDI into China increased at rates of 155% and 146% respectively. On average FDI in China increased by 33% a year during the 1990s, one of the highest sustained rates of FDI growth the world has ever seen.



Foreign investors felt better about investing in China when they had personal relationships, whether based on their own personal ties or acquired through joint ventures. As evidence of this consider the fact that foreign firms in joint ventures invested more money per project than WFOE. In 1994 FIE in EJV's invested $1.4 million per project, while WFOE's only invested $780,000 (All Statistics from National Bureau of Statistics China). The overall increase

in FDI during the 1990s and the rise in WFOE's, only began to change this relationship by the end of the decade. In 1997 EJV's spent $2.3 million and WFOE's only $1.8 million per project, but by 1999 EJV's were spending $2.1 million per project compared to $2.2 million by WFOE's. As the rule of law improved in China WFOE's became a more attractive option to investors who no longer needed the help of personal relationships to mitigate the uncertainty created by a weak rule of law.

Summary

China's rule of law was weak during the 1990s. China's weak rule of law generated a great deal of uncertainty for investors. Investors saw personal relationships with business partners and government officials as a means to reduce the uncertainty created by a weak rule of law. Once they established personal relationships investors felt secure enough to increase investment in China. At the same time, China's large pool of relatively cheap labor and large domestic market presented investors with an incredible economic opportunity. These two factors (personal relationships and economic opportunity) combined to attract investors to China during the 1990s despite its weak rule of law. The following decade would see China continue the pace of its economic and legal reforms resulting in a boost to the country's respect for the rule of law and its attractiveness as an investment location.

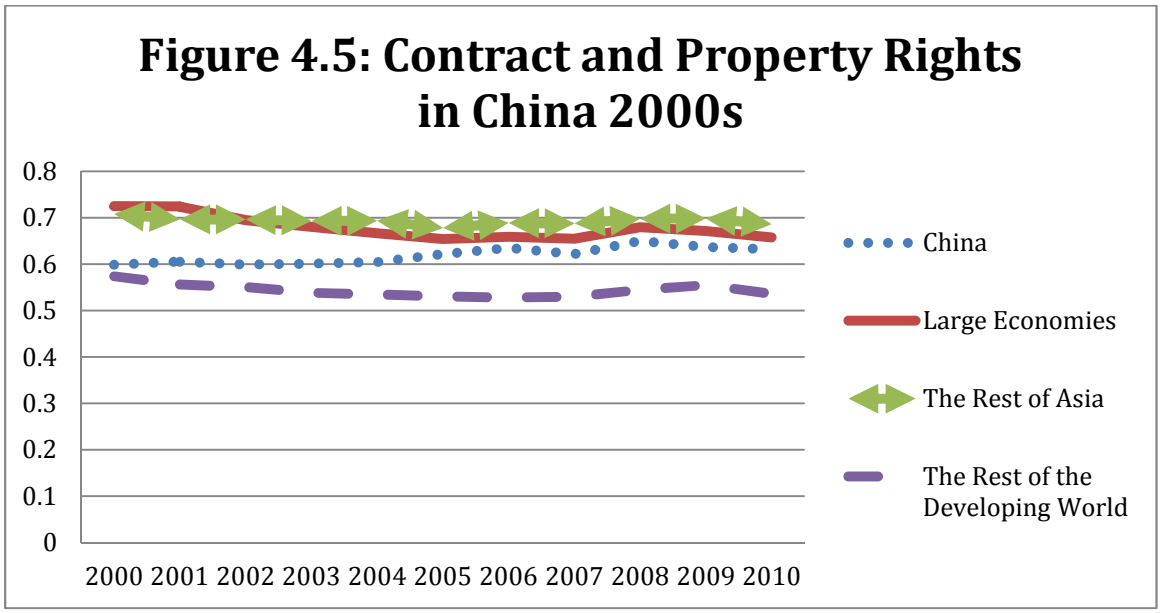
China, FDI, and the Rule of Law in the 2000s

China joined the World Trade Organization (WTO) in December of 2001. This began a new era of FDI in China as investors sought to take advantage of further liberalization and continued improvements in regulation and the rule of law. This period also marked an important time of change in the way business was conducted in China. During this period investors began to make less use of personal relationships and began to rely more on the ever-evolving and

improving formal legal system. At the same time, with its large market, improving infrastructure, and still relatively cheap labor China remained the most attractive investment location for multinational corporations.

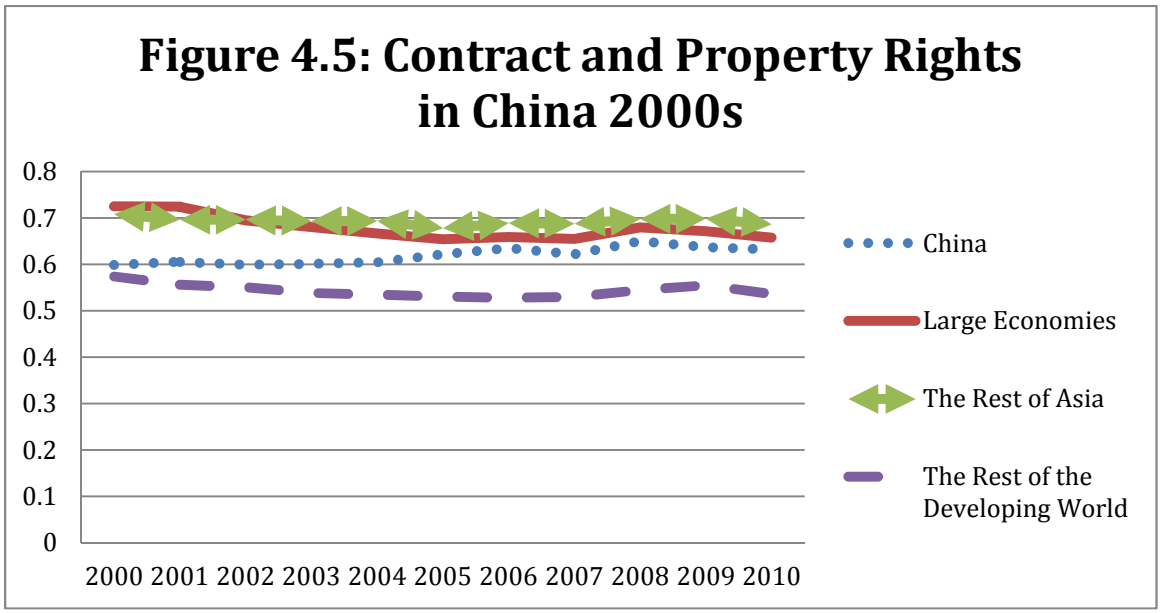
China's Rule of Law in 2000s

The Chinese authorities worked diligently during the 2000s to continue to improve their rule of law and legal environment for FDI. At the start of the decade the country continued to make changes in response to its ascension to the WTO in 2001. Joining the WTO accelerated the reform process as China worked to meet WTO requirements. In fact many saw the decision to join the WTO as a deliberate step by Chinese officials to lock-in economic reform at a time when some were questioning the benefits of a more open economy (Cross 2004; Fewsmith 2001).



2007 represented an important year for the rule of law and FDI in China. First, China passed the Property Rights Law, which made important steps by treating state, collective, and private property equally and providing specific instructions for the protection of property (Marechal et al. 2009). At the same time China also amended the constitution to include its first

support for the idea of property rights. While only rhetorical support, the constitutional amendment symbolized the government's commitment to legal reform and a commitment to creating a legal system in line with international standards.



Improved Rule of Law Reduces Uncertainty

The resulting improvements in the rule of law reduced investors' uncertainty. A weak rule of law created uncertainty about whether contracts would be enforced and whether property would be protected. However, with each new law the Chinese government made their support for these rights more and more clear. For example, AmCham China's 2005 member-survey found trouble enforcing contracts ranked as the seventh greatest challenge facing U.S. companies in China. However, by 2007 enforcing contracts had dropped off the list of challenges. Likewise, interview subjects noted that by the mid 2000s issues of property and contract rights were no longer a concern for investors. Investors responded extremely positively to both China's legal and economic reforms by increasing FDI and further integrating China into the world economy. 93% of respondents to AmCham's 2005 survey believed the reforms had improved the Chinese business climate for U.S. companies and 35% said the reforms improved

the climate to a 'great extent' (AmCham 2005). The positive perceptions of the Chinese market led to 82% of respondents stating they plan to increase their investment in China, 89% saying it was among their top-three investment priorities, and 47% stating they were likely to invest in research and development in China in the coming year (AmCham 2005).

Declining Importance of Personal Relationships

Improvements in the legal system meant investors no longer needed to rely upon personal connections because the formal legal system was now up to the task. During this period, lawyers who advised investors on doing business in China began to caution against the use of personal relationships because the risks of such relationships began to outweigh the benefits (Interview 10; Interview 11). Likewise, Chinese managers began making less use of personal connections during this time period, further reflecting the growing importance of the formal legal system (Guthrie 2009; 102 − 106).

In addition to improvements in the legal system, the Chinese government began to take greater strides to reduce corruption, ultimately impacting the importance of personal relationships for business. Between 1999 and 2005, U.S. firms in China consistently ranked corruption and lack of transparency as persistent challenges of the Chinese market (AmCham 2006). Responding to these complaints in 2002, President Jiang Zemin kicked off the CCP's sustained campaign to root out corrupt government officials with a major policy speech before the CCP's Central Commission for Discipline Inspection (Xinhuanet 2002). Between 2003 and 2007 over 12,000 Chinese officials were prosecuted for corruption (AP 2007**)** and the most egregious violators were given sentences of death. These efforts also contributed to the decline in the importance of personal relationships because of the possibility (real and perceived) that personal relationships result in corrupt practices. Chinese officials became afraid that close ties

to businesses would lead to prosecution under the anti-corruption campaign (Interview 9; Interview 10; Interview 11; Interview 12).

However, enforcement of anti-corruption efforts was not universal and regulations remained vague. As a result, corruption continued to persist in China and personal connections remained a part of the business process, particularly with local-level officials. These efforts did not necessarily impact the importance of personal relationships between businesses, particularly for small and medium sized enterprises. In interviews, CEOs of smaller firms expressed the continued importance of these relationships for doing business in China (Interview 4; Interview 5; Interview 6), while those who work with and advise larger companies indicated the importance of personal relationships continues to decline (Interview 11; Interview 12). Likewise, AmCham's member survey found that smaller and newer firms have greater issues with contract and property rights than larger firms (AmCham 2005). This suggests that these firms may benefit more from personal relationships to help overcome the initial challenges of the Chinese market.

The changing face of FDI in China during the 2000s also reflects the reduced need for personal relationships. In the 1990s, when the rule of law was weaker, investors preferred joint ventures to WFOE's when choosing to invest in China. However, this trend first changed in 1999 when the total number of WFOE's passed the total for joint ventures. The pattern would continue in the 2000s as firms felt less of a need to tap into the connections of partners as the rule of law improved (See Figure Table 4.2). In 2003, there were twice the number of WFOE's than joint ventures in China, by 2005 there were three times as many, and by 2009 there were almost six times the number of WFOE's compared to joint ventures. Additionally, during this time period investors began to sink more money into WFOE's on a per business basis than they did

into joint ventures. In 2003 WFOE's invested about $3 million per business compared to $2 million of EJVs. WFOE's would continue to invest more than joint ventures until 2007, when the global financial crisis would reduce FDI in China significantly.

Table 4.2: Number of Joint Ventures vs. Wholly Owned Foreign Enterprises 2000s

Year	Joint Ventures	WOFEs
2003	14068	26943
2004	12913	30708
2005	11646	32308
2006	11259	30164
2007	8290	29543
2008	5080	22396
2009	4673	18741
2010	5270	22085

Source: Chinese Statistical Yearbook Various Years

The changes in the type of investment in China reflect the diminished importance of personal relationships during this time period. Joint ventures provide investors with an opportunity to pair with a Chinese firm, which brings with it personal connections that can make it easier to operate when the rule of law is weak. WFOE's do not provide similar assurance since investors are alone in the Chinese market. The shift towards more WFOE's during the 2000s signals that investors feel more secure in the Chinese market on their own (Puck et al. 2009; Slangen and Tulder 2009). Investors learning how to act in China's market helps to explain some of this change, but it also reflects the improvements to China's rule of law and the diminished importance of personal relationships (Wilson and Brennan 2010). Improved legal institutions make relational guarantees less important to businesses that no longer see the added cost of personal ties as worth the investment.

China's Economic Opportunity Continues to Grow

As the importance of personal relationships for FDI declined during the 2000s, the importance of economic opportunity continued. Joining the WTO in 2001 increased China's potential as an investment location. China was already attractive to investors as a location for exports, but by joining the WTO China began to realize its potential as a market for goods and services. Joining the WTO triggered several policy changes that helped to make China a more attractive investment location, including a reduction in import and export tariffs, and commitments to open up more areas of the economy (particularly the service industry) to foreign investment.

Tariffs negatively impact FDI by increasing the cost of bringing goods in and out of a country. The WTO urges countries to reduce tariff barriers in order to encourage trade in goods and services. Historically, China maintained high tariff barriers in order to protect the development of certain industries, particularly those controlled by SOEs. For example in 1992 China's average tariff rate was 39.7% (WDI Online). With an eye towards joining the WTO, China began reducing tariffs after 1992. In 2000, just before joining the WTO, China's average tariff was 16.4% and by 2010 tariffs lowered to 7.7%. All total, China would reduce or eliminate tariffs on 7,000 items to comply with WTO rules (Economist Dec. 10 2010).

Different industries felt the impact of these changes more than others. For example, prior to joining the WTO China maintained an 80-100% tariff rate for automobiles and auto-parts. By joining the WTO China agreed to reduce the tariff on automobiles to 25% and auto-parts to 10% by 2006. This made it cheaper and easier for foreign automakers to enter the Chinese market (Rae 2002). For instance, imports of U.S.-made auto parts increased by 33% between 2001 and 2002 and by 48% between 2002 and 2003 (Morrison 2011).

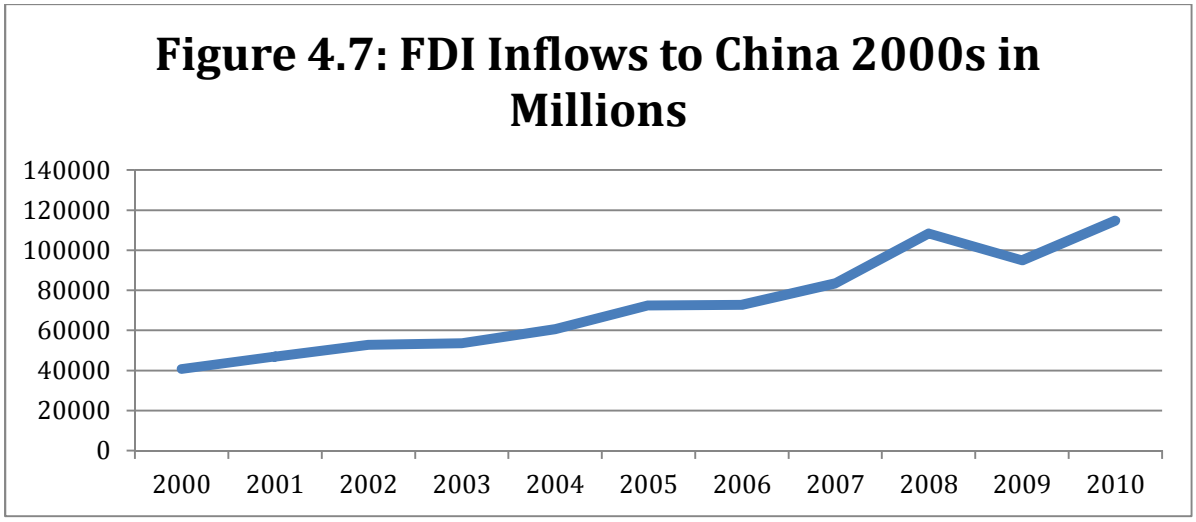
The government also made promises to open up more areas of the economy to international investment. Prior to joining the WTO, Chinese officials protected certain areas of the economy, particularly the service sector, by forbidding foreign firms from entering the market. By joining the WTO China had to give up these protections and this made China an even more attractive investment location to foreign firms, particularly to market-seeking FDI which had been largely kept out of China. In particular, China agreed to an unprecedented level of liberalization within the service sector, essentially guaranteeing to turn one of the world's most closed service sectors into one of its most open (Matoo 2003, 2).

Finally, China needed to agree to national treatment of foreign firms in order to join the WTO. National treatment means that a host-country government does not discriminate against foreign firms in favor of domestic firms. Investors hoped that by joining the WTO, SOEs would no longer receive what investors see as preferential treatment from government officials and regulators. The hope of a more level playing field and further SOE reform led investors to believe that the domestic Chinese market would become more open and more competitive. This again increased the perceived economic opportunity of investing in China. All together the 2000s were a period of high optimism about the Chinese market.

Investors Increase FDI to China During the 2000s

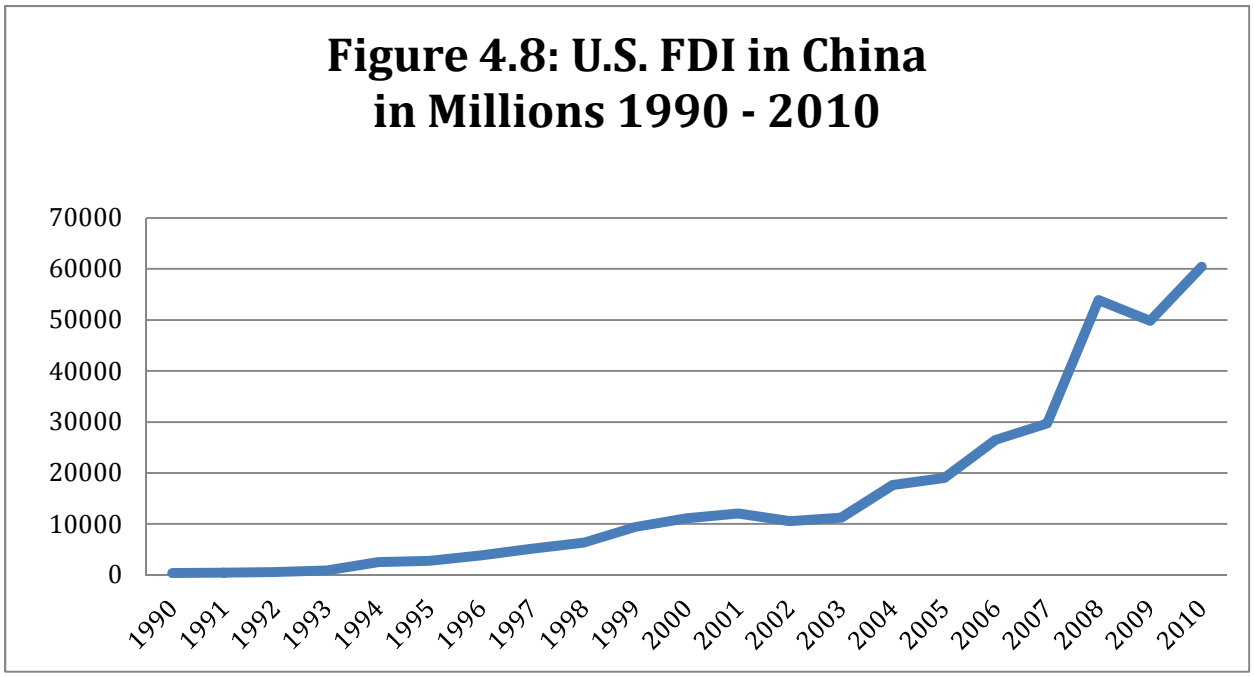
From 2000 through 2010 FDI in China increased significantly (see Figure 4.7). At the start of the period, China received $38.4 Billion in FDI (WDI Online). In 2002, the year after China joined the WTO, FDI to China jumped to $49 Billion, by 2005 it was up to $84 Billion, and by 2010 FDI reached $272 Billion (WDI Online). Policy changes in China also led to a deeper integration into the global economy. Imports increased significantly as tariffs declined. Imports accounted for 20% of GDP in 2000 and this would rise to 31% in 2007 before the Global

Financial Crisis slowed the world economy (WDI Online). Chinese exports also increased as more firms chose to make China a production center. In 2000 exports were 23% of China's GDP, in 2004 exports jumped to 34% of GDP, and peaked at 39% in 2006. Foreign firms played a critical role in the growth of Chinese trade. FIE's accounted for 52% of value of the imports and 47% of exports in 2000 (National Bureau of Statistics China). These totals increased to 58% of exports and imports in 2005 before dropping off to 54 % of exports and 52% of imports in 2010.



U.S. investment in China mirrors the trends found in the global data. U.S. FDI in China increased by over 400% during the 2000s. In 2000 U.S. firms only invested $11 Billion in China, but by 2005 it was $19 Billion, and $59 Billion in 2010 (see Figure 4.8**)**. U.S. investors responded positively to the opening of the financial sector by increasing FDI in this sector from $43 Million in 2000 to $1.2 Billion in 2004, and $2.3 Billion by 2010 (BEA Online). Other service sectors also saw increases in FDI during the 2000s. For instance, FDI in wholesale trade increased by 926%, FDI in information services, such as telecommunications, increased by over 3000%, and FDI in professional services, like legal services, increased by 439 % (BEA Online). These increases demonstrate the important impact joining the WTO had on Chinese FDI during

this period. In joining the WTO China agreed to further open its economy to international competition and, given China's huge domestic market, increased the country's attractiveness to foreign investors.



Reductions in tariffs and other barriers to trade also increased FDI by manufacturing firms seeking to take advantage of China's relatively low wages. Overall manufacturing FDI increased by 339% from $57 million in 2000 to $25 billion in 2010 (BEA Online). The largest increases came in the food and transportation sectors, which were among the most protected before China joined the WTO. Transportation FDI, which includes the auto industry, increased from $652 million in 2000 to $3 billion in 2010, an increase of 368%. In the food sector FDI increased by over 1000% jumping from $286 million in 2000 to over $4 billion in 2010.

Conclusion

Comparing the two periods of FDI in China demonstrates the important role personal relationships can play in countries with a weak rule of law, as well as the important role economic opportunity plays in determining investment decisions. Between 1990 and 2000

China's legal institutions were in their infancy and investors faced a great deal of uncertainty. Never the less, FDI to China increased during this period. Investors relied upon personal relationships with business associates and government officials to help them mitigate the uncertainty of a weak rule of law. These relationships provided investors with assurances that contracts would be honored and property protected. They also provided investors with important information about the best ways to operate in the Chinese market. At the same time, during the 1990s the Chinese government worked to improve its respect for the rule of law and alter its economic policies with the goal of joining the WTO in 2001. These changes continued during the 2000s and resulted in a reduction in investor uncertainty, a decrease in the need for personal relationships, and a further increase in FDI.

Chapter 5: Conclusion

At the beginning of this project I argued the rule of law is a critical determinant of FDI in developing countries. The analysis in Chapter 2 identified contract and property rights protection and respecting physical integrity rights as the most important elements of the rule of law for FDI. These findings raised the question of why some countries are able to attract FDI despite weak respect for these rule-of-law elements. In Chapter 3 I tested the possibility that investors use formal institutions like BITs or SEZs in order to mitigate a weak rule of law. However, the results indicated these institutions did not increase investment in countries with a weak rule of law. The survey results in Chapter 3 indicated that investors use personal relationships as a means to mitigate the risk of a weak rule of law. A statistical analysis found some broader support for this conclusion by indicating that U.S. firms invest more money in countries that have large immigrant populations living in the U.S.

Chapter 4 explored the link between the rule of law, personal relationships, and FDI in more depth by focusing on China in the 1990s and 2000s. This case study showed that personal relationships played an important role in the investment process. These relationships helped investors to reduce the uncertainty created by a weak rule of law by providing them with information, help with contract enforcement, and greater protection of property rights. At the same time, the case study further supports the findings of Chapter 3 by demonstrating the importance of economic opportunity for investment decisions. China's large market and low-cost labor continue to make it the world's top FDI location and this attractiveness helps to explain its high level of FDI, despite its weak rule of law.

Generalizing the Argument

We can extend the insights of this analysis to other developing economies struggling with a weak rule of law that share common characteristics with China. First, communist economies create the environment necessary for the development of personal relationships. Historically, communist economies were economies of scarcity that forced citizens to look outside official channels in order to get the goods and services that they needed. As a result, informal economies developed across the communist world and personal relationships played a fundamental role in making these economies function (Guthrie 1998; 1999; Hsu 2005, 311). Personal relationships helped create trust between individuals that made it easier for them to exchange goods and services, particularly with those outside their family (Ledeneva 1998; Yang 1994). The importance of these networks persisted through the collapse of communism and the rise of capitalism and played a key role in helping business people in the new economy (Ledeneva 2003; Yang 2002).

Informal economies are also a key feature of many other non-communist countries across the developing world. In these countries the informal sector developed in response to high levels of regulation in the formal economy, rigidity in the labor market, and high levels of inflation. Like informal sectors in communist countries, citizens in these economies developed personal relationships as a way to facilitate exchange in the absence of formal institutions. Citizens in the informal economy are forced to rely on alternative measures to enforce their contracts including cultivating personal relationship with business associates (De Soto 1990, 167). In a context of over-regulation it may even be more cost-efficient to rely upon personal relationship to facilitate exchange rather than relying on formal institutions (Roberts 1994, 8). The use of these relationships in the informal economy creates a norm within society that informal contracting and personal relationships are an acceptable way to conduct business. As the economy matures

and formalizes this norm persists, creating conditions conducive to personal relationships facilitating FDI.

Many countries also have cultural traditions that emphasize the importance of personal relationships and interdependence in everyday life and business. In China this is the concept of *gaunxi*; in Russia its *blat*; in Latin America its *palanca*; Indians refer to it as *jugaad*; it is called *ubuntu* in sub-Saharan Africa; and *wasta* in the Middle East. The precise meaning of each depends on the culture, but in each case they place an emphasis on interpersonal relationships as central to accomplishing goals in society. As these countries' economies evolved the importance of relationships transitioned beyond everyday life and towards business. Personal connections are now an important part of doing business in these societies. Cultural focus on personal connections in these societies helps to create the conditions under which personal relationships can help investors deal with a weak rule of law. Since this norm already exists in these societies it is easier for investors to tap into these networks in order to help reduce the uncertainty created by a weak rule of law.

Finally, the family-owned business continues to be the preferred ownership model throughout the developing world and is a natural result of cultures that emphasize the importance of family, collective interests, and personal connections. Family-owned businesses tend to function differently than publically held corporations and these differences facilitate the use of personal relationships in business. For instance, family ownership tends to result in more centralized decision-making, which makes personal relationships more reliable by increasing trust and reducing transaction costs. Centralized decision making means all important decisions are made by one central authority figure. This facilitates the use of personal relationships because these central figures are very powerful within their firms. Thus, if they make an

agreement it is easier to trust the whole firm will follow through. When dealing with family firms investors know that if they reach an agreement with the leader that person is speaking for the rest of the firm.

Furthermore, family-owned firms operate within a network of other related firms. These business groups use personal connections to facilitate business between members of the network. In these networks agreements are supported by social-sanction. This means if one party were to back out of an agreement they would be punished by the rest of the group through exclusion. Because the group can substitute for the missing formal institutions these business groups operate more efficiently than other ownership arrangements where the rule of law is weak. Overall, the prominence of family-owned firms in many developing countries represents a ready-made network of personal connections for foreign investors wary of a country's weak rule of law.

The Rule of Law and FDI

My research also has broader implications for political science. First, my research highlights the importance of disaggregating the concept of the rule of law. Aggregate measures of the rule of law are very useful to get an overall sense of how much law constrains actors in a particular context. But the rule of law is a complex concept that includes multiple legal dynamics. So, in order to develop precise theories about how the rule of law affects – and is affected by – other empirical outcomes, we need to examine the relationships between specific elements of the rule of law and these other important outcomes.

This project shows that investors care most about contract and property rights and the protection of physical integrity rights. It also shows that investors seek out personal relationships in contexts with a weak rule of law. My findings support those who advocate

'ends-based' understandings of the rule of law. These scholars argue previous rule-of-law promotion efforts have struggled because they place too much emphasis on developing the right institutions with out paying sufficient focus to outcomes. My research contributes to this line of critique by suggesting that the nature of the institution does not matter as long as it is providing the outcome investors desire. In the case of the rule of law, investors seem satisfied with using informal institutions, like personal relationships, instead of more formal legal institutions.

At the same time, the case study of China highlights that as formal institutions improve investors turn away from personal relationships. This suggests that while there may not be one 'right' institution in terms of the rule of law and FDI, there may be 'better' institutions. This means that in order to attract FDI developing countries need to continue their efforts to improve the institutions associated with the rule of law such as creating clear and comprehensive laws and creating functioning legal systems capable of defending investors' rights.

The dissertation also suggests that developing countries may be able to rely upon alternative institutional arrangements to support the rule of law while they work to improve formal institutions. Personal relationships are important in many developing countries and my research indicates investors can tap these relationships to help them overcome a weak rule law. Developing countries should take steps to foster connections between investors and domestic businesses and officials in order to encourage these types of relationships.

The dissertation also explored how investors overcome a weak rule of law. Chapter 3 tested whether or not formal institutions like BITs or SEZ improve FDI inflows to countries with a weak rule of law. The results were unambiguous. FDI did not respond to the presence of formal institutions. This does not mean that these agreements are not important for FDI. These agreements contain a number of different incentives and benefits that make a host-country more

attractive. In fact, U.S. investors have been pushing both China and the United States to come to terms on a BIT for two decades in hopes of making investment in China easier. However, my results call into question the belief that these agreements can help make up for a weak rule of law.

The Rational Investor?

Economists and political scientists typically assume foreign investors are rational actors that weigh the costs and benefits of an investment before making their decisions. This school of thought has been called into question when conditions in a host-country make it difficult for investors to accurately judge costs and benefits. My research contributes to this debate by examining investment in countries with a weak rule of law. A weak rule of law generates a great deal of uncertainty that can make it difficult for investors to evaluate costs and benefits. I found that investors use personal relationships to help them overcome the uncertainty of a weak rule of law. This supports those who challenge the 'rational investor' paradigm by highlighting the importance of factors outside typical costs and benefits in the investment process. At the same time my research shows that a certain level of economic opportunity can overcome a weak rule of law. In these cases it appears that if a country's economy is good enough investors can see past the uncertainty of a weak rule of law. In these cases they may not be able to completely gauge costs and benefits, but they can assess the benefits enough to judge the investment sound despite the risks.

Overall, my dissertation supports the view of investors as rational actors seeking to maximize benefits and reduce costs. In order to do so investors are willing to take chances on personal relationships when they judge these relationships as preferable to formal institutions. Investors are rational in the sense that they seek out substitutes for a weak rule of law that can

provide them with the same benefits. This allows investors to make a better assessment of the costs and benefits of an investment. At the same time, investors take a chance that the personal connection will deliver on their promises. Without formal institutions to support them, investors are forced to place a great deal of faith in their relationships.

The Relationship between Formal and Informal Institutions

In addition to demonstrating the importance of informal institutions for FDI, my research contributes to our understanding of the relationship between formal and informal institutions. More specifically, my project suggests other institutions within a society shape the importance of personal relationships. In particular, Chapter 4 demonstrated that the importance and role of personal relationships in business are dependent upon the political, social, and legal conditions in a country. In China, a weak rule of law, cultural norms that stress the importance of personal relationships in all aspects of life, and the pervasiveness of the CCP created conditions where personal relationships became critical for FDI. However, as these conditions changed so too did the importance of personal relationships. The second half of Chapter 4 demonstrated that the importance of personal relationship declined during the 2000s as China improved its respect for the rule of law and began to tackle corruption. These changes continue today.

On January 23, 2013 Xi Jinping, Chairman of the CCP, gave a speech before the CCP's Central Commission for Discipline Inspection where he identified corruption as one of the central challenges facing China. In the speech he stated, “We must have the resolve to fight every corrupt phenomenon, punish every corrupt official and constantly eliminate the soil which breeds corruption, so as to earn people's trust with actual results” (Xinhuanet 2013). With this speech Xi Jinping began one of China’s most far-reaching anti-corruption campaigns by promising to root out corruption by both ‘tigers’ and ‘flies’ (Wong 2012). In addition to a

number of lower-level officials (flies), the campaign has pursued a surprising number of upper-level officials (tigers) including a former member of the Politburo Standing Committee (the highest body in the CCP), a General and former Vice Chairman of the Central Military Commission, and Bo Xilai, a Chinese 'princeling' and Politburo member. In fact, the campaign netted so many high-ranking officials (40 at the level of vice-chairman or higher by September 2014) that the party was running out of room in the 'luxury prison' used to house high-ranking officials (Tiezzi 2014).

In addition to cracking down on corrupt officials, the CCP instituted a series of new rules designed to reduce corruption. Limits have been placed on gift giving, the use of vehicles, meals and banquets, travel, and hotel accommodations (Donovan 2014). The government is also enlisting the help of citizens in the campaign by asking them to report government officials seen spending lavishly. These new rules are already changing the behavior of government officials as evidenced by the steep decline in the sale of luxury goods in China and Hong Kong. Some estimate government officials accounted for half of all luxury good sales, but with the new rules in place luxury good sales declined almost 30% in 2013 (Osnos 2013). The tourism and travel industries have also felt the impact of the new rules. Macau's gambling industry witnessed a 23% drop in revenue in October of 2014 reflecting a decline in spending by Chinese officials (Masters 2014).

A number of international investors have also been caught up in the anti-corruption campaign. Foreign officials have faced both fines and jail time for violating Chinese anti-corruption laws. In the most high-profile case, China fined GlakoSmithKlein (GSK), the British pharmaceutical company, a record $490 million and sentenced GSK's head of Chinese operations to a three-year suspended sentence (BBC 2014). As a result of the anti-bribery

campaign foreign firms are stepping up their efforts to comply with local Chinese laws (Waldmeir 2014).

These changes to formal institutions are likely to impact informal institutions like personal relationships. Personal relationships have been a fundamental part of Chinese society for centuries. Furthermore, years of communist economic planning made Chinese citizens reliant on personal relationships as the only way to obtain necessary goods and services in an economy marked by over-regulation and scarcity. However, this most recent campaign may impact personal relationship more than previous campaigns because it specifically targets the cultural practices that lay beneath personal relationships. In China these connections are built upon an elaborate process where relationships are established through gift giving and banquets. The most recent campaign targets these behaviors for the first time and appear to be having success. In a 2014 survey of low-level Chinese officials 90% reported they did not receive any gifts during 2013 (Moses 2014). Gifts have traditionally served as the basis for establishing and maintaining personal relationships in China and without them businesses are struggling to figure out how to make connections they feel are important for their businesses. Furthermore, government officials have become fearful of accepting gifts, meals, or appearing too close with businesses, even if the relationship is not corrupt, out of fear of the anti-corruption campaign (Interview 12; Interview 13). Government officials are actually afraid to start new project for fear of appearing corrupt. As a result, government bank deposits are at all-time highs as officials hold off on authorizing new projects (Sudworth 2014).

These political actions combined with continued improvements in China's legal system (as discussed in Chapter 4) are likely to reduce the importance of personal relationships for FDI in China. These changes highlight the relationship between informal and formal institutions.

Informal institutions arise in the absence of formal institutions on the basis of existing social norms. The formal institutional environment existing within the country helps to shape these norms. In the case of China, the concept of *guanxi* has existed for centuries but its role in society changed with the advent of communist rule. Under communism, *guanxi* helped Chinese citizens survive scarcity and navigate a complex bureaucracy. The collapse of communism, the rise of capitalism, and the influx of FDI altered the role of *guanxi* yet again. Now it has moved beyond connections between Chinese to include relationships between business partners and government officials and helped to fill-in for weaknesses in China's rule of law. Finally, the role of *guanxi* becomes less pronounced as the formal legal institutions improved. The most recent anti-corruption campaign has only sped up this process by attacking the cultural underpinnings of *guanxi* and changing the political environment in which relationships take place.

Overall, this dissertation clarified our understanding of which particular aspects of the rule of law matter for FDI. In particular, it found contract/property rights and physical integrity rights are the most important aspects for FDI. The project also explained why countries with a weak rule of law are able to attract FDI. Using statistics, a survey, and a case study the dissertation demonstrated the important role personal relationships play in reduce investor uncertainty and encouraging FDI.

Bibliography

Aboal, Diego, Nelson Noya, and Andrés Rius. 2014. “Contract Enforcement and Investment: A Systematic Review of the Evidence.” *World Development* 64 (December): 322–38. doi:10.1016/j.worlddev.2014.06.002.

Acemoglu, Daron, and James Robinson. 2012. *Why Nations Fail: The Origins of Power, Prosperity, and Poverty*. Random House LLC.

Ambler, Tim, and Morgen Witzel. 2004. *Doing Business in China*. London: Psychology Press.

AmCham. 2005. “The Climate for U.S. Business in China.” http://www.amchamchina.org/article/3181.

———. 2006. “American Corporate Experience in a Changing China.” http://www.amchamchina.org/article/3183.

American Bar Association. 2013. “Total National Lawyer Counts 1878 - 2013.” http://www.americanbar.org/content/dam/aba/administrative/market_research/total_national_lawyer_counts_1878_2013.authcheckdam.pdf.

Apodaca, Clair. 2001. “Global Economic Patterns and Personal Integrity Rights After the Cold War.” *International Studies Quarterly* 45 (4): 587–602. doi:10.1111/0020-8833.00215.

Asiedu, Elizabeth. 2002. “On the Determinants of Foreign Direct Investment to Developing Countries: Is Africa Different?” *World Development* 30 (1): 107–19. doi:10.1016/S0305-750X(01)00100-0.

Asiedu, Elizabeth, and Donald Lien. 2004. “Capital Controls and Foreign Direct Investment.” *World Development* 32 (3): 479–90. doi:10.1016/j.worlddev.2003.06.016.

Associated Press. 2007. “China Launches Anti-Corruption Campaign,” May 10.

Bandelj, Nina. 2002. “Embedded Economies: Social Relations as Determinants of Foreign Direct Investment in Central and Eastern Europe.” *Social Forces* 81 (2): 411–44. doi:10.1353/sof.2003.0001.

———. 2008. *From Communists to Foreign Capitalists: The Social Foundations of Foreign Direct Investment in Postsocialist Europe*. Princeton, N.J: Princeton University Press.

Banister, Judith. 2005. “Manufacturing Earning and Compensation in China.” *Monthly Labor Review*, August. http://www.bls.gov/opub/mlr/2005/08/art3full.pdf.

Barro, Robert J., and Jong Wha Lee. 2013. “A New Data Set of Educational Attainment in the World, 1950–2010.” *Journal of Development Economics* 104 (September): 184–98. doi:10.1016/j.jdeveco.2012.10.001.

Beamish, Paul W. 1993. “The Characteristics of Joint Ventures in the People’s Republic of China.” *Journal of International Marketing* 1 (2): 29–48.

“BEA Online.” http://www.bea.gov/itable/index.cfm.

Bénassy-Quéré, Agnès, Lionel Fontagné, and Amina Lahrèche-Révil. 2005. “How Does FDI React to Corporate Taxation?” *International Tax and Public Finance* 12 (5): 583–603. doi:10.1007/s10797-005-2652-4.

Bersani, Mathew. 1992. “Enforcement of Arbitration Awards in China: Foreigners Find the System Sorely Lacking.” *China Business Review*.

Bickenbach, Frank, and Wan-Hsin Liu. 2010. “On the Role of Personal Relationships for Doing Business in the Greater Pearl River Delta, China.” *China Economic Journal* 3 (3): 281–306. doi:10.1080/17538963.2010.562043.

Biglaiser, Glen, and Karl R. DeRouen. 2006. “Economic Reforms and Inflows of Foreign Direct Investment in Latin America.” *Latin American Research Review* 41 (1): 51–75. doi:10.1353/lar.2006.0001.

Biglaiser, Glen, and Joseph L. Staats. 2010. “Do Political Institutions Affect Foreign Direct Investment? A Survey of U.S. Corporations in Latin America.” *Political Research Quarterly* 63 (3): 508–22. doi:10.1177/1065912909331428.

Björkman, Ingmar, and Sören Kock. 1995. “Social Relationships and Business Networks: The Case of Western Companies in China.” *International Business Review*, Relationship Marketing, 4 (4): 519–35. doi:10.1016/0969-5931(95)00023-2.

Blanton, Robert G., and Shannon Lindsey Blanton. 2010. “Rights, Institutions and FDI: An Empirical Assessment.” In *Annual Meeting American Political Science Association*. Washington D.C. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1643070.

Blanton, Shannon Lindsey, and Robert G Blanton. 2007. “What Attracts Foreign Investors? An Examination of Human Rights and Foreign Direct Investment.” *Journal of Politics* 69 (1): 143–55. doi:10.1111/j.1468-2508.2007.00500.x.

Blomström, Magnus, and Ari Kokko. 1998. “Multinational Corporations and Spillovers.” *Journal of Economic Surveys* 12 (3): 247–77. doi:10.1111/1467-6419.00056.

Blonigen, Bruce. 2005. “A Review of the Empirical Literature on FDI Determinants.” *Atlantic Economic Journal* 33 (4): 383–403. doi:10.1007/s11293-005-2868-9.

Bowles, Samuel, and Herbert Gintis. 2004. “Persistent Parochialism: Trust and Exclusion in Ethnic Networks.” *Journal of Economic Behavior & Organization* 55 (1): 1–23. doi:10.1016/j.jebo.2003.06.005.

Brady, Henry E., and David Collier, eds. 2010. *Rethinking Social Inquiry: Diverse Tools, Shared Standards*. 2nd ed. Lanham, Md: Rowman & Littlefield Publishers.

Brainard, S. Lael. 1993. “An Empirical Assessment of the Proximity-Concentration Tradeoff between Multinational Sales and Trade.” *National Bureau of Economic Research Working Paper Series* No. 4580. http://www.nber.org/papers/w4580.

Brewer, Thomas L. 1993. “Government Policies, Market Imperfections, and Foreign Direct Investment.” *Journal of International Business Studies* 24 (1): 101–20.

Brouthers, Lance Eliot, Yan Gao, and Jason Patrick McNicol. 2008. “Corruption and Market Attractiveness Influences on Different Types of FDI.” *Strategic Management Journal* 29 (6): 673–80. doi:10.1002/smj.669.

Brouthers, Lance Eliot, Steve Werner, and Timothy J. Wilkinson. 1996. “The Aggregate Impact of Firms’ FDI Strategies on the Trade Balances of Host Countries.” *Journal of International Business Studies* 27 (2): 359–73.

Calantone, Roger J., and Yushan Sam Zhao. 2001. “Joint Ventures in China: A Comparative Study of Japanese, Korean, and U.S. Partners.” *Journal of International Marketing* 9 (1): 1–23.

Carney, Michael. 2005. “Corporate Governance and Competitive Advantage in Family-Controlled Firms.” *Entrepreneurship Theory and Practice* 29 (3): 249–65. doi:10.1111/j.1540-6520.2005.00081.x.

Carothers, Thomas. 1998. “Rule of Law Revival, The.” *Foreign Affairs* 77: 95.

———. , ed. 2006. *Promoting the Rule of Law Abroad: In Search of Knowledge*. Washington, D.C: Carnegie Endowment for International Peace.

Carr, David L., James R. Markusen, and Keith E. Maskus. 1998. “Estimating the Knowledge-Capital Model of the Multinational Enterprise.” *National Bureau of Economic Research Working Paper Series* No. 6773. http://www.nber.org/papers/w6773.

———. 2001. “Estimating the Knowledge-Capital Model of the Multinational Enterprise.” *The American Economic Review* 91 (3): 693–708.

Carrubba, Clifford J. 2005. “Courts and Compliance in International Regulatory Regimes.” *The Journal of Politics* 67 (03). doi:10.1111/j.1468-2508.2005.00334.x.

Carrubba, Clifford James. 2009. “A Model of the Endogenous Development of Judicial Institutions in Federal and International Systems.” *The Journal of Politics* 71 (01): 55–69. doi:10.1017/S002238160809004X.

Chantasasawat, Busakorn, K. C. Fung, Hitomi Iizaka, and Alan Siu. 2010. “FDI Flows to Latin America, East and Southeast Asia, and China: Substitutes or Complements?” *Review of Development Economics* 14 (3): 533–46. doi:10.1111/j.1467-9361.2010.00569.x.

Cheng, Leonard K., and Yum K. Kwan. 2000. “What Are the Determinants of the Location of Foreign Direct Investment? The Chinese Experience.” *Journal of International Economics* 51 (2): 379–400. doi:10.1016/S0022-1996(99)00032-X.

Cheung, Kui-yin, and Ping LIN. 2004. “Spillover Effects of FDI on Innovation in China: Evidence from the Provincial Data.” *China Economic Review* 15 (1): 25–44. doi:10.1016/S1043-951X(03)00027-0.

Cingranelli, D. L. and Richards, D. L. 2010. *The Cingranelli-Richards (CIRI) Human Rights Dataset*. Version 2010.05.17. http://www.humanrightsdata.org.

Clague, Christopher, Philip Keefer, Stephen Knack, and Mancur Olson. 1999. “Contract-Intensive Money: Contract Enforcement, Property Rights, and Economic Performance.” *Journal of Economic Growth* 4 (2): 185–211. doi:10.1023/A:1009854405184.

Clarke, Donald C. 2007. “Introduction: The Chinese Legal System Since 1995: Steady Development and Striking Continuities.” *The China Quarterly* 191 (September): 555–66. doi:10.1017/S0305741007001567.

Cohen, Stephen D. 2007. *Multinational Corporations and Foreign Direct Investment: Avoiding Simplicity, Embracing Complexity*. New York: Oxford University Press.

Cole, Matthew A., Robert J.R. Elliott, and Jing Zhang. 2009. “Corruption, Governance and FDI Location in China: A Province-Level Analysis.” *Journal of Development Studies* 45 (9): 1494–1512. doi:10.1080/00220380902890276.

Collier, P. 1999. “On the Economic Consequences of Civil War.” *Oxford Economic Papers* 51 (1): 168–83. doi:10.1093/oep/51.1.168.

Collier, Paul, and Catherine A Pattillo. 2000. “Investment and Risk in Africa.” In . New York: St. Martin’s Press.

Crenshaw, Edward. 1991. “Foreign Investment as a Dependent Variable: Determinants of Foreign Investment and Capital Penetration in Developing Nations, 1967-1978.” *Social Forces* 69 (4): 1169–82. doi:10.2307/2579307.

Cross, Karen Halverson. 2008. *China’s WTO Accession: Economic, Legal, and Political Implications*. SSRN Scholarly Paper ID 1082546. Rochester, NY: Social Science Research Network. http://papers.ssrn.com/abstract=1082546.

Cungu, Azeta, Hamish Gow, Johan F. M. Swinnen, and Liesbet Vranken. 2008. “Investment with Weak Contract Enforcement: Evidence from Hungary during Transition.” *European Review of Agricultural Economics* 35 (1): 75–91. doi:10.1093/erae/jbn001.

Das, Mitali, and Papa N ’Diaye. 2013. “Chronicle of a Decline Foretold: Has China Reached the Lewis Turning Point?” *IMF Working Paper*, January. http://www.imf.org/external/pubs/ft/wp/2013/wp1326.pdf.

Davies, Howard, Thomas K. P Leung, Sherriff T. K Luk, and Yiu-hing Wong. 1995. “The Benefits of ‘Guanxi’: The Value of Relationships in Developing the Chinese Market.” *Industrial Marketing Management* 24 (3): 207–14. doi:10.1016/0019-8501(94)00079-C.

Dessler, David. 1991. “Beyond Correlations: Toward a Causal Theory of War.” *International Studies Quarterly* 35 (3): 337–55. doi:10.2307/2600703.

Dicey, Albert Venn. 1915. *Introduction to the Study of the Law of the Constitution*. London: Macmillan.

DiMaggio, Paul, and Hugh Louch. 1998. “Socially Embedded Consumer Transactions: For What Kinds of Purchases Do People Most Often Use Networks?” *American Sociological Review* 63 (5): 619–37. doi:10.2307/2657331.

“Distrust About China’s Antitrust Campaign.” 2014. *The Diplomat*. Accessed November 5. http://thediplomat.com/2014/09/distrust-about-chinas-antitrust-campaign/.

Dixit, Avinash, and Robert S. Pindyck. 1994. *Invesment Under Uncertainty*. New York: Princeton University Press.

Donovan, Tim. 2014. “China’s Crackdown on Corruption and Government Spending: A Timeline | China Business Review.” *China Business Review*, January 23.

http://www.chinabusinessreview.com/chinas-crackdown-on-corruption-and-government-spending-a-timeline/.

Duhigg, Charles, and Keith Bradsher. 2012. “Apple, America and a Squeezed Middle Class.” *The New York Times*, January 21, sec. Business Day. http://www.nytimes.com/2012/01/22/business/apple-america-and-a-squeezed-middle-class.html.

Du, Julan, Yi Lu, and Zhigang Tao. 2008. “Economic Institutions and FDI Location Choice: Evidence from US Multinationals in China.” *Journal of Comparative Economics* 36 (3): 412–29. doi:10.1016/j.jce.2008.04.004.

Dunning, John H. 1988. “The Eclectic Paradigm of International Production: A Restatement and Some Possible Extensions.” *Journal of International Business Studies* 19 (1): 1–31.

Edwards, Sebastian. 1992. “Capital Flows, Foreign Direct Investment, and Debt-Equity Swaps in Developing Countries.” *National Bureau of Economic Research Working Paper Series* No. 3497. http://www.nber.org/papers/w3497.

Egger, Peter, and Hannes Winner. 2005. “Evidence on Corruption as an Incentive for Foreign Direct Investment.” *European Journal of Political Economy* 21 (4): 932–52. doi:10.1016/j.ejpoleco.2005.01.002.

Elizabeth, Asiedu. 2002. “On the Determinants of Foreign Direct Investment to Developing Countries: Is Africa Different?” *World Development* 30 (1): 107–19. doi:10.1016/S0305-750X(01)00100-0.

Epstein, Lee, Jack Knight, and Olga Shvetsova. 2001. “The Role of Constitutional Courts in the Establishment and Maintenance of Democratic Systems of Government.” *Law & Society Review* 35 (1): 117–64. doi:10.2307/3185388.

Faccio, Mara. 2006. “Politically Connected Firms.” *The American Economic Review* 96 (1): 369–86.

Fallon, Richard H. Jr. 1997. “Rule of Law as a Concept in Constitutional Discourse, The.” *Columbia Law Review* 97: 1.

Fewsmith, Joseph. 2001. “The Political and Social Implications of China’s Accession to the WTO.” *The China Quarterly* 167 (September): 573–91. doi:10.1017/S0009443901000328.

Finkel, Jodi. 2005. “Judicial Reform as Insurance Policy: Mexico in the 1990s.” *Latin American Politics and Society* 47 (1): 87–113. doi:10.1111/j.1548-2456.2005.tb00302.x.

Folta, Paul H. 2005. “Cooperative Joint Ventures.” *China Business Review*, January 2. http://www.chinabusinessreview.com/cooperative-joint-ventures/.

Frye, T., and E. Zhuravskaya. 2000. “Rackets, Regulation, and the Rule of Law.” *Journal of Law, Economics, and Organization* 16 (2): 478–502. doi:10.1093/jleo/16.2.478.

Gakidou, Emmanuela, Krycia Cowling, Rafael Lozano, and Christopher JL Murray. 2010. “Increased Educational Attainment and Its Effect on Child Mortality in 175 Countries between 1970 and 2009: A Systematic Analysis.” *The Lancet* 376 (9745): 959–74. doi:10.1016/S0140-6736(10)61257-3.

Gastanaga, Victor M., Jeffrey B. Nugent, and Bistra Pashamova. 1998. “Host Country Reforms and FDI Inflows: How Much Difference Do They Make?” *World Development* 26 (7): 1299–1314. doi:10.1016/S0305-750X(98)00049-7.

Gelatt, Timothy A. 1990. “Lawyers in China: The Past Decade and beyond.” *New York University Journal of International Law and Politics* 23: 751.

George, Alexander L. 2005. *Case Studies and Theory Development in the Social Sciences*. BCSIA Studies in International Security. Cambridge, Mass: MIT Press.

Globerman, Steven, and Daniel Shapiro. 2003. “Governance Infrastructure and US Foreign Direct Investment.” *Journal of International Business Studies* 34 (1): 19–39.

Gordon, Roger H., and James R. Hines Jr. 2002. “Chapter 28 International Taxation.” In *Handbook of Public Economics,* Volume 4:1935–95. Elsevier. http://www.sciencedirect.com/science/article/pii/S1573442002800076.

Görg, Holger, and Eric Strobl. 2005. “Spillovers from Foreign Firms through Worker Mobility: An Empirical Investigation.” *The Scandinavian Journal of Economics* 107 (4): 693–709. doi:10.1111/j.1467-9442.2005.00427.x.

Gourevitch, Peter. 1978. “The Second Image Reversed: The International Sources of Domestic Politics.” *International Organization* 32 (04): 881–912. doi:10.1017/S002081830003201X.

Granovetter, Mark. 1985. “Economic Action and Social Structure: The Problem of Embeddedness.” *American Journal of Sociology* 91 (3): 481–510.

“GSK Fined $490m by China for Bribery.” 2014. *BBC News*. Accessed November 5. http://www.bbc.com/news/business-29274822.

Guthrie, Douglas. 1998. “The Declining Significance of Guanxi in China’s Economic Transition.” *The China Quarterly* 154 (June): 254–82. doi:10.1017/S0305741000002034.

———. 2001. *Dragon in a Three-Piece Suit: The Emergence of Capitalism in China*. Princeton University Press.

———. 2009. *China and Globalization: The Social, Economic and Political Transformation of Chinese Society*. Rev. ed. Global Realities. New York: Routledge.

Gyimah-Brempong, Kwabena. 2002. “Corruption, Economic Growth, and Income Inequality in Africa.” *Economics of Governance* 3 (3): 183–209. doi:10.1007/s101010200045.

Habib, Mohsin, and Leon Zurawicki. 2002. “Corruption and Foreign Direct Investment.” *Journal of International Business Studies* 33 (2): 291–307.

Haggard, Stephan, Andrew MacIntyre, and Lydia Tiede. 2008. “The Rule of Law and Economic Development.” *Annual Review of Political Science* 11 (1): 205–34. doi:10.1146/annurev.polisci.10.081205.100244.

Halaby, Charles N. 2004. “Panel Models in Sociological Research: Theory into Practice.” *Annual Review of Sociology* 30 (January): 507–44.

Hale, Galina, and Cheryl X. Long. 2006. “FDI Spillovers and Firm Ownership in China: Labor Markets and Backward Linkages.” *Federal Reserve Bank of San Francisco Working Paper No. 2006-25*, August. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=938518.

Hall, Peter A., and Rosemary C. R. Taylor. 1996. “Political Science and the Three New Institutionalisms*.” *Political Studies* 44 (5): 936–57. doi:10.1111/j.1467-9248.1996.tb00343.x.

Hatum, Andrés, and Andrew Pettigrew. 2004. “Adaptation Under Environmental Turmoil: Organizational Flexibility in Family-Owned Firms.” *Family Business Review* 17 (3): 237–58. doi:10.1111/j.1741-6248.2004.00016.x.

Hayek, Friedrich A. von. 1944. *The Road to Serfdom*. Chicago: University of Chicago Press.

Hay, Jonathan R., and Andrei Shleifer. 1998. “Private Enforcement of Public Laws: A Theory of Legal Reform.” *The American Economic Review* 88 (2): 398–403.

Heide, Jan B. 1994. “International Governance in Marketing Channels.” *Journal of Marketing* 58 (January).

Heide, Jan B., and George John. 1992. “Do Norms Matter in Marketing Relationships?” *Journal of Marketing* 56 (2): 32–44. doi:10.2307/1252040.

Heide, Jan B, and Kenneth H Wathne. 2006. “Friends, Businesspeople, and Relationship Roles: A Conceptual Framework and a Research Agenda.” *Journal of Marketing* 70 (3): 90–103. doi:10.1509/jmkg.70.3.90.

Henisz, W. J. 2000. “The Institutional Environment for Economic Growth.” *Economics & Politics* 12 (1): 1–31. doi:10.1111/1468-0343.00066.

Henisz, W. J. 2000. “The Institutional Environment for Multinational Investment.” *Journal of Law, Economics, and Organization* 16 (2): 334–64. doi:10.1093/jleo/16.2.334.

Hillman, Amy J., Asghar Zardkoohi, and Leonard Bierman. 1999. “Corporate Political Strategies and Firm Performance: Indications of Firm-Specific Benefits from Personal Service in the U.S. Government.” *Strategic Management Journal* 20 (1): 67–81. doi:10.1002/(SICI)1097-0266(199901)20:1<67::AID-SMJ22>3.0.CO;2-T.

Hsu, Carolyn L. 2005. “Capitalism without Contracts versus Capitalists without Capitalism: Comparing the Influence of Chinese Guanxi and Russian Blat on Marketization.” *Communist and Post-Communist Studies* 38 (3): 309–27. doi:10.1016/j.postcomstud.2005.06.003.

Huntington, Samuel P. 2006. *Political Order in Changing Societies*. New ed. New Haven, Conn.□; London: Yale University Press.

Hutzschenreuter, Thomas, Torben Pedersen, and Henk W. Volberda. 2007. “The Role of Path Dependency and Managerial Intentionality: A Perspective on International Business Research.” *Journal of International Business Studies* 38 (7): 1055–68. doi:10.1057/palgrave.jibs.8400326.

Inglehart, Ronald, and Christian Welzel. 2005. *Modernization, Cultural Change, and Democracy: The Human Development Sequence*. New York: Cambridge University Press.

International Country Risk Guide Political Risk Services. 2011. East Syracuse, NY: Political Risk Services.

Jain, ed. 2001. “Corruption, Growth and Public Finances.” In *The Political Economy of Corruption*. London: Routledge.

Jaspersen, F, A Aylward, and A Knox. 2000. “The Effects of Risk on Private Investment: Africa Compared with Other Developing Areas.” In *Investment and Risk in Africa*, edited by Paul Collier and Catherine Pattillo, 71–95. St. Martin’s Press.

Javorcik, Beata. 2004. “Does Foreign Direct Investment Increase the Productivity of Domestic Firms? In Search of Spillovers Through Backward Linkages.” *The American Economic Review* 94 (3): 605–27. doi:10.1257/0002828041464605.

Jensen, Nathan M. 2003. “Democratic Governance and Multinational Corporations: Political Regimes and Inflows of Foreign Direct Investment.” *International Organization* 57 (3): 587–616.

Jensen, Nathan M. 2006. *Nation-States and the Multinational Corporation: A Political Economy of Foreign Direct Investment*. Princeton, N.J: Princeton University Press.

Kaufmann, Daniel, Aart Kraay, and Massimo Mastruzzi. 2009. “Governance Matters VIII: Aggregate and Individual Governance Indicators, 1996-2008.” *SSRN eLibrary*, June. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1424591.

Khadaroo, Jameel, and Boopen Seetanah. 2009. “The Role of Transport Infrastructure in FDI: Evidence from Africa Using GMM Estimates.” *Journal of Transport Economics and Policy (JTEP)* 43 (3): 365–84.

Khanna, Tarun, and Yishay Yafeh. 2007. “Business Groups in Emerging Markets: Paragons or Parasites?” *Journal of Economic Literature* 45 (2): 331–72.

Khwaja, Asim Ijaz, and Atif Mian. 2005. “Do Lenders Favor Politically Connected Firms? Rent Provision in an Emerging Financial Market.” *The Quarterly Journal of Economics* 120 (4): 1371–1411.

Kleinfeld, Rachel. 2006. “Competing Definitions of the Rule of Law.” In *Promoting the Rule of Law Abroad: In Search of Knowledge*, edited by Thomas Carothers. Washington D.C.: Carnegie Endowment for International Peace.

Leahy, Dermot, and Stephen Pavelin. 2003. “Follow-My-Leader FDI and Tacit Collusion.” *International Journal of Industrial Organization* 21 (3): 439–53. doi:10.1016/S0167-7187(02)00091-7.

Ledeneva, Alena V. 1998. *Russia’s Economy of Favours: Blat, Networking and Informal Exchange*. Cambridge University Press.

———. 2003. “Informal Practices in Changing Societies: Comparing Chinese Guanxi and Russian Blat.” Working / discussion paper. *(Economics Working Papers 45). Centre for the Study of Economic and Social Change in Europe SSEES, UCL: London, UK. (2003)*. September. http://discovery.ucl.ac.uk/17529/.

———. 2008. “Blat and Guanxi: Informal Practices in Russia and China.” *Comparative Studies in Society and History* 50 (01): 118–44. doi:10.1017/S0010417508000078.

Lewis, W. Arthur. 1954. “Economic Development with Unlimited Supplies of Labour.” *The Manchester School* 22 (2): 139–91. doi:10.1111/j.1467-9957.1954.tb00021.x.

Lieberman, Evan S. 2005. “Nested Analysis as a Mixed-Method Strategy for Comparative Research.” *American Political Science Review* 99 (03): 435–52. doi:10.1017/S0003055405051762.

Li, Hongbin, Lingsheng Meng, Qian Wang, and Li-An Zhou. 2008. “Political Connections, Financing and Firm Performance: Evidence from Chinese Private Firms.” *Journal of Development Economics* 87 (2): 283–99. doi:10.1016/j.jdeveco.2007.03.001.

Linzer, Drew A., and Jeffrey K. Staton. 2012. “A Measurement Model for Synthesizing Multiple Comparative Indicators: The Case of Judicial Independence.” http://polisci.emory.edu/faculty/jkstato/resources/WorkingPapers/LS-scaling-140430.pdf.

Lipsey, Robert E. 1999. “The Location and Characteristics of U.S. Affiliates in Asia.” *National Bureau of Economic Research Working Paper Series* No. 6876. http://www.nber.org/papers/w6876.

Li, Quan. 2009. “Democracy, Autocracy, and Expropriation of Foreign Direct Investment.” *Comparative Political Studies*, February. doi:10.1177/0010414009331723.

Li, Quan, and Adam Resnick. 2003. “Reversal of Fortunes: Democratic Institutions and Foreign Direct Investment Inflows to Developing Countries.” *International Organization* 57 (01): 175–211. doi:10.1017/S0020818303571077.

Litwack, John M., and Yingyi Qian. 1998. “Balanced or Unbalanced Development: Special Economic Zones as Catalysts for Transition.” *Journal of Comparative Economics* 26 (1): 117–41. doi:10.1006/jcec.1997.1502.

Loree, David W., and Stephen E. Guisinger. 1995. “Policy and Non-Policy Determinants of U.S. Equity Foreign Direct Investment.” *Journal of International Business Studies* 26 (2): 281–99.

Lo, Vai Io. 2009. *Law for Foreign Business and Investment in China*. London□; New York: Routledge.

Lubman, Stanley B. 1999. *Bird in a Cage: Legal Reform in China after Mao*. Stanford, Calif: Stanford University Press.

Luo, Yadong. 1998. *International Investment Strategies in the People’s Republic of China*. Aldershot□; Brookfield, USA: Ashgate.

Lusch, Robert F., and James R. Brown. 1996. “Interdependency, Contracting, and Relational Behavior in Marketing Channels.” *Journal of Marketing* 60 (4): 19–38. doi:10.2307/1251899.

Lu, Yi, and Travis Ng. 2010. “Does Weak Contract Enforcement Impede R&D Alliance Formation?” http://saet.uiowa.edu/pdfs/Weak%20enforcement.pdf.

Lu, Yi, and Zhigang Tao. 2009. “Contract Enforcement and Family Control of Business: Evidence from China.” *Journal of Comparative Economics* 37 (4): 597–609. doi:10.1016/j.jce.2009.06.002.

MacLeod, W. Bentley. 2007. “Reputations, Relationships, and Contract Enforcement.” *Journal of Economic Literature* 45 (3): 595–628.

Markusen, James R., and Natalia Trofimenko. 2009. “Teaching Locals New Tricks: Foreign Experts as a Channel of Knowledge Transfers.” *Journal of Development Economics* 88 (1): 120–31. doi:10.1016/j.jdeveco.2008.02.002.

Masters, Farah. 2014. “UPDATE 2-Macau Oct Gaming Revenues Fall 23 Pct, Drop Worst on Record.” *Reuters*, November 4. http://www.reuters.com/article/2014/11/04/macau-gambling-revenue-idUSL4N0SU22120141104.

Mattoo, Aaditya. 2002. “China’s Accession to the WTO: The Services Dimension.” *World Bank Working Paper*, December. http://siteresources.worldbank.org/INTRANETTRADE/Resources/mattoo_services.pdf.

Mauro, Paolo. 1995. “Corruption and Growth.” *The Quarterly Journal of Economics* 110 (3): 681–712. doi:10.2307/2946696.

McMillan, John, and Christopher Woodruff. 1999. “Interfirm Relationships and Informal Credit in Vietnam.” *The Quarterly Journal of Economics* 114 (4): 1285–1320.

Morrison, Wayne M. 2011. *China-U.S. Trade Issues*. Congresional Research Service. http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1867&context=key_workplace&sei-redir=1&referer=http%3A%2F%2Fscholar.google.com%2Fscholar%3Fhl%3Den%26q%3Dchina%2Bu.s.%2Bauto%26btnG%3D%26as_sdt%3D1%252C5%26as_sdtp%3D#search=%22china%20u.s.%20auto%22.

Mosley, Layna, and Saika Uno. 2007. "Racing to the Bottom or Climbing to the Top? Economic Globalization and Collective Labor Rights." *Comparative Political Studies* 40 (8): 923–48. doi:10.1177/0010414006293442.

"National Bureau of Statistics China." http://www.stats.gov.cn/english/statisticaldata/AnnualData/.

Neumayer, Eric, and Laura Spess. 2005. "Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries?" *World Development* 33 (10): 1567–85. doi:10.1016/j.worlddev.2005.07.001.

North, Douglass Cecil. 1990. *Institutions, Institutional Change, and Economic Performance*. The Political Economy of Institutions and Decisions. Cambridge□; New York: Cambridge University Press.

North, Douglass C., and Barry R. Weingast. 1989. "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England." *The Journal of Economic History* 49 (04): 803–32. doi:10.1017/S0022050700009451.

O'Donnell, Guillermo. 1978. "Reflections on the Patterns of Change in the Bureaucratic-Authoritarian State." *Latin American Research Review* 13 (1): 3–38.

Oneal, John R. 1988. "Foreign Investments in Less Developed Regions." *Political Science Quarterly* 103 (1): 131–48.

Osnos, Evan. 2013. “China Targets Corruption, Luxury Brands Mourn.” *The New Yorker*. February 7. http://www.newyorker.com/news/evan-osnos/china-targets-corruption-luxury-brands-mourn.

Pak Hung, Mo. 2001. “Corruption and Economic Growth.” *Journal of Comparative Economics* 29 (1): 66–79. doi:10.1006/jcec.2000.1703.

Pan, Yigang. 1996. “Influences on Foreign Equity Ownership Level in Joint Ventures in China.” *Journal of International Business Studies* 27 (1): 1–26.

Park, Seung Ho, and Yadong Luo. 2001. “Guanxi and Organizational Dynamics: Organizational Networking in Chinese Firms.” *Strategic Management Journal* 22 (5): 455–77. doi:10.1002/smj.167.

Pearce, Jone L. 2001. “How We Can Learn How Governments Matter to Management and Organization.” *Journal of Management Inquiry* 10 (2): 103–12. doi:10.1177/1056492601102002.

Peerenboom, Randy. 2002. *China’s Long March toward Rule of Law*. Cambridge, UK□; New York: Cambridge University Press.

———. 2009. “The Future of Rule of Law: Challenges and Prospects for the Field.” *Hague Journal on the Rule of Law* 1 (01): 5–14. doi:10.1017/S1876404509000050.

Pellegrini, Lorenzo, and Reyer Gerlagh. 2004. “Corruption’s Effect on Growth and Its Transmission Channels.” *Kyklos* 57 (3): 429–56. doi:10.1111/j.0023-5962.2004.00261.x.

People’s Daily. 2002. “Number of Lawyers Rapidly Rising in China.” *People’s Daily*, July 8. http://www.china.org.cn/english/Life/36430.htm.

Peters, B. Guy. 2005. *Institutional Theory in Political Science: The “New Institutionalism.”* 2nd ed. London: Continuum.

Poole, Jennifer P. “Multinational Spillovers through Worker Turnover.” Department of Economics, University of California, Santa Cruz.

Poppo, Laura, and Todd Zenger. 2002. “Do Formal Contracts and Relational Governance Function as Substitutes or Complements?” *Strategic Management Journal* 23 (8): 707–25. doi:10.1002/smj.249.

Potter, Pittman B. 1996. “Foreign Investment Law in the People’s Republic of China: Dilemmas of State Control.” In *China’s Legal Reforms*, edited by Stanley Lubman, 155–85. New York: Oxford University Press.

———. 2001. *The Chinese Legal System: Globalization and Local Legal Culture*. Routledge Studies on China in Transition 11. London□; New York: Routledge.

Puck, Jonas F., Dirk Holtbrügge, and Alexander T. Mohr. 2008. “Beyond Entry Mode Choice: Explaining the Conversion of Joint Ventures into Wholly Owned Subsidiaries in the People’s Republic of China.” *Journal of International Business Studies* 40 (3): 388–404. doi:10.1057/jibs.2008.56.

Rae, Sheila. 2002. “AmCham China - The WTO Drives Big Changes in China’s Auto Industry.” April 3. http://www.amchamchina.org/article/5853.

Rao, Alaka N., Jone L. Pearce, and Katherine Xin. 2005. “Governments, Reciprocal Exchange and Trust among Business Associates.” *Journal of International Business Studies* 36 (1): 104–18.

Raz, Joseph. 1979. *The Authority of Law□: Essays on Law and Morality*. Oxford □;New York: Clarendon Press□;;Oxford University Press.

Roberts, Bryan. 1994. “Informal Economy and Family Strategies.” *International Journal of Urban and Regional Research* 18 (1): 6–23. doi:10.1111/j.1468-2427.1994.tb00248.x.

Rogers, James R. 2001. “Information and Judicial Review: A Signaling Game of Legislative-Judicial Interaction.” *American Journal of Political Science* 45 (1): 84–99. doi:10.2307/2669361.

Rushford, Greg. 1999. “Chinese Arbitration: Can It Be Trusted?” *Asian Wall Steet Journal*, November 19.

Salacuse, Jeswald W., and Nicholas P. Sullivan. 2005. “Do BITs Really Work: An Evaluation of Bilateral Investment Treaties and Their Grand Bargain.” *Harvard International Law Journal* 46: 67.

Schneider, Friedrich, and Bruno S Frey. 1985. “Economic and Political Determinants of Foreign Direct Investment.” *World Development* 13 (2): 161–75. doi:10.1016/0305-750X(85)90002-6.

Seidlitz, Peter, and David Murphy. 1998. “Foreigners Stuck in Legal Trap, Mainland Courts Are in the Dock.” *South China Morning Post*, October 25.

Sen, Amartya Kumar. 1999. *Development as Freedom*. New York: Random House Digital, Inc.

Sheng, Shibin, Kevin Zheng Zhou, and Julie Juan Li. 2011. “The Effects of Business and Political Ties on Firm Performance: Evidence from China.” *Journal of Marketing* 75 (1): 1–15. doi:10.1509/jmkg.75.1.1.

Slangen, Arjen H. L., and Rob J. M. van Tulder. 2009. “Cultural Distance, Political Risk, or Governance Quality? Towards a More Accurate Conceptualization and Measurement of External Uncertainty in Foreign Entry Mode Research.” *International Business Review*, Multinational Enterprises and the Internationalisation Process, 18 (3): 276–91. doi:10.1016/j.ibusrev.2009.02.014.

Smith, Charles Anthony, and Mark Jorgensen Farrales. 2010. “Court Reform in Transitional States: Chile and the Philippines.” *Journal of International Relations and Development* 13 (2): 163–93. doi:10.1057/jird.2009.34.

Solinger, Dorothy J. 1989. “Urban Reform and Relational Contracting in Post-Mao China: An Interpretation of the Transition from Plan to Market□.” *Studies in Comparative Communism* 22 (2–3): 171–85. doi:10.1016/0039-3592(89)90012-4.

South China Morning Post (Hong Kong). 1994. “Buying Property Rights Is New Investment Rage,” July 24. http://www.lexisnexis.com/lnacui2api/api/version1/getDocCui?lni=3S4T-P4B0-0002-P3TW&csi=8411&hl=t&hv=t&hnsd=f&hns=t&hgn=t&oc=00240&perma=true.

Staats, Joseph L., and Glen Biglaiser. 2011a. “Foreign Direct Investment in Latin America: The Importance of Judicial Strength and Rule of Law.” *International Studies Quarterly*, 1–15.

———. 2011b. “The Effects of Judicial Strength and Rule of Law on Portfolio Investment in the Developing World*.” *Social Science Quarterly* 92 (3): 609–30. doi:10.1111/j.1540-6237.2011.00784.x.

Standifird, Stephen S, and R. Scott Marshall. 2000. “The Transaction Cost Advantage of Guanxi-Based Business Practices.” *Journal of World Business* 35 (1): 21–42. doi:10.1016/S1090-9516(99)00032-2.

Staton, Jeffrey K. 2006. “Constitutional Review and the Selective Promotion of Case Results.” *American Journal of Political Science* 50 (1): 98–112. doi:10.1111/j.1540-5907.2006.00172.x.

———. 2010. *Judicial Power and Strategic Communication in Mexico*. Cambridge [U.K.]□; New York: Cambridge University Press.

Stephenson, Matthew C. 2004. “Court of Public Opinion: Government Accountability and Judicial Independence.” *Journal of Law, Economics, and Organization* 20 (2): 379–99. doi:10.1093/jleo/ewh038.

Stone, Andrew, Brian Levy, and Ricardo Paredes. 1996. “Transaction Costs and Economic Development.” In *Empirical Studies in Institutional Change*, edited by Lee J. Alston, Thrainn Eggertsson, and Douglas C. North, 95–128. New York: Cambridge University Press.

Suchman, Mark C., and Lauren B. Edelman. 1996. “Legal Rational Myths: The New Institutionalism and the Law and Society Tradition.” *Law & Social Inquiry* 21 (4): 903–41. doi:10.1111/j.1747-4469.1996.tb00100.x.

Sudworth, John. 2014. “Price Tag of China Anti-Corruption Drive.” *BBC News*. Accessed November 5. http://www.bbc.com/news/blogs-china-blog-26864134.

TANC 2014. United States’ Office of Trade Agreements Negotiations and Compliance. http://tcc.export.gov/Trade_Agreements/Bilateral_Investment_Treaties/index.asp

Tanzi, Vito, and Hamid R. Davoodi. 2000. “Corruption, Growth, and Public Finances.” *SSRN eLibrary*, November. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=880260.

Tao, Zhigang, and Tian Zhu. 2001. “An Agency Theory of Transactions without Contract Enforcement: The Case of China.” *China Economic Review* 12 (1): 1–14. doi:10.1016/S1043-951X(01)00040-2.

The Economist. 2011. “All Change,” December 10. http://www.economist.com/node/21541448.

Tiezzi, Shannon. 2014. “China Running out of Room in ‘Luxury Prisons’ for Corrupt Officials.” *The Diplomat*. Autumn. http://thediplomat.com/2014/09/china-running-out-of-room-in-luxury-prisons-for-corrupt-officials/.

Trochev, Alexei. 2008. *Judging Russia: Constitutional Court in Russian Politics,1990-2006*. Cambridge□; New York: Cambridge University Press.

Tsai, Pan-Long. 1994. “Determinants of Foreign Direct Investment and Its Impact on Economic Growth.” *Journal of Economic Development* 19 (1): 137–63.

Tuman, John Peter, and Craig F. Emmert. 2004. “The Political Economy of U.S. Foreign Direct Investment in Latin America: A Reappraisal.” *Latin American Research Review* 39 (3): 9–28.

United Nations, Department of Economic and Social Affairs, Population Division. 2013. *World Population Prospects: The 2012 Revision*. New York.

UNCTAD 2014. International Investment Agreements Navigator. http://investmentpolicyhub.unctad.org/IIA

UNCTAD 2104. Interactive Statistical Database. http://unctad.org/en/Pages/DIAE/FDI%20Statistics/Interactive-database.aspx

University of London. 2000. *Bribery and Blat in Russia: Negotiating Reciprocity Fromthe Middle Ages to the 1990s*. Edited by Stephen Lovell, Alena V. Ledeneva, and A. B. Rogachevskiĭ. Studies in Russian and East European History and Society. New York: St. Martin’s Press.

U.S. Department of State. 2000. “1999 Country Reports on Human Rights Practices, China.” February 25. http://www.state.gov/www/global/human_rights/1999_hrp_report/china.html.

U.S. State Department. 1996. “China Human Rights Practices, 1995.” March. http://dosfan.lib.uic.edu/ERC/democracy/1995_hrp_report/95hrp_report_eap/China.html

U.S. Department of Commerce Bureau of Economic Analysis (BEA). *Interactive Data Online*. http://www.bea.gov/itable/index.cfm

Uzzi, Brian. 1997. “Social Structure and Competition in Interfirm Networks: The Paradox of Embeddedness.” *Administrative Science Quarterly* 42 (1): 35–67. doi:10.2307/2393808.

Vanberg, Georg. 2001. “Legislative-Judicial Relations: A Game-Theoretic Approach to Constitutional Review.” *American Journal of Political Science* 45 (2): 346–61. doi:10.2307/2669345.

———. 2005. *The Politics of Constitutional Review in Germany*. Political Economy of Institutions and Decisions. Cambridge□; New York: Cambridge University Press.

Vogel, Ezra F. 2011. *Deng Xiaoping and the Transformation of China*. Cambridge, Mass: Belknap Press of Harvard University Press.

Waldmeir, Patti. 2014. “Chinese Anti-Corruption Laws Worry US Companies.” *Financial Times*, February 25. http://www.ft.com/intl/cms/s/0/f44fa00c-9e0e-11e3-b429-00144feab7de.html#axzz3IAe817MW.

Wang, Jin. 2013. “The Economic Impact of Special Economic Zones: Evidence from Chinese Municipalities.” *Journal of Development Economics* 101 (March): 133–47. doi:10.1016/j.jdeveco.2012.10.009.

“WDI Online.” *World Bank World Development Indicators*. http://databank.worldbank.org/data/views/variableSelection/selectvariables.aspx?source=world-development-indicators.

Weidenbaum, Murray L., and Samuel Hughes. 1996. *The Bamboo Network: How Expatriate Chinese Entrepreneursare Creating a New Economic Superpower in Asia*. New York: Martin Kessler Books.

Weingast, Barry R. 1997. “The Political Foundations of Democracy and the Rule of Law.” *The American Political Science Review* 91 (2): 245–63. doi:10.2307/2952354.

Wei, Shang-Jin. 2000. “How Taxing Is Corruption on International Investors?” *Review of Economics and Statistics* 82 (1): 1–11. doi:10.1162/003465300558533.

———. “Foreign Direct Investment in China: Sources and Consequences.” In *Financial Deregulation and Integration in East Asia*, edited by Ito Takatoshi and Anne O. Krueger. University of Chicago Press.

Wheeler, David, and Ashoka Mody. 1992. “International Investment Location Decisions: The Case of U.S. Firms.” *Journal of International Economics* 33 (1–2): 57–76. doi:10.1016/0022-1996(92)90050-T.

Williamson, Oliver E. 1990. “A Comparison of Alternative Approaches to Economic Organization.” *Journal of Institutional and Theoretical Economics (JITE) / Zeitschrift Für Die Gesamte Staatswissenschaft* 146 (1): 61–71.

———. 1991. “Comparative Economic Organization: The Analysis of Discrete Structural Alternatives.” *Administrative Science Quarterly* 36 (2): 269–96. doi:10.2307/2393356.

Wilson, Jonathan, and Ross Brennan. 2010. “Doing Business in China: Is the Importance of Guanxi Diminishing?” *European Business Review* 22 (6): 652–65. doi:10.1108/09555341011082934.

Wong, Edward. 2012. “New Communist Party Chief in China Denounces Corruption in Speech.” *The New York Times*, November 19, sec. World / Asia Pacific. http://www.nytimes.com/2012/11/20/world/asia/new-communist-party-chief-in-china-denounces-corruption.html.

Woodruff, Christopher. 1998. “Contract Enforcement and Trade Liberalization in Mexico’s Footwear Industry.” *World Development* 26 (6): 979–91. doi:10.1016/S0305-750X(98)00031-X.

World Bank 2014. World Bank Global Preferential Trade Agreements Database. http://wits.worldbank.org/gptad/database_landing.aspx

Xiao, Geng. 2004. “People’s Republic of China’s Round-Tripping FDI: Scale, Causes and Implications.” *Asia Development Bank Institute Discussion Paper* 7. http://www5.iadb.org/laeba/downloads/WP_24_2004.pdf.

Xinhua. 2014. “CPC Solicits Holiday Tip-Offs,” August 11. http://www.chinadaily.com.cn/china/2014-08/11/content_18287131.htm.

Xinhuanet. 2013. “Xi Jinping Vows Unswerving Fight Against Corruption.” *Xinhuanet*, January 22. http://news.xinhuanet.com/english/china/2013-01/22/c_132119843.htm.

Xin, Katherine K., and Jone L. Pearce. 1996. “Guanxi: Connections As Substitutes for Formal Institutional Support.” *Academy of Management Journal* 39 (6): 1641–58. doi:10.2307/257072.

Yackee, Jason. 2008. “Bilateral Investment Treaties, Credible Commitment, and the Rule of (International) Law: Do BITs Promote Foreign Direct Investment?” *Law & Society Review* 42 (4): 805–32.

Yang, Mayfair Mei-hui. 1994. *Gifts, Favors, and Banquets: The Art of Social Relationships in China*. The Wilder House Series in Politics, History, and Culture. Ithaca, N.Y: Cornell University Press.

———. 2002. “The Resilience of Guanxi and Its New Deployments: A Critique of Some New Guanxi Scholarship.” *The China Quarterly* 170 (June): 459–76. doi:10.1017/S000944390200027X.

Yeaple, Stephen Ross. 2003. “The Role of Skill Endowments in the Structure of U.S. Outward Foreign Direct Investment.” *Review of Economics and Statistics* 85 (3): 726–34. doi:10.1162/003465303322369849.

Yu, Li, and Travis Ng. 2010. “Does Weak Contract Enforcement Impede R&D Alliance Formation?” Working Paper. www.saet.uiowa.edu/pdfs/Weak enforcement.pdf.

Zhou, Kevin Zheng, and Laura Poppo. 2010. “Exchange Hazards, Relational Reliability, and Contracts in China: The Contingent Role of Legal Enforceability.” *Journal of International Business Studies* 41 (5): 861–81. doi:10.1057/jibs.2010.7.

Interviews

Interview 1. February 28, 2014. CEO, small construction and mining firm. Phone interview.

Interview 2. March 7, 2014. CEO medium-sized electronics manufacturing firm. Phone Interview.

Interview 3. March 12, 2014. CEO small-sized manufacturing firm. Phone interview.

Interview 4. March 17, 2014. CEO medium-sized retail firm. Phone Interview

Interview 5 March 17. 2014. CEO of a medium-sized real estate firm. Phone Interview.

Interview 6. March 20, 2014. CEO medium-sized manufacturing firm. Phone interview.

Interview 7. March 21, 2014. CEO large-sized manufacturing firm. Phone interview.

Interview 8. March 27, 2014. CEO medium-sized software development firm. Phone interview.

Interview 9. March 28, 2014. CEO large-sized retail firm. Phone Interview

Interview 10. March 31, 2014. CEO medium-sized electronics manufacturing firm. Phone Interview.

Interview 11. August 15, 2014. Business Association Employee. Phone Interview

Interview 12. September 1, 2014. Business Association Employee. Phone Interview

Interview 13. September 3, 2014. Business Association Employee. Phone Interview

Interview 14. September 5, 2014. Lawyer. Phone Interview

Interview 15. September 11, 2014. Lawyer. Phone Interview