

# The Link between **Foreign Direct Investment** and **Corruption** in Transitional Economies

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## **Abstract**

This paper analyzes how corruption affects foreign direct investment in transitional economies. Popular development and economic theories today maintain that foreign investment is beneficial for economic growth and that corruption is damaging in economic development. Based on primary and empirical research, using an inter-disciplinary approach, this paper examines how the two are related.

The paper begins by examining the literature on corruption and Foreign Direct Investment (FDI) and defining the problem that transitional economies face. Then, using a cross country regression, data from 1992-2000 for transitional economies is used to try and find the effect that corruption has on the inflows of FDI. These results are expanded upon in chapter IV, by using specific case analysis for Russia, Azerbaijan and Ukraine. The conclusion contains policy recommendations for governments, international organizations and NGOs on how to address and reduce corruption.

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## Chapter I: Introduction

The fall of the Soviet Union placed a large group of countries into the economic category of 'transitional' as they changed from a command market to free markets, from communism to democracy and from closed to open for foreign investors. This meant that public goods had to be privatized; it meant a new government would be introducing new rules and new legislation and it also meant that there were new opportunities for investors and entrepreneurs. Foreign Direct Investment is an important part of economic development and the Soviet Successor states could benefit greatly from its positive effects. These countries had reasonably advanced economic structures, highly educated work forces, large markets, plenty of natural resources and little competition, offering foreign and local investors great potential for profits. Analysts and economists predicted great inflows of FDI, but year after year, the expected rush of investment did not occur.

There is a great deal of evidence that FDI can improve a country's economic growth and assist in the development of its economy. The low amount of FDI into the transitional economies could be limiting their potential for growth; therefore it is important to try to understand why investors are wary. One of the explanations for the hesitant inflows of FDI is the high level of corruption in these countries. Corruption has been recognized as an urgent international problem and there have been many studies aimed at demonstrating its harmful effects on economic growth and development. More recently there has been research examining the linkages and actual effects of corruption of foreign investment levels. However, there remains a lack of sufficient empirical evidence to illustrate the impact that corruption has on FDI in the newly formed markets of the Post-Soviet economies.

Corruption is mentioned, either directly or indirectly, almost everyday in one of the Eastern European newspapers. Someone is either describing it, complaining about it, giving examples of it or offering solutions for it. But what is corruption? More specifically, what is corruption in transitional economies? Is it a problem? Does it affect the economy? Does it affect FDI? And most importantly: How does it affect foreign investment? This essay will address these questions through a theoretical review and an empirical analysis focusing on FDI and corruption in Central and Eastern Europe (CEE) (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Poland, Romania, Slovak Republic, Slovenia) and the Commonwealth of Independent States (CIS) (Azerbaijan, Armenia, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan,

Turkmenistan, Uzbekistan, Ukraine). It will then expand on this topic by using case studies to illustrate the linkage, both directly and indirectly, between FDI and corruption and then end by offering policy recommendations specific to economies in transition.

*Why is corruption an important factor when examining FDI inflows?*

Corruption and FDI have been chosen for this study because FDI is believed to promote growth and offer other benefits to a host country, which would be helpful to transitional economies during their restructuring. Corruption, on the other hand, is seen as being an obstacle for investors but it is believed that it is intrinsically part of Post-Soviet culture. When asked whether they think corruption affects foreign investment most people respond with a definitive 'yes'.<sup>1</sup> There is a belief that corruption has played a large role in discouraging foreigners from establishing themselves in the transitional economies. There are many reasons why this may be the case but how it affects investment is the important question and one which requires a much deeper investigation. Additional empirical examinations of the relationship between the two variables will help discover not only its magnitude, but also to distinguish between different types of corruption and identify their specific effects. Only through this process will it be possible to find policy recommendations that target the problem precisely and discover viable solutions to the adverse effects of corruption.

<sup>1</sup> Interviews done with local and foreign investors, legal experts, NGOs, international institutions and government officials carried out in Russia, Azerbaijan, Ukraine and Estonia in February 2003.

FDI was chosen as the focus of this study because investment is not only important for economic growth, but it can also demonstrate the progress of the transition. Simply put, an increase in investment ought to indicate, and promote, increased market development. Most FDI occurs in higher developed and industrial nations therefore FDI can be affiliated with high levels of development. It is logical that FDI is attracted by these more developed host countries because the determinants such as market size, openness and stability are extremely strong and the potential for profit is high. The second variable, corruption, which is divided into several measurements of risks and regulatory qualities, can exist in many different spheres of government, which can affect FDI in various ways. This study aims to separate the term 'corruption' into various categories to see which form of corruption has a more significant effect on FDI. This independent variable has been divided into: government effectiveness, regulatory quality, the rule of law, corruption, the perception of corruption and the level of crime.

### *Why transitional economies?*

Countries of transition represent a large portion of the global market and hold great potential for the development of various industries and natural resources such as the energy and mineral sectors. Due to the advanced state of their economies, these countries ought to be able to advance and restructure their markets at a faster pace than developing economies. The process and methods used in these transitions may provide insight into potential methods for development for countries that will go through a transition period in the future. These countries can also provide good case studies for examining FDI inflows and various types of corruption because they are emerging markets that share a common history of a command based economy. The Eastern European countries share a similar global position, as do the countries of the CIS, which will reduce disparities in variables such as economic structures, traditional trading partners, and features not directly captured in other variables in the analysis.

However, their differences will assist in discovering the causes of, and perhaps solutions for, corruption. The countries that are candidates for membership in the European Union will act as a comparison group to the other Eastern European countries, while Kazakhstan and Azerbaijan offer insight into the power of natural resources over corruption when attracting FDI. After the collapse of the Soviet Union, each government developed its own legislation and laws governing FDI, privatization and other aspects of restructuring the economies. The difference in government procedures will be helpful in analyzing the costs and benefits of certain government policies with regard to corruption.

### **Methodology**

To analyze the effects of corruption on FDI this paper will begin by using a cross-country regression. This comparison of transitional economies will provide insight into how investment, the dependent variable of the regression, is affected by corruption included as an explanatory variable. The regression will include traditional FDI determinants that have been proven to have a significant effect on the location of FDI. Drawing from several empirical studies that use variables such as market size, tariffs and labour force, along with determinants that are an important part of transitional development, such as the percentage of privatized firms and the level of stability, the regression will use those proven to be most significant.

Empirical economic studies rely largely on financial and statistical data to provide results and arguments. This paper is at a disadvantage in two ways; firstly, the Soviet Union and the countries that were formed as a result of its collapse, lack statistical information. Data had been altered under Communist rule and now there is an information vacuum in

many areas (Onyschuk-Morozov, 2003). Secondly, corruption, in any country, is difficult to measure simply owing to its secretive nature. "Studying the Russian economy is similar to examining an iceberg" where the informal sector remains a large part of economic activity (Gaddy and Ickes, 1998). This, however, should not inhibit research in this area since solutions can still be found to assist in reducing the spread of corruption.

Obtaining accurate and reliable information on the extent of corruption in a state or the cost of corrupt transactions in a country is next to impossible. Corruption is defined by secrecy and illegality and has variations across different economic activities (Wei, 1997). However, it is possible to obtain useful information on the extent of corruption within a country. Some studies in this area have been too broad and therefore do not adequately examine the level of corruption. For example, Wheeler and Mody (1992) combined corruption measures with 12 other indicators and labeled this variable "Risk" which included 'attitude of opposition groups to FDI', 'government support for private business' and 'overall living environment for expatriates'. While these factors may affect FDI, they will not adequately measure the level of corruption in a country.

There are four measurements of corruption that come from the World Bank Group's KKZ (Kaufmann, Kraay and Zoido-Lobaton, 2002) study, one from the Corruption Perception Index (CPI) that Transparency International (TI) publishes annually and one from Interpol. The KKZ database has created measurements for government effectiveness, regulatory quality, the rule of law and corruption by using results from studies done in 199 countries and territories for four time periods: 1996, 1998, 2000, and 2002. The measurements are based on several hundred individual variables taken from 25 separate data sources created by 18 different organizations. The results come from various surveys done by the Economist Intelligence Unit, Price Water House Coopers, Business Environment Risk Intelligence, the World Bank's Business Environment and Enterprise Survey and Freedom House among others. The KKZ measurements allow researchers to separate the 'risk' measurement to focus on the specific area of risk that needs to be examined. The measurement compiled by TI uses similar surveys but tries to focus on the perception that the international community and local people have about the corruption in a country. This is relevant for FDI since the idea that corruption is a problem in a country may dissuade investors from considering the economy as a potential location. The results of the TI measurements have been similar to Business International (BI) (now the Economist Intelligence Unit) and the Global Competitiveness Report (Wei, 1998) even when using different questions. Wei compares these three indices and concludes that the similarity in their results indicates that these measurements of corruption are fairly reliable.

A less significant issue is that it is not possible to know what percent of FDI entering a country is money being invested by ex-nationals or money that left the country as capital flight in the early 1990's. This, however, is not going to have an effect on the regression due to the fact that the amount of investment coming from ex-nationals is a very small percentage of FDI (Voloshina, 2003). And although it does not qualify as foreign investment, it does demonstrate investor confidence in the economy because the nationals that are investing their money are also seeking secure investment prospects.

It is impossible to measure the number of companies that do not invest in these economies due to corruption or perceptions of corruption. If this data were available, it may actually demonstrate the cost and the amount of investment that these economies are missing out on. However, at this time no such numbers are available and the costs must be implied and estimated through different methods such as large sample analysis and case studies.

By including only Post-Soviet countries in the study, some of the major variables will be reduced. Until recently, these countries had command economies and similar political and social structures. Although they have different cultures, they were united by the experience of Soviet Communism for almost a century. Some of the variables that cannot be controlled are the natural resources, the level of international assistance or the specific reforms that occurred in each country after the break-up. As mentioned earlier, however, analyzing the economic policies that individual governments implemented after the collapse of the Soviet Union may ultimately lead to insights into how the adverse effects of corruption can be reduced.

Large sample analyses are effective because they allow statistical tests to be performed. These statistical results can be beneficial when trying to form policy recommendations and can provide insight into the overall problem being examined. However, in these large samples, the details can often be lost and the complexity of the problem is not always accurately represented. To compensate for the potential losses that can occur through large samples, this study will fill in the gaps by including specific case studies that will offer insight into the complexity of the problem. Corruption is difficult to capture and measure, which can pose a problem when using a large sample analysis. A small sample with specific examples will assist in understanding the effects of corruption because it will make it easier to pinpoint the exact issue and help locate the causes and effects of the problem. The supplemented case studies are based on primary research done in Russia, Azerbaijan, Ukraine and Estonia. The case studies are a result of discussions with foreign and local investors, trade commissioners, lawyers and with members of the World Bank, Transparency International, and various Non-Government Organizations that took place over a six-week period in Russia,

Azerbaijan, Ukraine and Estonia. The focus was on trying to distinguish between types of corruption, the direct effects corruption has on FDI and also how corruption impacts the determinants of FDI. Case studies also allow researchers to analyze the potential different effects of certain characteristics of corruption, for example, the difference between predictable and unpredictable corruption.

Through the interviews the distinction between predictable and unpredictable corruption emerged as a characteristic of corruption that may also affect investor related decisions. The effect of the difference being that investors could predict future costs more easily when corruption is predictable. Wei (1998) has looked at this issue by treating corruption as a tax that investors would have to pay. In this study, he concludes that if corruption is seen as a tax, or as an organized form of corruption, then it does not dissuade investors to the same extent that an unpredictable form does.

At this point it is clear that corruption is a complicated subject which has many facets. Analyzing countries of transition requires a broad, multidisciplinary approach since the reform process cannot be divided into political, economic or social sections. When dealing with corruption, transition and reform, these processes become deeply entwined. The following essay unravels the complexity of the subject by dividing corruption into various types and analyzes the effects of corruption directly on FDI and indirectly on specific FDI determinants.

## Chapter II: Literature Review

Foreign Direct Investment (FDI) refers to the acquisition or building of production units in a foreign country into domestic structures, equipment, and organizations (Gilman, 1981). This type of investment contributes directly to the development of a country and its growth.<sup>2</sup> FDI is related to international investment where an investor has controlling interest in an enterprise in another country. FDI includes many types of capital contributions, such as the purchases of stocks, the reinvestment of earnings by a company incorporated abroad, or the financing of a foreign subsidiary or branch.

<sup>2</sup>Portfolio investments are inflows of capital and include instruments with fixed payouts (such as bonds) or equities and stocks which have no predetermined payouts. (Gray, 1981).

According to the United Nations Conference on Trade and Development (UNCTAD, 2000), the global expansion of FDI is currently being driven by over 60,000 transnational corporations with more than 800,000 (foreign) affiliates. Economists believe FDI will help economic development and this is becoming widely accepted. Governments try to attract it through policies and investment incentives designed to increase investor interest in an attempt to benefit from the potential economic development. The following section will discuss how FDI affects growth and what factors determine a company's decision to invest abroad.

### Foreign Direct Investment and Growth

How can FDI contribute to the growth of an economy? There are two main schools of thought on the effects of FDI: the dependency theory and the finance-for-development theory. Contemporary finance-for-development theories place great importance on an economy's ability to attract foreign investment.

Recent developments in these growth theories emphasize the improvements in technology, efficiency and productivity as results of FDI. Findlay (1978) states that FDI increases the rate of technical progress in the host country through a "contagion effect" that comes from the more advanced technologies and management systems of foreign firms. This "efficiency spillover", or "knowledge diffusion", can lead to improved systems in the host country simply by providing an example or by demanding better quality. Lall (1980) summarizes the benefits that arise from transnational corporation and supplier interactions as: helping suppliers create production facilities; demanding reliable, quality products that are delivered on

time; providing technical assistance and information to improve the suppliers' system and making training available. FDI is important for development because it results in the transfer of technology and knowledge, the creation of jobs, boosting productivity and enhancing competitiveness and entrepreneurship.<sup>3</sup> FDI provides a package of financial capital, technology, managerial skills, information and goods and services that can make an economy more competitive in the world market, thereby promoting growth.

<sup>3</sup> The benefits of FDI may not be poverty reducing if the benefits are not equally distributed.

The dependency theory is skeptical about the bargaining power of developing nations when FDI enters a host country. It argues that FDI will only make them more reliant on the transnational corporations. However, countries that have import substitution policies are at a disadvantage. There is evidence that protectionist policies allow inefficient industries to remain while the country locks out technologies that it needs to raise its level of competition and necessary capital. Haddad and Harrison (1993) suggest that FDI could affect domestic firms negatively in the short run by taking away market share, which in turn, leads to reduced capacity utilization for firms. However, this does not mean that over the long run positive spillovers cannot occur.

FDI is particularly important for transitional economies because it not only provides the effects mentioned above but it can offer specific transitional benefits. The Soviet successor states were lacking a model of corporate governance as they attempted to restructure their markets and individual firms. Corporate governance offers a system in which firms are operated and monitored by the managers, owners, and outside financial institutions. Under communist rule the government was responsible for allocating demand and supply decisions and dictating how firms and sectors would be run. During the privatization process, the government was still playing an active role in the market while attempting to restructure the management of firms. During the restructuring process, foreign investors and firms can offer examples of how firms ought to operate.

Also under the Soviet regime, there was an information vacuum. That is to say, access to information about sectors and industries was extremely limited and when it was available, it was not necessarily accurate or reliable. This is partly due to the fact that the government altered the information to illustrate a more positive image of the economy's state and partly due to the fact that such information, which is crucial for business development in the West, was not necessary in the Soviet Union because opening a private firm was not an option. Access to information is important for those who want to invest in an economy because it helps in establishing market potential, competition, consumer demand for a good

or service and financial forecasting. FDI can assist transitional economies change this aspect of their market simply by demanding such information be available. The creation of information services will then make it easier for local investors to understand the business potential in their economies.

The problem with access to information is linked to the problem of transparency. The lack of transparency in government structures can breed corruption. This combined with the lack of accountability for officials, makes it easier for them to demand bribe payments. This fact may be magnified when the potential bribe payer is a foreigner because the official may assume they are more naïve about the system. FDI can help this by importing transparent and ethical business policies and structures.

Transitional economies have an advantage over developing countries when it comes to receiving the benefits of FDI because they already have a reasonably advanced economic structure. This separates them from developing countries that lack not only businesses found in the developed world, but also the economic structure to build upon. But while aspects of the economic structures of transitional economies are advanced, they function below potential and suffer from outdated technology. These characteristics ought to make FDI more efficient at promoting development and growth in transitional economies because there is evidence that host economies need to have achieved a certain threshold of development for FDI to be useful. This economic base allows countries to absorb the new technology at a higher rate. Blomstrom, Lipsey and Zejan (1994) found that FDI can positively influence growth rates in higher-income developing countries and interpret this as a result of the technology absorption factor. Moreover, at the economy-wide level, the absorption capacity depends on the level of human capital. Borenzstein, De Gregorio and Lee (1995) found that the positive growth impact followed the level of human capital stock. They also found that FDI facilitates the expansion of domestic firms through complementarities in production thereby increasing total investment. In other words, if a country has achieved a minimum level of development in its economic structure, human capital and institutional infrastructure, it will benefit from FDI at a faster pace simply because the amount of necessary changes and advancements will be reduced.

Does foreign investment cause economic growth or is higher growth attracting foreign investment? Rodrik (1999) argues that much of the correlation between FDI and improved economic performance is a result of reverse causality, where transnational corporations locate to more productive, faster growing and profitable economies. However, a study by Blomstrom, Lipsey and Zejan, looking at 78 developing countries, found this was not the case. Growth rates in GDP per capita over five-year periods were associated with direct

investment flows only in the preceding and current five-year periods and not with direct investment in the following period, demonstrating that it is FDI that contributes to growth.

This study also addresses a point made earlier about the absorption capacity of recipients. The researchers divided the recipients of FDI into two categories. The first group is the “least developed” countries. They may not benefit from the technology brought by multinationals simply because their local firms are too far behind to be imitators or suppliers to the multinationals. The second group is the higher income developing countries, such as transitional economies, who are the likeliest candidates to benefit from spillovers since local firms are advanced enough to learn from foreigners.

The debate on the effects of FDI on growth continues, but contemporary thought and international policies encourage foreign investment because there is a belief that it will improve economic growth. From a policy perspective, then, the problem is to identify the factors that affect the decisions made by foreign investors. Transnational companies face additional costs when investing abroad: there are higher costs in moving personnel, communication costs, language and cultural barriers, informational costs on local procedures, and costs of being outside domestic networks. They also face higher risk factors, such as changes in exchange rates, political instability or expropriation by the host country. There is a traditional theory of FDI that tries to explain why firms produce abroad and incur such risks over simply accessing the desired markets through exporting.

### **Determinants of FDI**

Dunning (1977, 1981), introduced the concept of “OLI” as a theoretical framework to analyze the determinants of FDI. This framework considers FDI as determined by Ownership, Location and Internalization advantages that foreign investors have over operating outside of the host country. When these advantages outweigh costs, FDI will increase. The ownership advantage refers to a product or a production process to which local firms do not have access. It could refer to a patent or an intangible advantage like a reputation for quality. The location advantage comes directly from the foreign market, such as low factor prices or consumer access, along with trade barriers or transport costs, which makes FDI more profitable than exporting. Finally, the internalization advantage is a concept that explains why licensing may not be practiced and it is derived from a firm’s interest in maintaining its knowledge assets internally. Internalization prevents host country firms from copying once they understand the technology, thereby acquiring the potential to be in direct competition with the investor. The advantages are derived from the reduction of transaction costs that arise in the case of licensing. The OLI model has remained a part of FDI theory and others have expanded on this framework.

More recently, it seems that the focus has been on two main reasons why a firm would want to invest in a foreign location: to better serve the local market or to get lower-cost inputs, Brainard (1993) and Shatz and Venables (2000). To explain, FDI can be divided into “horizontal” or “market-seeking” FDI, and “vertical” or “efficiency seeking” FDI. The first involves building duplicate plants in a host country to supply the local market. This approach is done to reduce the costs that arise from supplying the market through exporting, in which case, market size and high tariffs play a large role in determining profitability. The latter category of vertical FDI is production cost-minimizing, where firms seek to produce in lower cost locations or seek inexpensive inputs in order to export their product. This type of FDI tends to be unaffected by market size and relies more on labour resource availability and factory costs, such as import taxes. The differentiation between the two is that market-seeking FDI aims at penetrating the local markets of the host country, whereas efficiency-seeking FDI is interested in creating new sources of competitiveness for firms.

There are several important traditional factors that affect FDI such as, economic distance and transport cost, other trade costs and tariffs, market size, factor cost, fiscal incentives, investment climate, economic stability, and infrastructure quality. Some of these will affect all FDI, while others are horizontal or vertical specific. Where there is a high export cost to achieve market access, investors will want to relocate within the market to avoid paying for access to the market if it is horizontal. However, if the company plans on exporting the product outside the host market, higher transport costs will discourage FDI. On the other hand, if the horizontal FDI aims to overcome trade barriers by relocating in the host country, a decrease in trade barriers and transport costs could decrease this type of investment since it may reduce the need to establish firms. However, since vertical FDI seeks countries that have open and predictable trade environments and which allow easy transportation and exporting, predictable trade barriers may offer an incentive for investors.

Due to economies of scale and lower fixed cost per unit of output, larger markets will encourage horizontal investment. In cases of vertical FDI, market size is less important because the product or service is not going to be sold directly to the host country. Yet the net impact of lower production costs is positive for both vertical and horizontal FDI. A stable, reliable, business climate will lower costs, thereby encouraging FDI. Avoiding problems with regulatory, bureaucratic and judicial hurdles, property rights, enforceable contracts, performance and content requirements, or bribe payments will be seen as positive because they reduce risk and uncertainty. Basically, the more obstacles that companies perceive they will have to face in a host country, the less attractive it becomes. The ability to communicate, to access information and to transport internally is useful to investors because they can reduce costs

of developing the infrastructure necessary to them.

Dunning (1999) later argues that FDI in developing countries has shifted from market-seeking to efficiency-seeking, where less importance would be placed on the size of national markets and focus would be directed on cost differences between locations, infrastructure, availability of skills and the ease of doing business. However, over time and in various studies, the size of host country markets remains the most popular explanation for FDI. The types of market-size variables include: Gross Domestic Product (GDP), GDP per capita, GDP growth and population as seen in studies by Agarwal (1980), Wheeler and Mody (1992), Tsai (1994), Chakrabarti (2001). While Singh and Jun (1995) find that export orientation is one of the strongest explanatory variables, Chakrabarti (2001) found that openness to trade was the strongest variable affecting FDI. Nunnenkamp (2001) found that the traditional determinants (GDP per capita, GDP growth, population, administration, entry restrictions and risk factors) remain the dominant factors shaping the distribution of FDI. The non-traditional determinants (cost factors, taxes, factors of production, sufficiently qualified labour and openness to trade) also affect FDI but not as much as the traditional determinants.

Studies done by Brainard (1993) and Markusen and Venables (1998) begin with the observation that most FDI is motivated by “market-access” reasons, rather than by differences in factor prices. This seems to make sense since over 90% of FDI is between North-North countries (UNCTAD, 2000) rather than North-South. The main idea is that a firm faces a trade-off between advantages of proximity (to the foreign market) and advantages in the host country, given the presence of firm-level economies of scale as well as the usual plant-level economies of scale. With transport costs, whenever the former advantage outweighs the latter, a firm will go transnational and replace exports with FDI.

Table 1 shows several studies that have been conducted in measuring determinants of FDI. The following review of determinants will help define the regression in the next chapter. It will look at the empirical evidence that demonstrates which determinants have a significant effect on the location of FDI. This table illustrates the determinants that should theoretically have an impact on FDI. The first column contains the names of the authors, the study, the date of publication and a brief remark of the results. The second column indicates the determinants that were used in the study.

Table 1: Studies Unveiling the Determinants of FDI

Name, Date of Publication and Results	Determinants used
<p>Harry G. Broadman and Francesca Rcanatini. (2001). "Where has all the foreign investment gone in Russia?"</p> <p>Looking at determinants for internal location, they found that market size, infrastructure developments and policy frameworks that encourage FDI explained FDI location.</p>	<p>Wage Gross Regional Product Education Crime Paved Roads Voter Participation Openness to Trade Domestic Private Investment Climate Investment rating</p>
<p>Alan A Bevan and Saul Estrin. (2000) "The Determinants of Foreign Direct Investment in Transition Economies"</p> <p>Found that: FDI inflows are significantly influenced by risk, unit labour cost, and host market size. Key risks included: corruption, private sector development, government balance and industrial development.</p> <p>They also identified that the announcement of EU accession impacted FDI directly. (Not simply through improved credit ratings or macro-economic development.</p>	<p>Gross Domestic Product Deposit Rate Total imports Risk Distance Unite labour cost Percentage of private sector of GDP Quality of privatization Government balance External debt stock End-year gross reserves Industrial output EU membership</p>
<p>Garibaidli, Mora, Sahay and Zettelmeyer. (1999) "What Moves Capital to Transition Economies"</p> <p>This study found that macro-economic stability, trade liberalization, natural resource endowment and government effectiveness were strong indicators. They noticed that risk and investor perception may be influential.</p>	<p>Inflation, Fiscal Balance, Growth Exchange rate regime Trade Liberalization Extent of privatization Institutional qualities Natural resources Location (distance from Europe) Country risk Competitiveness Restrictions to foreign investment</p>
<p>Peter Nunnenkamp. (2001) "Determinants of FDI in Developing Countries: Has Globalization Changed the Rules of the Game?"</p> <p>Nunnenkamp shows that traditional market-related determinants are still the dominant factors shaping FDI distribution, while non-traditional determinants remain less important, though significant.</p>	<p>Administration bottlenecks Change in trade share Complementary factors of production (local finance, education) Cost factors (taxes, labour restrictions) Entry restrictions (access to sectors) GDP growth and GDP per capita Population Post-entry restrictions Restrictions on foreign trade Risk factors (stability, crime) Years of schooling</p>

Name, Date of Publication and Results	Determinants used
Claudia M Buch, Robert M. Kokta, Daniel Piazolo. (July 2001) "Does the East Get What Would Otherwise Flow to the South? FDI Diversion in Europe"	EU membership GDP Population Exchange rate Imports Trade Distance

Table 1: Studies Unveiling the Determinants of FDI

Table 1 shows various indicators used to measure the traditional determinants: market size (population, GDP, Growth), cost factors (wage, education, paved roads and natural resources), openness (entry restrictions, imports, trade) and restructuring (privatization and EU membership). Some of these studies included risk variables such as crime and stability. This illustrates that stability is an important part of host country determinants and worth further examination.

In summation, FDI is recognized as an important factor for economic growth. And economic growth is something crucially needed in transitional economies. Empirical research is increasing and becoming more proficient at evaluating the determinants involved in FDI location. The most widely used variables to examine FDI inflows are GDP, distance to other markets, trade costs, privatization, and risk, and in cases of Eastern European countries, the possibility of becoming a member of the EU.

What many of these studies miss, however, are measurements of political factors such as corruption and the political component of corruption. The studies that include risk or stability try to include the influence that corruption can have on FDI, however, it is often not adequately defined to capture the sole effects of corruption. These measurements are often combined with economic risk which includes macro-economic indicators that do not address political risks such as corruption. These types of studies also do not take into account that corruption can affect the determinants of FDI themselves.

### Corruption

Corruption can affect FDI directly by tarnishing the perception of stability and quality of an investment potential. When investors believe that there is a high amount of corruption in the host country they are considering, they may see this as an impediment for doing business there. They will see it as an extra cost that they may have to incur and a problem when adequately forecasting financial returns.

Prior to analyzing its effects, corruption must be defined. The analysis of corruption as an issue in economic growth began in the 1960's (see: Abueva, 1966, Bayley, 1967, Leff, 1964). It was then widely believed that corruption had harmful long-term effects but that it can 'grease the wheels' of the economy in the short-term. Since that time, the empirical evidence of the negative effects of corruption has steadily mounted. Over the years, many studies have been carried out in an attempt to demonstrate the effects that corruption may have on growth; positive, negative or neutral. This essay will focus on corruption in the economic sphere of government and will use the widely held definition of corruption, also used by the World Bank and International Monetary Fund, which states that corruption is "the abuse of public office for private gain". In such cases, state corruption occurs when an official has the opportunity to manage resources that do not belong to him or her.

A public servant is required to make decisions based on the established rules of the state (constitution, laws and regulations) and by publicly approved cultural and moral norms. Corruption exists when the official diverges from the system and is replaced by the official's personal interest (INDEM, 1998). It must be noted that corruption can only exist where there is a receiver and therefore, obviously a supplier. Suppliers generally exist outside the political system. The continuation of corruption among officials and suppliers implies a certain level of tolerance for corruption in society at large. The norms and morals accepted by society vary from country to country and what is considered to be corruption in one place may not be seen the same way in another. For example, in Canada, accepting a gift for a service that is a required part of a position could be seen as a bribe; whereas in some Central Asian countries not offering a gift would be considered an insult. Regardless of whether corruption is culturally accepted, the fact remains that investors have a choice of where to invest and they may not share the foreign country's tolerant attitude.

The definition being used does not encompass corruption that occurs in the private sector. Private sector corruption can affect the economy just as much as the public variety and

the two often overlap. In this study, however, private forms of corruption will be included only when they are part of the form of government corruption.

Corruption has also been described as “behavior which deviates from the formal duties of a public role because of personal financial or status-gains; or violates rules against the exercise of certain types of private-regarding behavior.” It “breaks down trust, confidence and the rule of law,” while decreasing the morale of citizens and discouraging foreign investment (Klitgaard, 1988). Corruption can affect every sector and level of the government, from the top executive, legislative and judicial branches down to regional and local officials. It is therefore a potential threat to all sectors and institutions within a country.

To see the effects of corruption on an economy, the following review presents the theories on how corruption affects growth and how corruption affects FDI. Afterwards, some empirical evidence showing the relationship between the two will be examined.

### **Corruption and Growth**

Corruption tends to increase according to the level of the discretionary power of an official, the degree of responsibility, the amount of regulation and the risk involved (Savona, 1997). Corruption tends to grow or flourish during times of modernization, which is certainly the case for Post Soviet countries. The lack of laws governing official behavior and the ambiguity of market rules, allow those who wish to make a quick profit plenty of opportunities to do so (INDEM, 1998). Transitional economies provide a good example of corruption in a time of modernization and facilitate an examination of corruption due to the speed of modernization and the differences in government policies. Other developing countries are modernizing at a slower pace and provide less scope for such a study.

Developments in the international community illustrate the desire to combat bribery and other forms of corruption. The OECD has created the Convention on Combating the Bribery of Foreign Public Officials in International Business Transactions; non-governmental organizations have been created to monitor and reduce it; and governments are implementing laws to overcoming corruption.

Some literature argues that efficiency-improving corruption can further economic growth using second-best world examples. However, these are more often short-term benefits in growth. The long-term effects are negative in the whole. Huntington (1968) argued that a “rigid, over centralized dishonest bureaucracy” is better than a “rigid, over centralized, honest bureaucracy”. The dishonest government would provide immediate benefits to groups that would otherwise

be at a disadvantage and therefore may be a functional way to improving an ineffective political system. While this position may hold some truth, an examination of both sides of the argument is required.

There are many cases where political scientists argue that corruption is beneficial. Robert Merton (1957) argued that corruption was a necessary ‘grease’ to move the slow moving bureaucracies in developing countries. Bequart-Leclercq (1989) saw corruption as important for redistributing public resources. Similarly, Werner (1989) found that corruption encourages foreign investment by allowing a mechanism to overcome burdensome regulations. The notion that through practices of facilitation or “speed money” individuals can avoid administrative delays, can thereby create an improved economic situation.<sup>4</sup> For example, government employees that benefit from bribe taking may work harder in order to procure more bribes, especially when bribes are received by piece rates. Also, in cases of developing countries, where the government is inefficient, corruption may be the only way to encourage investment by offering alternative ways to conduct business.

<sup>4</sup> Facilitation money has only recently been classified as corruption. “Speed money” still does not fall under the United States anti-bribery code for foreign investors (see Facilitation Act 1977) but is included in the United Kingdom act.

Corruption specifically can affect economic development in positive ways by creating entrepreneurialism. When corruption is normal, there is a climate of risk-taking and profit seeking and since illegal enterprises require planning, risk and cost assessment and adaptability and this may create skilled business people.

Other arguments for corruption involve market forces. The abandonment of price controls can lead to administrative savings since the cost of policing them is no longer incurred, thereby allowing of the market to operate as it would freely.

However, Klitgaard (1988) notes that these arguments have several common features. First, they often refer to the benefits that arise from specific illicit acts and do not consider the systemic impact of corruption on the whole or in the long-term. Although a given incident or transaction may have positive results, it may also generate negative externalities that decrease the performance of the system and compromise the economy’s long-term efficiency.

Economists often tend to argue that corruption negatively affects economic growth due to the dissipation of capital. There is no evidence to support the idea that corrupt gains will be spent in desirable areas. Another effect of corruption is that it tilts public spending towards projects that make bribe-taking easier. This happens at the expense of priority projects. The result typically ends with preference going

to sectors that may not encourage development, such as defense over education since it is more difficult to benchmark high-tech custom built equipment. The problem also occurs in construction, which leads to lower quality buildings being erected. Corruption can lead to the squandering of natural resources. Tenders for government contracts are won based on bribes rather than merit. Corruption can destroy free competition, resulting in an inferior enterprise supplying the goods or services. For example, if a government sends out a tender for the construction of a building, rather than the best company to perform the project winning the job, the one that pays the highest bribe or the company that has a personal relationship with the government official supplying the tender will win the contract. Some have argued that in such cases, the best company to provide the service will still win since the one that can pay the highest bribe is the most successful of the competitors. However, this is a spurious position since many cases of corrupt tenders are the result of personal favors.

Paulo Mauro (1997) uses the Business International (BI) indices to argue that corruption does in fact hurt growth and investment. To summarize his findings, the economic impacts of corruption are as follows; the shadow economy can reduce a country's tax revenues to the budget thereby decreasing its control over the national economy, market efficiency is affected because market competition is disrupted since the winners may not be the most competitive but rather, those who succeeded through bribes, and budget funds, government contracts and credits are distributed inefficiently.

Although some argue that it creates entrepreneurs, corruption can actually stifle entrepreneurship. The gains that can be won through corruption dissuade people to enter legitimate businesses where gains may be less. And those involved in legitimate businesses that have to deal with corruption see it as an additional cost.

Rather than concentrating on efficiency, public servants focus on illegal gains, thereby weakening administrative capacities. This is because officials will create more bottlenecks to extract more payoffs (Rose-Ackerman, 1978, 1999). For example, officials who receive bribes may purposely slow down the administrative process to enhance the amount of bribes offered to them. Payoffs are a way to allocate scarce goods and services. Transactions that would be legal payments in market economies are illegal payoffs in corrupt systems. It distorts the redistributive role of the state, fuels the informal sector and acts as an incentive to evade taxes. It also distorts programs aimed at poverty reduction and undermines international assistance and reconstructive programs.

### **Corruption and FDI**

Corruption is seen as having negative effects on an economy, while FDI has been shown to be beneficial. Research combining

the variables of FDI and corruption is lacking in transitional economies, partly due to the fact that it is a fairly new area, the lack of information and the diversity among the countries. Also, research on corruption tends to generalize its causes and effects among countries. Although this is helpful when looking at economic impacts, it is less so when examining ways to find solutions. Corruption can become very much a part of a country's life and the causes and effects can be seen in its history and society. Since there are different types of corruption, there will also be different solutions.

In a 1995 study on investment and loan risk information, Ades and Di Tella found that an increase of \$4,400 US in per capita income would improve a country's ranking on a corruption index by two points out of ten. They also found that increased competition would lead to an improvement on the corruption scale. These studies show a link between the development of an economy and corruption and they also show that corruption has a strong economic dimension. Paulo Mauro's 1997 study on 67 countries found that if a country could heighten the efficiency of its administration and improve its corruption score from 4 out of 10 to 6 out of 10, the rate of investment would increase by 3% and the growth rate would increase by 0.5%. The study done by Shang-Jin Wei shows that decreasing Singapore's corruption score of 10 to that of Mexico's 3.25, would have the same economic effects of raising the tax rate by 21%. This empirical evidence shows there is a correlation between corruption and growth and between FDI and corruption.

Some theories argue that for a given level of corruption, countries in which corruption functions more predictably have higher investment rates. This approach has been expanded on by Campos, Lien, and Pradhan (1999), who make use of the same data by the World Bank and the University of Basel in a cross-section of 59 countries. The authors controlled for GDP per capita and secondary school enrollment, they found that low predictability and the overall level of corruption reduce the ratio of investment to GDP. The same measure of the predictability of corruption has also been used by Kaufmann and Wei (1999). The authors provide evidence that the level of corruption and its predictability are crucial determinants for managers in negotiations.

To summarize the literature review, there is a great deal of evidence that shows there is a definite relationship between corruption and FDI, in which most empirical evidence points towards a negative correlation. However, there has not been such a study that focuses specifically on the transitional economies. These countries are considered to be among the most corrupt yet each has a different level of FDI and there is a potential to find the reason for the difference in levels. The following regression has isolated these countries for the examination of the problem.

## Chapter III: Empirical Evidence

The purpose of a multiple regression is to understand more about the relationship between a number of independent or predictor variables and a dependent variable. The cross country regression will use traditional determinants of FDI and corruption variables to examine the influence of each on FDI inflows into transitional economies. The chapter will begin by describing the data as variables included in the regression and then proceed with the empirical results.

The data for the regression covers the years 1992-2000 for Central and Eastern Europe (CEE) (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Poland, Romania, Slovak Republic, Slovenia) and the Commonwealth of Independent States (CIS) (Azerbaijan, Armenia, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Uzbekistan, Ukraine). Through the use of panel-data covering years and countries for multiple variables, the relationship between corruption in countries over time and the effects on FDI can be explored.

The dependent variable is FDI net inflows as a percentage of GDP. The growth of FDI is a good general indicator to measure the success of economic reforms in transitional economies (Bowser, 2003). And as discussed earlier, FDI can play an important role in a country's development. The amount of FDI that a country is able to attract can indicate international perception of the country's performance and market potential. FDI can also show the integration of previously closed economies into the world market. For this reason it is interesting to use it in a study of corruption since the inflow can portray investor confidence which can indicate an increase or decrease in the perception of corruption. This data is also fairly easy to measure and tends to be reliable and consistent, having been collected from the World Development Indicators (WDI) 2001.

The various empirical studies have focused on a range of independent, or explanatory, variables that are thought to affect FDI. The explanatory variables used here have been divided into groups according to the type of determinant;

### Variables

The first category of explanatory variables is Market Size. As stated in the previous chapter, market size is one of the most widely proven significant determining variables in FDI location. If foreign investors are seeking to sell their product or service

to the host country, the economic potential of the targeted region is of utmost importance. This will be measured by:

GDP growth, *growth*, is shown through the annual increase in growth by percent and this number has been lagged to avoid a correlation where FDI would be based on growth in a previous year. (World Development Indicators, 2001).

GDP per capita, *GDP*, is measured in constant 1995 US dollars. This measure should have a significant impact on FDI inflows because it indicates market wealth and purchasing power. (World Development Indicators, 2001).

Population, *pop*, is given in actual numbers demonstrating the size of the country. (World Development Indicators, 2001).

Kilometers to Berlin, *Berlin*, measurement illustrates the distance from the capital to the nearest largest industrial market that would be important for market access when exporting goods. Berlin was chosen because it is close to the East yet fairly central in the European Union. In a future study this location would have to change to account for the enlargement of EU borders.

Labour Force, *LF*, represents the people in the labour force of the host country as a percent of the total population. (World Development Indicators, 2001).

The second category is Costs and Quality: In either efficiency-seeking or market-seeking FDI, host country costs are considered. These variables will measure aspects of costs that will make investment more appealing to investors because they can reduce costs in developing infrastructure or training.

Enrollment in tertiary education, *school*, is a way to look at the quality of potential labour force. This measure is particularly important for transitional economies because they do have a high level of education which should assist in attracting FDI. (World Development Indicators, 2001)

Resources: Oil production, *oil*, is one of the biggest industries in certain transitional economies and can attract large amounts of investment. It should be significant regardless of other variables because the profit potential is so high. The number represents barrels produced per day.

Infrastructure: *rds\_km*, is the percent of roads paved per square kilometer and should be fairly significant because it affects transport costs when exporting or relocating goods. This ought to be especially significant for investors that plan on selling to neighboring countries or having regional coverage. (World Development Indicators, 2001)

The third category of explanatory variables is Openness/Integration into World Economy:

Exports, *exp*, as a percentage of GDP, is expected to be significant because it demonstrates the openness and export abilities of the host country. (World Development Indicators, 2001).

Direction of trade to industrial countries, *tr\_ind*, shown by the percent of exports going to industrial countries. This will be particularly important for investors that want to export their products. (Direction of Trade Statistics, IMF, 1997 & 2001)

Imports, *imp*, as a percentage of GDP, is expected to be significant because it demonstrates the openness and import abilities of the host country. (World Development Indicators, 2001)

Tariffs, *tariffs*, is shown as import duties as a percentage of imports. This variable should be very significant because it impacts the cost of importing and can give an indication of costs of exporting. For market seeking FDI, the higher the tariffs, the more incentive to relocate. (World Development Indicators, 2001)

The fourth category is Privatization, EU accession and stability: These variables are crucial to Post-Soviet transitional economies because there is such a great deal of privatization occurring in these countries and there is a greater risk in stability since these states are newly formed.

Privatization of Firms, *priv*, as a percentage of the private sector in GDP, this number illustrates the progress the country has achieved in the transition process. This variable should be very significant because it not only measures the changes from a command based economy to a free market one, but also affects investors that want to go into joint ventures. An increase in privatization might also be seen to be accompanied by improved business environments for investors. (European Bank for Reconstruction and Development: Transition Report, 1997, 2001)

Stability, *i\_stabil*, is an index that was compiled by the World Bank that measures political and economic stability within a country. This is a crucial factor when it comes to FDI because it is a way that investors measure the security of their investment. It aims to measure the likelihood that the government in power will be destabilized in unconstitutional or violent means. The index rates countries on a scale from 0-100, where a higher rating, indicates better stability. A lower rating should attract less FDI into the country. (World Bank, GRICS, 2002)

European Union Candidacy, EU, eight of the countries in this study are candidates to become EU members. This should have a significant effect on FDI because the countries have had to make many changes, both economically and politically in preparation for accession. The measurement is a dummy

variable, where the number 1 is assigned to countries that are likely to be members in 2004. (Europa, 2003)

The last category is Corruption and Governance:

Government Effectiveness, *i\_effect*. This variable is an index measuring a government's ability to act in an effective manner. This covers the quality of the public service and bureaucracy, the capability of civil servants, their independence from political pressure and the credibility of commitments made by governments to change. The index rates countries on a scale from 0-100, where a higher rating, indicates improved government effectiveness. A lower rating should attract less FDI into the country (World Bank, GRICS, 2002).

Regulatory Quality, *i\_reg*, another government-based index that focuses on the policies including perception of burdens that occur from excessive regulation on trade and business development, price controls and inadequate banking supervision. The index rates countries on a scale from 0-100, where a higher rating, indicates better regulatory quality. A lower rating should attract less FDI into the country. (World Bank, GRICS, 2002).

Rule of law, *i\_law*, is an index that covers the effectiveness and the predictability of the judiciary and the enforceability of contracts and aims at measuring the confidence that agents have in the rules of society. The index rates countries on a scale from 0-100, where a higher rating, indicates a stronger rule of law. A lower rating should attract less FDI into the country. (World Bank, GRICS, 2002).

Corruption, *i\_corr*, by measuring things such as "additional payments to get things done" and similar effects that corruption has on the business environment, the index aims at covering corruption specific qualities. The index rates countries on a scale from 0-100, where a higher rating, indicates less corruption. A lower rating should attract less FDI into the country. (World Bank, GRICS, 2002).

Perception of corruption, *i\_per*. The measure for perception is a combination of various studies that evaluate how business people and the public in general view the level of corruption within a country. The countries measured are rated on a scale from 1-10, where 1 is very corrupt and 10 is the least corrupt. (Corruption Perception Index, Transparency International, 1996, 1997, 1998, 1999, 2000).

Crime Rate, *crime*. The predictability of corruption within the government is difficult to measure. Corruption can indicate a more dangerous business environment with added risks involved for investors. A high crime rate also signals a lack of the rule of law and government effectiveness which are also thought to pose problems for FDI. This number measures the

crimes reported per 100,000 inhabitants and as this number rises, FDI should fall. (Interpol, 2001).

Table 2: FDI determinants: Single regression results for various corruption indices

Independent variables	FDI & Crime	FDI & Stability	FDI and Gov. Effective	FDI & reg. quality	FDI & rule of law	FDI & corrupt	FDI & percept of corr.
Crime Rate	0.21159 (0.03745) ***						
Stability		-0.1145 (0.043) **					
Government Effectiveness			0.130 (0.043) ***				
Regulatory Quality				0.113 (0.0432) **			
Rule of Law					0.113 (0.0431) **		
Corruption						0.130 (0.043) ***	
Perception of Corruption							0.155 (0.0458) ***
N	256	256	256	256	256	256	256
Adj. R <sup>2</sup>	0.1082	0.0233	0.0308	0.0224	0.0224	0.0308	0.0396

\*, \*\*, and \*\*\* indicate statistical significance at 10%, 5%, and 1% respectively.

Estimated Coefficient

Standard errors in parenthesis.

N = number of observations

As a preliminary analysis, Table 2 illustrates the effects of various corruption and governance measurements on FDI. Alone, there is a positive correlation, showing that as the ratings for corruption, perception of corruption, stability, regulatory quality, government effectiveness and the rule of law improve, levels of FDI increase. For example, improving the level of corruption by 10% would attract an increase of investment by 1.3% of the GDP. Interestingly, the regression also indicates that as the crime rate increases, so does FDI. This is contrary to what was expected. FDI should want to avoid host countries with higher crime rates, not only because it can make business environments unstable and more dangerous but also because higher crime rates can indicate

government ineffectiveness, lack of the rule of law and increased corruption. This variable will be examined closer to see if an explanation can be formed. To see a more accurate effect of corruption on FDI, the variables have to be combined with other significant determinants. However, prior to this, the

Table 3: Correlation matrix of Corruption variables

<b>CRIME</b>	1.0000						
<b>STABILITY</b>	0.3869	1.0000					
<b>EFFECTIVENESS</b>	0.4053	0.9817	1.0000				
<b>REG QUALITY</b>	0.3960	0.9909	0.9908	1.0000			
<b>RULE OF LAW</b>	0.3961	0.9909	0.9908	1.0000	1.0000		
<b>CORRUPTION</b>	0.4053	0.9817	1.0000	0.9908	0.9908	1.0000	
<b>PERCEPTION</b>	0.4869	0.2814	0.2930	0.2872	0.2872	0.2930	1.0000
	<b>CRIME</b>	<b>STABIL</b>	<b>EFFECT</b>	<b>REG</b>	<b>LAW</b>	<b>CORR</b>	<b>PERCEP</b>

corruption indicators need to be examined to ensure they are significantly independent.

The results for stability, government effectiveness, regulatory quality, rule of law and corruption are all fairly similar. This may indicate that there is some multicollinearity in the variables. Prior to evaluating the effects of corruption on FDI when combined with other determinants, the corruption variables that are too closely correlated or significantly dependent need to be removed. To do this, a correlation matrix will illustrate which variables are significantly independent and therefore, reasonable useful for including in the study.

The findings from Table 3 show that some of the variables measuring corruption are not significantly independent. This will pose problems in the regression, so the remaining large sample analysis will only use the governance indicators that are independently significant. The result from the correlation matrix shows that the crime rate and perception are significantly independent from the other variables, while the other measurements taken from the World Bank's KKZ database are quite similar. For the regression, corruption will be used as a representative for the government effectiveness, rule of law, stability and regulatory quality indicators. This is justifiable since the index ratings are obviously capturing a similar measurement.

Table 4: Results of the regression including all determinant variables.

Independent variables	Model 1	Model 2	Model 3	Model 4	Model 5
<b>GDP</b>	-1.283 (0.674) *				
<b>Growth</b>	1.393 (0.705) **	0.195 (0.775) **			
<b>Population</b>	0.0004 (0.00009) ***	0.0003 (0.00009) ***	0.0004 (0.00009) ***	0.0002 (0.00005) **	0.0003 (0.00004) **
<b>Exports</b>	0.193 (0.115) **				
<b>Tariffs</b>	0.093 (0.031) **	0.098 (0.032) **	0.100 (0.033) **	0.091 (0.033) **	0.095 (0.033) **
<b>Oil Production</b>	-0.006 (0.002) ***	-0.006 (0.002) ***	-0.007 (0.002) ***		-0.01 (0.002) ***
<b>Privatization</b>	0.635 (0.086) ***	0.647 (0.084) ***	0.676 (0.075) ***	0.655 (0.08) ***	0.691 (0.079) ***
<b>EU Candidacy</b>	8248 (3559) **	7367 (3369) **	7786 (3418) **	7259 (3026) **	6314 (3053) **
<b>Crime</b>		-0.886 (0.489) *	-0.911 (0.517) *	-1.414 (0.567) **	-1.15 (0.592) *
<b>Crime Squared</b>		-0.000009 (0.000005) *	-0.000009 (0.000005) *	-0.00001 (0.000005) **	-0.00001 (0.000006) **
<b>Corruption</b>		-117 (92.6)	-129 (91.2)		
<b>Corruption Squared</b>		-0.001 (0.0009)	-0.00129 (0.0009)		
<b>Perception of Corruption</b>		-293 (379)			
<b>Perception of Corruption Squared</b>		-0.002 (0.004)			
<b>Russia</b>					34805 (16570) **
<b>N</b>	256	256	256	256	256
<b>Adj. R<sup>2</sup></b>	0.5506	0.5315	0.5321	0.5188	0.5349

\*, \*\*, and \*\*\* indicate statistical significance at 10%, 5%, and 1% respectively.

Note: This is a one-sided test

Standard errors in parenthesis.

N = number of observations

To ensure that the traditional determinant variables are also significantly independent, a formal test for multicollinearity is performed on the remaining FDI indicators. From this formal test, the variables that were not significantly independent were the roads per squared kilometer and the level of trade. To examine these relationships on another level, another correlation matrix was done on these variables. (See Appendix 1). Trade seems to be dependent on the level of privatization as well as the roads per squared kilometer, so the regression will not use the variable for trade. The number enrolled in tertiary education is linked to the distance between the capital of the host country and Berlin, to avoid a dependent interaction, Berlin was removed. The next step is to combine the traditional variables with the corruption determinants and measure the effects these have on FDI inflows.

Model 1 is the basic regression equation showing the traditional determinants. In Model 2, the corruption variables are added to the most significant traditional determinants. In addition to the linear relationship, the corruption variables have been squared to include the potential effects of a quadratic relationship. Model 3 modifies the equation to eliminate perception which is insignificant, then Model 4 uses only the variables with the most significance. To arrive at the results in Model 5, various tests using the most significant results with different countries were performed. Russia was the only one found to have a significant result.<sup>5</sup>

<sup>5</sup> Other tests were performed but did not generate any results.

### **Analysis of the regression:**

From the regression, the determinants that are most significant are population, tariffs, oil production, privatization and EU candidacy, with privatization leading the list. This is in line with previous empirical evidence that showed similar levels of significance for these variables and with the theoretical literature. The population is a representation of market size which firms consider to measure market potential. Tariffs show a positive correlation because market-seeking investors will want to relocate within the target market. As import duties rise, by 5% of total imports, FDI increases by 4.65% of GDP presumably to avoid import duties incurred when exporting to the market, which can put investors at a disadvantage to local businesses.

Oil was expected to show a positive correlation, however, the regression shows that as oil production increases by 100 barrels per day, FDI will decrease by 0.6% of GDP. This could be a result of the unpredictability and risks involved in the natural resource industry. Another plausible explanation is that oil remains a national industry. Therefore, any investment entering a host country in this sector may not be accounted for in the net inflows of FDI. In joint ventures with governments,

investors would not have controlling interest so although investment is occurring, it not registered as FDI.

The regression results show a highly significant correlation between FDI and privatization. This was predicted in previous studies and is theoretically sound. A 10% increase in the percentage of privatized firms will yield an increase of 6.35% of GDO in FDI inflows. The number and level of privatized firms increase the ease of doing business and demonstrate that a host country has a more developed and free market economy. Therefore the method and pace of privatization in transitional economies can have a positive or adverse effect on investment.

The potential of becoming a member of the EU is significantly correlated with FDI inflows. For efficiency seeking investors, EU candidacy is of high interest since the borders are soon going to open. The criteria for joining the EU is strict and has demanded many changes and improvements on the candidate countries, such as macro-economic stability, good governance, the rule of law and increased privatization. This has been accompanied by the reality and the perception of dramatic changes and restructuring which has lead to investor confidence.

Unfortunately, the indicator for corruption did not remain significant when combined with the traditional determinants. When corruption is the only variable combined with FDI, there is a significant correlation which demonstrates that corruption can harm FDI inflows. A direct link between corruption and FDI does not materialize in the regression; however, this does not mean that corruption does not play a role in determining FDI location. Due to lack of information and difficulty measuring corruption, the relationship between the two variables could be lost. This analysis needs to be accompanied by case studies which will try to explain corruption using different tools. Although the regression does provide a starting point for understanding the complex relationship between FDI and corruption, it cannot illustrate how corruption affects the determinants specifically. The large sample analysis does not capture the indirect effects of corruption on FDI, nor can it adequately separate the types of corruption. The following chapter examines how corruption negatively impacts determinants such as infrastructure, privatization, oil and growth, which are important for attracting FDI.

The regression showed that there is a significant correlation between the measurement of crime rates and FDI inflows. FDI will decrease by 1.2% when the number of crimes per 100,000 inhabitants decreases by 10%. This result is a combination of a number of factors that accompany crime rates. Crime can make business environments dangerous and unpredictable. It can also indicate that there is a lack of government effectiveness and rule of law, which were thought to directly affect FDI. The results from the squared crime rate

show that the correlation between FDI and crime is a non-linear relationship. That is to say that as crime increases, FDI will decrease at a much more rapid rate than a straight linear line can capture.<sup>6</sup>

$$^6 -0.0001 C^2 - 1.414 C$$

$$-0.0002 C = 1.414$$

$$C = -1.414 / 0.0002$$

$$C = -70700$$

When  $C = -70700$ , demonstrates a maximum. However, since crime cannot be a negative number, this shows that the relationship is not linear

A dummy variable for Russia was introduced in Model 5 to see if there was anything about this country that was not being captured in the regression. The regression results show that there is something special about Russia's case when examining FDI. In the case study, a more specific analysis of this country will take place.

To conclude, the regression was not as successful as had been anticipated, however, it provides a good starting point for a deeper analysis of the corruption and situation of transitional economies. The results that were similar to previous empirical studies examining FDI inflows adds support to the research analyzing FDI determinants. The significant correlation between FDI and crime could be a starting point for understanding risks that investors are most worried about. Never less, corruption remains a very difficult variable to measure and an extremely hard aspect of society to find accurate and comprehensive data on. It is for this reason that a large sample analysis will not suffice in the examination of the link between corruption and FDI. The following chapter uses specific cases to look further at the relationship between the two.

## Chapter IV

### Case Studies: Russia, Azerbaijan and Ukraine

The results from the large sample analysis, although not always significant, show that there could be a relationship between FDI and corruption but that the relationship is more complex than a basic regression can reveal. To examine the complexities of corruption and its link to FDI, the specific cases of Russia, Estonia, Azerbaijan and Ukraine will be used. Case studies will be helpful because the numbers representing corruption variables are not able to capture the complexities of the subject. Specific examples allow researchers to look further at the causes and effects of variables while addressing the many sides of the issues involved.

The following inter-disciplinary examination of corruption in Russia, Estonia, Azerbaijan and Ukraine includes culture, history, policy and political systems to locate the roots of corruption in transitional economies and the effects it has on investment. Through an examination of cultural values and norms, historical context, privatization methods and the legacy of Soviet bureaucracy in these countries, this chapter will address how corruption affects the determinants of FDI. By examining the indirect ways that corruption affects FDI determinants, it will become more clear that corruption is a serious problem for countries trying to increase their desirability to foreign investors. Corruption hinders the important indicators such as growth, infrastructure, education, tariffs, natural resources, privatization and stability. By examining the direct effects that corruption has on these specific determinants, the linkage between FDI and corruption will be strengthened.

The case studies and examples of how corruption in Russia, Azerbaijan, Ukraine and Estonia are a result of field work that was done over a six-week period. Interviews were carried out with foreign and local investors, lawyers, government officials, people from the World Bank, the International Finance Corporation, Trade Commissioners, and representatives from various non-governmental organizations such as Transparency International and the New Democratic Institute. These were done to gain a broad understanding of corruption in the investment climates. The discussions also provided specific case examples and details that assisted in defining the study of corruption.

#### Corruption as a Cultural Phenomenon

Is corruption simply a part of the culture in Soviet Successor states? The answer to this question is partly historical and partly sociological. In the Communist era, there was a large underground economy that functioned outside of the state's

control due to a lack of supply of consumer goods. Goods and services were often purchased through a barter system or through personal favors. This type of system became somewhat of a norm in Russia and neighboring countries (Katsenelinboigen, 1983). With the disintegration of the command-based economies and a lack of rules to guide exchanges and purchases and a great deal of uncertainty in society about the future, these norms prevailed. Uncertainty about employment made it difficult for people to adjust to the new demands placed on them. People continued to operate in the same fashion as they did under communist rule (Alieva, 2003).

People in Russia understand that corruption is a problem, but most of these citizens also understand that at times, using corrupt practices can provide advantages. In one interview, a Moscow lawyer stated that 'corruption is a problem...but if you need anything, let me know because I have all the necessary connections'. This is a typical attitude that demonstrates that there are certain values that will continue to allow corruption to thrive. The belief that everyone uses bribes to get what they want creates a vicious cycle. People will continue offering bribes because they feel that if they don't, the next person will, thereby, getting ahead.

When discussing the problem of corruption with people in Russia and Ukraine, they are very pessimistic about the situation changing. One Ukrainian student said 'you'll never get rid of corruption in Ukraine. It's always been here and it always will be'. In a similar vein, a local Moscow businessman added to this comment by explaining that as long as there's money to be made by corrupt officials, they will find a way to continue making it (Novotov, 2003). It is in this sense of helplessness that the values and norms that accept corruption are able to persist. This is simply a starting point for the examination of why corruption exists in these cultures, a point of reference to keep in mind when looking at its effects and policy implications. Adding to the problem of corruption in the norms and values of society are the information vacuums and the lack of transparency that exist in these cultures. These two aspects inherited from the Soviet state facilitate the existence of corruption.

#### Corruption and the Determinants of FDI

With this cultural characteristic in mind, the following analysis examines how corruption affects the determinants of FDI directly. It has already been shown in Chapter 2 that corruption affects growth in various ways, which also affects the morale of citizens. By showing how corruption affects FDI indirectly, the linkage between the two becomes more clear. The following demonstrates the effects of corruption on infrastructure, education, tariffs, privatization and stability.

The level of infrastructure is a considering factor for investors

and in countries where corruption is a problem, infrastructure and construction can be negatively affected. Corruption, combined with a lack of transparency and an information vacuum, has created an ideal situation for the corrupt officials to make a profit. This affects the development of infrastructure and construction because tenders for such sectors pass through public servants' hands and often are not allocated to an acceptable bidder. This occurs in a variety of sectors but construction is a particularly problematic one since it is easier to hide misallocated funds. For example, in Ukraine, government tenders may appear publicly but information about who won the tender and how much it was granted for is not available. It is also not possible for the public to monitor the development of projects. This type of system has negatively impacted the construction of roads and buildings because corrupt officials take bribes from companies trying to get the government tender, or else award it based on private relationships. Thus, it is not necessarily allocated to the best supplier for the service (Alieva, 2003). Also, in infrastructure projects it is very easy to overprice and overcharge because items accounted for such as cement are very difficult to measure once a building or road is constructed.

As reported by INDEM, the top three sectors that are most corrupt are education, health and border controls. The level of education can be an important determining factor for investors that require a high standard of human capital for their investment. In the Soviet Union, access to education was based on merit, yet since the regime's collapse, corruption has changed the education system in a negative way. Many parents in St. Petersburg and Moscow understand that if they want their child to attend university, and in some cases high schools, bribes will necessarily play a crucial role. This process devalues the education system and does not maximize the potential human capital available within the country, since it is not the best students who are being educated.

The fact that so much corruption exists in border controls brings the examination to tariffs and how corruption affects this significant determinant. Investors that are seeking to export their product to a Post Soviet country may find that corrupt officials in border control cause great difficulty. This added cost can act like a high tariff and influence an investor's decision. Theoretically, higher tariffs should encourage investors to relocate within the host country, but does this still apply when the high tariffs are illegal fees applied by corrupt officials? Some say that if the fees are predictable, then they will act like a tax and will therefore still encourage investment to develop within the market. However, this is not necessarily the case for the efficiency seeking investors who desire to export their product. Import and export taxes that can be measured can be taken into account when analyzing costs and benefits. Obviously, when corruption exists, this analysis becomes much less reliable. Investors will not want to rely on analyzing costs based on the amount of the last bribe they had to pay

because this is an undependable and unpredictable method. The next border control official may demand more, which can then eliminate or reduce estimated profits.

According to TI, this is exactly what is happening in Azerbaijan. The illegitimate 'fees' that are being demanded from corrupt officials for imports and exports are rising. For example a typical fee in the early 1990's for importing a product was \$100 whereas in 2002 this price has risen to up to \$5000. This can be viewed as a positive sign since increased bribes may indicate that the consequences for being caught accepting a bribe are greater which creates a need for the official to raise the fee in order to be compensated for the risks involved (Sefereliyeva, 2003).

Corruption can and did affect the privatization process. This not only causes a problem within society but discourages investors. The percentage of firms privatized has a positive direct impact in the level of FDI inflows that a host country receives. If firms are not being privatized in a manner that is conducive to encouraging foreign investors, (creating viable joint-venture options, allowing true corporate governance and disallowing illegal activity by newly privatized operations), then investors may not see the necessary structural and governance changes. Privatization demonstrates a movement away from a command economy and it shows investors a commitment to restructuring the market on the government's behalf. Privatization also provides investors with potential business opportunities and creates new companies that would increase the ease of doing business, for example by acting as suppliers for certain products and services. Therefore, how corruption is linked to the privatization process is extremely important when analyzing investment potential (Demidov, 2003).

There were various methods of privatization undertaken by the different countries, each with different outcomes. To illustrate how the privatization process was affected by corruption, Russia's 'spontaneous privatization' will be compared with Estonia's international tender privatization. Russia's privatization process has been compared to the "robber barons" of nineteenth century American capitalism because from the process, a few 'oligarchs' became incredibly rich (Bean, 2003).

In 1991, President Gorbachev, in an attempt to reform the slow moving Soviet economic system, decided to remove the power from the Soviet cabinet ministers over the individual general directors of thousands of enterprises. The new independence of general directors, or managers, allowed them to act as they wanted. The gap between prices charged for goods in Russia and the prices they could charge if they were exported presented an opportunity for individuals to get rich quick by stripping assets and selling goods abroad or on the black market. Although there are some merits to spontaneous privatizations, for example, the former managers that became

owners were most likely the best suited for the position since they understood the firm, this type of privatization was not carried out in a transparent manner. The lack of transparency provided officials with an opportunity to choose sectors, firms and the managers that would run them. The officials were seen to have acted corruptly in allocating the firms by deciding based on personal interests and relationships. In this type of allocation, the firms were not distributed to the best bidder or to the best person for the job. The method of privatization in Russia did not create the most efficient use of the firms and this can affect FDI negatively because firms and the new market are not being put to their optimal use.

This was particularly notable in the natural resource sector. The Soviet Union exploited its major reserves of oil, gas, coal and diamonds to subsidize the inefficiencies in the manufacturing economy. Much of the corruption that occurred between 1989 and 1994 was concentrated in these resource industries since prices were controlled by the state and were almost 150 times cheaper in Russia than they were on the world market. This structure allowed those who wanted to capitalize illegally in the restructuring process the opportunity to smuggle goods out of Russia (which was easy to do across borders during the collapse) (Blasi, Kroumova, Kruse. 1997). Basically, the lack of transparency, rules, regulations and precedents, allowed corrupt officials to allocate firms as they wanted. Therefore, privatization was not done fairly, openly or efficiently and often led to the deterioration of firms through asset stripping rather than long-term investment needs.

Compared to Estonia's method of privatization, the role that corruption played in Russia's public good restructuring policy becomes even more clear. Estonia has been hailed as one of the shining examples of privatization. Adopting the East German model, the government hired a privatization agency, Eesti Erasmus. The large firms were privatized through international tenders, which eliminated many of the negative effects that Russia experienced with spontaneous privatization. Firms and potential owners were examined for their credentials and long-term investment plan, leading to businesses being allocated in a way that would foster economic growth rather than the selling of assets for quick cash, as was seen in Russia. In summation, corruption can and did affect privatization by not allowing firms to be designated or sold to the best investor who would take the long term development into account (Country Guide, 1997).

The existence of corruption was not the only problem in Russia's privatization process, the lack of laws that governed the newly-formed private sector presented many opportunities for individuals to take advantage of the potential for financial gain. The method of privatization plays a crucial role in the long-term outcome of firms, the development of a market economy and thereby the attractiveness of a host country for FDI. An upshot of Russia's privatization process was that it

raised the general public's suspicion about privatization and of its consequence reforms that governments were promising to the market. This exemplifies the sense of hopelessness about changing government corruption in Russia.

Political risks are becoming a more important factor for investors when looking to invest abroad and this can encompass many aspects of corruption discussed in this chapter. Many financing institutions (Export Development Corporation, Overseas Private Investment Corporation, Multilateral Investment Guarantee Agency and regional development banks) are now offering risk insurance and risk analysis which indicates the rising importance of its role in deciding if a project is viable and its ability to attract financing for the project. The types of risks covered are expropriation, inconvertibility of funds to hard currencies and political violence. Expropriation of foreign investors in a host country can sometimes be directly related to corrupt officials that want bribes but do not get what they demand.

Soviet bureaucracy was not known for efficiency and it has left a legacy of incompetence that is difficult to reform as quickly as needed. Even President Putin sees corruption as a huge impediment to attracting investment. "The country's colossal potential," declared Putin, "is being blocked by a cumbersome, inflexible and ineffective state apparatus." That bureaucracy, he argued, "is badly organized... not adapted to meet strategic objectives [because it is] rare for officials to know about modern management science." As a result of "these administrative costs," he claimed, "it is extremely difficult to conduct business in a civilized manner in this country." "The way the state apparatus is organized at present unfortunately promotes corruption... Corruption is not the result of the absence of repression, but a direct consequence of the restriction of economic freedoms." (Helmer, 2002). Government officials tend to be corrupt because the wages are low and do not provide them with enough to maintain a decent standard of living. There is uncertainty about the future of their employment which makes people less likely to perform well. Also, they see other officials taking bribes and there are no severe consequences for the act (Onyschuk-Morozov, 2003).

### **The Problem of Political Instability and Government Ineffectiveness**

The index rating used in this study tries to capture stability in the transitional economies by using a combination of economic and political measures, but each aspect of instability needs to be examined to see the effects that corruption can have. As shown above, the combination of history, values, privatization and bureaucracy, mixed with other factors, has sustained and supported the various types of corruption that exists in transitional economies and the uncertainty of the future increases the problem. To get to the root of the problem, the

examination will look at how corruption affects stability and effectiveness.

Stability is a crucial characteristic of an economy that investors want to see prior to placing their investment in a host country. Political and economic stability enhances the amount of predictability and ability to forecast future occurrences. Most investors, when creating a business plan or project proposal want to be able to estimate costs, competition, regulations, and potential returns. If the host country is unstable then forecasting business ventures is not possible. Economic stability can be captured in macro-economic indicators, such as inflation and growth. However, political stability can be more easily affected by corruption and is more difficult to measure. Indicators that affect political stability are: government effectiveness, regulatory quality, and the rule of law. Examples of each will demonstrate the relationship and will illustrate how corruption diminishes the stability that these factors otherwise could offer investors.

Government effectiveness is severely affected by corruption. The problem arises because employees are not doing their job as effectively as possible and are thinking about how to maximize their personal gains rather than carrying out their duties. This focus on profiting from and hiding illicit gains deters officials from performing their regular tasks. For investors this is a very unattractive characteristic of a government.

Corruption decreases the regulatory quality by imposing time-consuming and evasive business regulations and investment barriers which are illegal. Regulatory quality is hindered by government ineffectiveness and the lack of an ability and desire to respond quickly. People continue to offer bribes and officials continue to take them because it is accepted in society and often it is the easiest way to accomplish things. However, these types of inefficiency in an economy will hinder and negatively affect the growth and development of strong determinants that are necessary to attract FDI.

The rule of law is also greatly affected by corruption. The rule of law refers to the enforceability of contracts, something that foreign investors place great importance on. Investors want to know that their rights and their business will be protected when operating abroad. Corruption diminishes the rule of law, most simply because some businesses do not operate within the law and this reduces fair competition. Often, in dispute resolution cases, the side that pays the judge the higher bribe is the side that is 'right'. A Moscow lawyer boasted that he never lost a case and then proceeded to explain that he knew many judges from the time he served in the military and his various positions in the government. This type of system does not ensure that foreign or local investors will be able to operate a legitimate business. The rules of business are in a process of change and although governments are promising to strengthen investment laws and property rights, there is fear

that they will not be able to override the existing corruption. The confidence in these promises of enforcement relies on government effectiveness, which was just shown to also be affected by corruption (Demidov, 2003).

In short, stability is primarily about being able to predict future costs, the ability to trust in government operations and legislation and government actions. This introduces the refining of the term 'corruption' into that of unpredictable and predictable corruption.

### **Predictable and Unpredictable Corruption**

Separating corruption into the forms; 'predictable' and 'unpredictable' is difficult, yet it plays an important role when analyzing FDI. Predictable corruption does not necessarily negatively influence an investor's ability to predict future activities (less than they would be able to in normal circumstances). Predictable corruption exists in instances when bribes are paid and the good or service is delivered, and the bribe payer feels assured it will be delivered. It is also knowing the 'prices' or bribe fees that are required. For example, in Russia, it is common knowledge that a drunk driving fee is \$100 US dollars. The opposite is unpredictable corruption, where there is no guarantee that a bribe of a specific amount will return results.

Ukraine and Azerbaijan provide case examples of the difference in the predictability of corruption and shed light on how to measure which type of corruption exists within governments. The Transparency International branch in Azerbaijan explains that corruption in government is very predictable because it is so organized. Investors and citizens alike can easily understand and predict the fees they will have to incur and be somewhat assured that they will receive what they pay for and not worry that there will be extra 'fees' once the good or service is promised. In these types of cases, it is essentially a service charge. In Azerbaijan, the corruption is very predictable, where the costs of services can be easily anticipated and clients feel guaranteed that the services will be rendered (Sefereliyeva, 2003).

In Ukraine, foreign investors and government officials that were willing to speak out against their corrupt system explained that the corruption is very unorganized in the government. There are many actors taking bribes and there is often no guarantee that the goods or services that have been 'paid for' will be delivered. There are organized crime groups that expect payments for services and there are various payments that need to be made to multiple government officials.

One foreign investor in Kiev described how difficult this unorganized system can be when establishing a business. He wanted to establish a service based wholly-owned enterprise in Kiev. He had become familiar with the investment regulations

and procedures for the Ukraine and was prepared to deal with corrupt officials. He paid two officials that promised he would get the necessary licenses and permits for their 'fee'. Several weeks later, as he was in the middle of trying to establish his business, he was told by a third official that in order to complete his investment requirements, he would need to pay another 'fee'. In the end he was required to make bribe payments to four different officials prior to establishing his business. Once it was established he was then approached by an organized crime group that also demanded money. After a year of operating in the Ukraine, the business owner was frustrated and was contemplating leaving the area. These types of experiences are extremely negative for attracting FDI in the future.

Predictable corruption can offer increased stability for investors over the unpredictable form of corruption. Although it can still have a negative impact on FDI, it demonstrates a certain level of government effectiveness where unpredictable corruption creates a business environment of insecurity and uncertainty.

Almost all investors interviewed said that there is a need to see successful investor experiences to encourage future FDI. If an investor examines previous FDI attempts in a host country and a large portion of them failed, then this will affect their interest in the country. From those interviewed, investors in Ukraine have had many negative experiences, while in Russia it is mixed. At the other end of the scale, experiences have been fairly positive in Azerbaijan.

The latest oil investment in Russia should be a good indication for other investors that are considering Russia as a host country. The British Energy company BP has recently invested \$6.75 billion in a joint venture with a Russian firm. This huge amount of money and commitment demonstrates to other potential investors that Russia is becoming a good place in which to invest, and doing business there is not only possible but profitable. Simply put, the experiences of other investors will affect the decision of investors in the future (Belton, 2003).

From this review of corruption's consequences, it is clear that corruption has many dimensions. If it is engrained in the mentality of a society, it can penetrate many aspects of a country that will then negatively affect the determinants of FDI. Although in the regression corruption did not exhibit a significant correlation with FDI, the above analysis of how corruption can affect the actual determinants illustrates that corruption does in fact affect FDI. This indirect link between FDI and corruption will deter investors from locating in transitional economies, whether they view their decision to be based on corruption or not. The negative impacts that corruption has on an economy and on a society will reduce the possibility of attracting the FDI it needs for increased economic growth.

Although corruption seems to be deeply embedded in certain Post-Soviet states, there are measures that can be taken by the international community and local governments to assist in its reduction. The following chapter will make policy recommendations that will focus on reducing corruption.

## Chapter V: Policy Recommendations and Conclusion

The research results and the case studies demonstrate that corruption will negatively affect FDI inflows, or negatively impact other determinants of FDI, into transitional economies. It is now crucial to find viable policy measures that will aim to reduce these levels and the potential increase of corruption over time. Firstly, the chapter will cover the policies and attempts made by the international community towards reducing corruption, then suggest national measures that may assist in the fight against corruption with an explanation of how these recommendations will reduce corruption in ways that will encourage FDI.

Since 1983 Transparency International (TI) has been holding International Anti-Corruption Conferences. These have been crucial for facilitating information exchanges among actors such as politicians, national and local government officials, representatives of business, the judicial, law enforcement and accounting professions, researchers, international development organizations, the media, and non-governmental organizations. There has been an increased awareness over the decades leading to more research on the causes and effects of corruption, and more recently, international agreements that aim at reducing it.

The Convention on Combating Bribery of Foreign Public Officials in International Business Transactions targets the offering side of the bribery transaction. It is essentially an effort to eliminate the source of bribes to foreign officials. The Convention began with a clear definition of bribery and required countries to impose sanctions that dissuade the offering of bribes. It also encourages

co-ordination between countries through regular contact with the OECD Working Group on Bribery and calls on signatories to carry out a follow-up programme to monitor and implement the Convention.

The aims of the Convention are reinforced by OECD Recommendations. These set out to measure which countries need to implement the accounting, public procurement, and criminalizing bribes to foreign public officials. These measures require companies to maintain adequate accounting records, adopt internal company controls, and undergo external audits. In the area of public procurement, the OECD suggests that companies found guilty of bribing foreign officials be suspended from future public contract bids. (OECD, 1998)

The recommendation on Tax Deductibility of Bribes to Foreign

Officials calls on countries to deny the deductibility of bribes to foreign public officials. The OECD Fiscal Committee surveys compliance with this instrument as a result there should be no OECD country that allows such tax deductibility. The Recommendation to Combat Corruption in Aid-Funded Procurement calls on countries to require anti-corruption provisions in bilateral aid-funded procurement. Finally, the Recommendation on Improving Ethical Conduct in the Public Service, calls on countries to take action to ensure well-functioning institutions and systems that promote ethical conduct in the public service.

One international investment lawyer feels that there needs to be a 'show trial' to illustrate the seriousness of these conventions and recommendations. He felt that the next step would be to make an example of an investor that did not adhere to the OECD rules. This would lower the likeliness of other foreign investors offering bribes in the future since they would know the severity of the repercussions (Bean, 2003).

The Global Programme Against Corruption (GPAC) was launched by the United Nations Office on Drugs and Crime Prevention (UNODC), in collaboration with the United Nations Interregional Crime and Justice Research Institute (UNICRI), to assist Member States in their efforts to prevent corruption by increasing the risks and costs of abusing power for private gain. GPAC is composed of three main components: action learning, which covers information about anti-corruption practices, relevant national legislation and regulatory mechanisms; technical cooperation that provides advisory services and pools together experts for research and representation, and an evaluation system to measure the progress of member countries and programs. (UNODC)

GPAC will advise governments on drafting and revising relevant legislation and provide training for all stakeholder groups including local authorities, business councils, grassroots organizations and ordinary citizens on new anti-corruption measures. It also aims to include the development of public-awareness campaigns, codes of conduct, and a credible public complaints system and encourage the declaration and monitoring of assets and an increased access to information. (UNODC)

The World Bank Group has devoted a substantial amount of resources to anti-corruption measures. The goals include; increasing political accountability, strengthening civil society participation, creating a competitive private sector, institutional restraints on power and improving public sector management. However, TI recommends that the World Bank promote major campaigns by the International Finance Corporations (IFC), the World Bank's private sector affiliate, to strengthen business awareness that bribing foreign public officials is now a criminal offence in most exporting countries. TI also suggests that if corruption is suspected, "Service Delivery Surveys" should be

implemented, and required, to verify whether public services actually reach the intended beneficiaries before additional loans are considered.

This briefly summarizes the international efforts to tackle corruption. These attempts are an excellent starting point but before these international conventions can reach their potential effectiveness level, individual countries need to make internal changes.

One of the most basic, yet crucial, ways in which a country can contribute to the reduction of corruption is through raising public awareness. Many people in Post Soviet economies know that corruption exists, understand that it has negative effects but remain pessimistic about reducing it. However, this impression that there is no way to change it and that it is necessary to pay bribes to achieve things or even that it can be a helpful way to accomplish tasks that otherwise couldn't be done needs to be changed. These societies need to be informed on the negative impacts of corruption and on ways they can assist in fighting corruption. One straightforward way of increasing citizen knowledge is by allowing NGOs to expand. Transparency International has established in many of the Post-Soviet states and has worked towards informing citizens about how they can reduce corruption in their country. The New Democratic Institute has incorporated corruption information for officials when they are facilitating government workshops and include information on what local officials can do to address corruption. NGOs can help in creating a strong civil society thereby establishing a way for citizens to voice their opinions (Server, 2003).

As established in chapter 4, the differences between predictable and unpredictable corruption will affect the stability and perception that investors have about potential host countries. With limited resources, it may not always be possible to completely eliminate corruption but changing it into a more predictable form can benefit countries in the shorter term making investment and growth more realistic. The most effective way to enhance the predictability of corruption is to publicize the government regulations, legal interventions, and officially authorized fees. By reducing the ambiguity of government rights, investors and citizens in general, will know their rights. For example, in Ukraine, ticket fees for driving offenses were made public and the government implemented rules which required tickets to be paid at a head office. This removed the power of local police officers to demand payments on the spot and eliminated their ability to demand more than the legal ticket price (Bowser, 2003).

More relevant to investment, confidence in the government's regulatory role in the economy needs to be increased. Efforts should be made to simplify government regulations and inspections, systematize and unify the work of inspection agencies and the procedures for conducting inspections,

publicize clear and understandable information on laws and regulations and the rights and duties of inspection agencies. Taxation bodies need to be made liable for unjustified fees, or an agency that registers inspections and limits the number of inspections could be created to replace the existing system. Many business people believe this would discourage frequent and illegal inspections.

In order to keep businesses out of the shadow economy, urgent measures are needed to reduce the taxation pressure and replace some of the multiple taxes with a unified business tax. Simplifying the tax system ought to simplify both the collection of and the payment of taxes. It will also provide governments with the necessary finances to increase wages and improve economic growth in general and create a more predictable and stable business environment.

It is also important to improve the enforcement of dispute resolution and 'conflict of interest' legislation. Legislation that prohibits conflicts of interest already exists in most transitional economies. These laws prohibit officials and MPs from using their positions to assist individuals or legal entities in entrepreneurial activities or in receiving subsidies, loans or other benefits. Unfortunately, these laws are ambiguous and therefore difficult to enforce. Dispute resolution legislation also exists but there is concern among investors that these mechanisms do not adequately protect their investments. This is partly due to the weak rule of law. This problem can be improved upon by creating an independent dispute resolution mechanism or by improving the legitimacy of those responsible for regulating legal disputes and contracts (Demidov, 2003).

The status of civil servants needs to be reformed. Although there is not a great deal of consensus in the business community about whether or not increasing the salaries of civil servants will reduce corruption, there are other reforms in this area that may help. If their wages are increased but the possibility to make additional income through corrupt means is still easily accessible, the likelihood that their corrupt practices will decrease is not certain. However, most investors and transition analysts agree that the status, responsibilities and benefits of civil servants should be increased significantly, while reducing the number of employees. This should be accompanied with reducing the amount of official discretion and enhancing accountability. This can be done by creating a system where there are several people needed to approve a license or provide a service. This ought to reduce an individual's options for taking bribes.

Merit-based recruitment can reduce political patronage and assist in attracting and retaining more capable staff. Clear and widely understood rules of conduct, accountability in performance, and transparency in decisions on pay and promotion all contribute to a healthy work environment. A system that rewards those who do not take bribes and

punishes officials who participate in corrupt practices can persuade officials to refrain from corruption. This accompanied with an increase in strengthening mechanisms that monitor and punish people who pay bribes as well as those who accept them is important (Sever, 2003).

To increase FDI, it is extremely important to include the private sector in the corruption reduction strategies, not only when implementing new measures but also in the process of locating the problem and when trying to find solutions. Investors and business people deal with corrupt officials so know first hand where the problems are and can offer insightful ways to reduce it. In September 1998, the St. Petersburg business community created the Declaration of Integrity in Business Conduct, a voluntary statement of commitment to international business principles and practices. By adopting the Declaration, a company promises to repudiate corruption and to implement a code of business ethics as part of its policy of corporate governance. For companies that do not have a corporate code, Sovereign Ventures, Inc. developed a Model Code of Business Conduct containing the best corporate governance practices of leading international companies.

Developing business associations that could effectively lobby the interests of business in the parliament and the government can replace businesses having to rely on illicit negotiations with government officials that take place behind closed doors. Many investors and business people claim that one of the most effective ways to advance their business interests is to use personal contacts and relations with government officials. This not only creates a system that is unfair but may also put foreign investors at a disadvantage. If this is the case, the foreigner will see this as an impediment.

Independent watchdog institutions that are part of the government structure can control corruption. Ombudsmen could hear citizen complaints and help increase the accountability of government agencies while independent anticorruption inspectors could investigate accusations and bring cases to trial. To provide citizens with the means to act as independent watchdogs, governments should publish budgets, revenue collection data, statutes and rules, and the proceedings of legislative bodies. Financial data in businesses should be audited by an independent authority. Even if the necessary information and the means of punishing corrupt practices are available, individual citizens need to be able to act when they disagree with government or an official's action. Laws that make it easy to establish associations and NGOs can also help resolve this problem.

The process for reducing corruption will take time and results may not occur for some time. However, corruption, over time, will become more ingrained in society and may become more acceptable as more officials take bribes and more citizens and investors offer them. The transition process is occurring

at a fast pace and it is important to incorporate corruption reducing measures now while during the creation of other changes. If the new laws, regulations, values and norms include or allow for corruption to continue then it will become part of the end result.

Transitional economies are in an ideal position to implement changes now. They are still in the process of restructuring their economies and societies. It is crucial to change the values and norms that maintain corruption and change the system that allows corruption to continue. Some argue that it would be too difficult to make all the changes at once and that without corruption in the economy, it would fall apart. However, after displaying one aspect of the negative effects of corruption, it ought to be clear that with corruption, the economy also risks falling apart. Transition is about change and with government commitment, international assistance and a shift in society, the continuation of corruption can also be changed.

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