CORRUPTION AND FDI:
THE RELATIONSHIP BETWEEN HOST STATE CORRUPTION AND INVESTOR STATE WILLINGNESS TO BRIBE

A Thesis
submitted to the Faculty of the
Georgetown Public Policy Institute
of Georgetown University
in partial fulfillment of the requirements for the
degree of
Master of Public Policy

By

Peter John Sima-Eichler

Washington, DC
April 8, 2009
This paper examines the relationship between host state corruption and bribe paying regulations in investor states. In the foreign direct investment literature, one assumption is that as host state corruption decreases, foreign direct investment increases. The standard mechanism is the reduced level of uncertainty; a state with a high level of corruption has variable fixed business costs because investors will have to pay bribes at the leisure of government bureaucrats. This paper argues that investor states are affected by changes in host state corruption in different ways. Specifically, investor states with strict anti-bribery regulations will be much more sensitive to changes in host state corruption. One reason for this effect is that it is difficult for corporations from states with strong anti-bribery regulations to compete with corporations from states with loose anti-bribery regulations in corrupt environments. Thus, if a host state decreases its level of corruption, investor states with strong anti-bribery regulations will be able to compete more effectively for
contracts, increasing their interest and potential for investment. I test my predictions using data from the World Bank (control variables like GDP, inflation rate, etc.), Source OECD (FDI flows), the Center for Economic Policy Research (distance between capital cities), the OECD (Convention on Combating Bribery of Foreign Public Officials in International Business Transactions), and Transparency International (Bribe Payers Index, Perceptions of Corruption Index). The results suggest that this effect is correct using the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions in a fixed effects model. The results are also significant using the Bribe Payers Index as a proxy in a gravity model. Still, the results are not robust, and more work needs to be done. From a policy perspective, this paper is even more evidence that countries benefit from corruption reform.
I would not have been able to complete this project without the help of Tobias Pfutze, Jennifer Tobin, Kathleen McNamara, Igor Kheyfets, and the entire staff of the Georgetown Public Policy Institute. Thank you for all of your advice and statistical knowledge.
TABLE OF CONTENTS

Chapter 1. Introduction ....................................................................................1
Chapter 2. Background/Literature Review........................................................4
Chapter 3. Conceptual Framework and Hypothesis ..........................................9
Chapter 4. Data and Methods .........................................................................11
  Analysis Plan ..............................................................................................13
  Variables......................................................................................................15
Chapter 5. Results ..........................................................................................19
  Model 1: OECD Anti-Bribery Convention Ratification .........................20
  Model 2: Bribe Payers Index .....................................................................22
Chapter 6. Policy Implications .......................................................................26
Chapter 7. Conclusion....................................................................................29
References .........................................................................................................31
Chapter 1. Introduction

Corruption plays a number of roles in international trade. It can decrease transaction costs in the face of clumsy bureaucracy, illicitly secure deals at the expense of superior firms, and suppress corporate profitability in the name of personal graft. There is an extensive literature on the types of corruption that bolster international trade in the face of inefficient government (Kaufmann and Wei) and a number of studies about the economic losses caused by corruption. This paper puts a slightly different spin on the discussion about corruption. Do states that strictly prohibit bribery by their overseas corporations face a disadvantage when investing in corrupt states? Put differently, are bribe-taking states likely to see a greater rate of foreign direct investment from corporations based in bribe-paying states than from those based in non-bribe-paying states?

The main policy implication of this question is that state attitudes towards bribery and corruption should depend not only on the distinction between "greasing the wheel" corruption and graft; states should also consider where they hope to invest. States that primarily receive FDI flows from bribe-paying states should be wary of the consequences of corruption crackdowns, and states that hope to receive greater FDI flows from non-bribe-paying states should consider the potential benefits of reform. The same basic points hold true for investors: expanding business enterprises in bribe-
taking states may require a greater willingness to overlook corruption - otherwise, it may be too difficult to compete.

To examine this question, I use bilateral FDI flows compiled by the Organization for Economic Cooperation and Development. Using tables that show the sources of FDI flows into host economies, I will examine the changes in flows from 1997 to the present. To determine which states are bribe-payers, I will use Transparency International's Bribe Payers Index (BPI). States with low scores on the BPI will be considered "bribe-payers" and states with high scores will be considered "non-bribe-payers." To determine which states are bribe-takers, I will use Transparency International's Perceptions of Corruption Index (CPI). States with high scores on the CPI will be considered "bribe-takers." As investor states become less willing to pay bribes (high BPI scores), they should become increasingly sensitive to host state corruption. When bribe-paying becomes impossible for corporations due to increased regulation, they are not able to get contracts as easily in corrupt states. In other words, all else being equal bribe-paying investor states should invest in corrupt states at a higher rate, and non-bribe-paying states should invest in corrupt states at a lower rate.

In December 1997, 37 states began to ratify a document banning bribery in international business transactions that emerged from the OECD Convention on
Combating Bribery of Foreign Public Officials in International Business Transactions.

My hypothesis is that, after ratification, investor states should become increasingly sensitive to host state corruption. Ratification reflects a decision to increase domestic regulation, preventing corporations from paying bribes overseas. As with the Bribe Payers Index, I will use OECD convention ratification as a proxy for investor state anti-bribery enforcement. All else being equal, states that ratify the OECD convention should invest in corrupt states at a lower rate. Bribery is a useful tool for acquiring contracts in many states; if states are serious about taking bribery off the table for their overseas businesses, it should put those businesses at a competitive disadvantage in states where bribery is common.
Chapter 2. Background/Literature Review

Foreign Direct Investment (FDI) plays a significant role in modern economies. World FDI flows have increased from $25 billion in 1973 (Drabek 1998) to $1.4 trillion in 2007 (Kekic 2007). For lesser developed countries, FDI flows often outstrip foreign aid and make-up a sizable part of local and national economies (Drabek 1998). In a highly globalized world, successful competition for FDI is a vital part of policymaking and a requisite part of developing states.

Various barriers limit FDI flows: lack of private property rights, poor infrastructure, excessive regulation, high tax rates, and - not surprisingly - corruption. Many authors focus on the question of whether corruption has a positive or negative effect on FDI, growth, and productivity. Responding to conventional wisdom and Samuel Huntington's comment that "in terms of economic growth, the only thing worse than a society with a rigid, over-centralized, dishonest bureaucracy is one with a rigid, over-centralized, honest bureaucracy" (Huntington 1968), Kaufmann and Wei find that corruption does not "grease the wheels" of business. High levels of corruption are associated with greater capital costs and lower profits; bribe-paying may not be an effective strategy for business (Kaufmann and Wei 1999). Corruption is also associated with lower levels of development (Ades and Tella 1997), and there is considerable evidence that it limits private investment (Mauro, 1998). Much of the
literature on corruption focuses on the negative impact of corruption and bribery on 
FDI, growth, education spending, and related topics.

One reason that corruption can preclude a partner state from receiving a high 
level of FDI is that with corruption comes uncertainty (Wei 1997). All else being 
equal, states would prefer to pay a higher tax rate in a partner country than contend 
with a high level of corruption because, with corruption, the total costs cannot be 
known (Wei 1997). Smarzynska and Wei demonstrate that moving from Mexico's 
level of corruption to Singapore's affects FDI more than a 20% tax rate increase 
(Smarzynska and Wei 2000).

Imagine building a large factory overseas, paying a few bribes to acquire land 
and infrastructure, and initiating production. A year later, the electricity goes out, and 
a government employee explains to the factory owner that he has two options: be 
without power for three months or pay an additional "fee." This "fee" could cost him 
anywhere from $1 to $100,000 (or more), but he had no reasonable way to prepare for 
it - all he knew was that corruption would be a business cost. His business is 
completely at the mercy of corrupt practitioners; new "fees" can crop up at any time. It 
is easy to see why the presence of corruption has a negative impact on FDI flows and 
private investment (Wei 1997, Kaufmann and Wei 1999, Mauro 1998). By contrast, 
transparency has a strong positive effect on FDI flows (Drabek and Payne 2001).
Corruption may also decrease FDI flows because it can lead to inefficiency (bottlenecks, high costs) and violations of business norms and best practices, making international investors more concerned with corruption than local investors (Habib and Zurawicki 2002). Habib and Zurawicki argue that the level of corruption in investor states will impact where their corporations choose to invest; businesses will try to do business in environments where they are comfortable. Corporations from corrupt states may feel more comfortable investing in corrupt states. To test their hypothesis, they interact the CPI score in host countries with the CPI score in investor states in a regression explaining FDI outflows using data from 1996-1998.

The data supports their hypothesis, but the data is limited because the CPI expanded greatly in the years following the conclusion of their project; between 1996 and 1998, CPI was only available for a small number of states. Also, the effect may have less to do with norms and more to do with comparative advantage: states from corrupt states may have fewer restrictions on their ability to pay bribes in host states, enabling them to out-compete states with strong anti-bribery laws for contracts abroad. This is better evaluated by using the Bribe Payers Index and OECD Convention Ratification to see which states frequently pay bribes overseas.

Two papers by Peter Egger and Hannes Winner look specifically at the question of how corruption and risk affect FDI flows (Egger and Winner 2003, 2006).
In their 2006 paper "How Corruption Influences Foreign Direct Investment: a Panel Data Study," Egger and Winner examine how other factors impact corruption's effect on bilateral FDI flows. Their observations are FDI country pairs from 1983-1999, and to assess level of corruption (or perceived level of corruption), Egger and Winner use the Transparency International Perceptions of Corruption Index (CPI). Their empirical model follows other corruption studies, regressing bilateral FDI flows on CPI and other variables. By building in variables to account for country size, location, factor endowments, and transport costs, they conclude that - while corruption has a negative impact on FDI flows - the interaction of corruption with other factors (factor endowments, location, etc.) can amplify or minimize this impact. Egger and Winner also conclude that corruption is more relevant for FDI flows between two OECD states and less so for OECD states investing in non-OECD states.

Taken as a whole, decreasing corruption leads to higher rates of FDI. But corporations from some states are less willing to pay bribes - Switzerland and Sweden, for instance - while others are more likely to pay bribes (Bribe Payers Index 2006). It therefore follows that the significance of corruption is different depending on a recipient state's target investors and current investment partners. Corporations from states with a higher tolerance for bribery have a comparative advantage at investing in states with high levels of corruption because they are more willing to suffer the costs of
doing business. Bribe-taking states should see a higher rate of investment from states that have a greater tolerance for bribe-paying. On the other hand, when an investor state makes it more difficult for its corporations to pay bribes overseas (through greater transparency, regulation, reporting, etc.), it will decrease its corporations' ability to out-compete corporations from states with lax bribe-paying laws for desirable contracts in corrupt states.
Chapter 3. Conceptual Framework and Hypothesis

My central argument is that corporations from states with strong anti-bribery laws will invest in corrupt states at lower rates than corporations from states with weaker anti-bribery laws. This is because corruption is a business cost in some states; if international corporations are unwilling - or unable because of national anti-bribery laws - to "pay-to-play" in certain states, corporations that are willing to pay will receive the contract. As this effect plays out, states with anti-bribery laws will have lower levels of FDI in corrupt states. While most of the literature focuses on how much corruption reduces FDI, this paper examines how corruption influences who invests.

This leads to two hypotheses. My first hypothesis is that states that are unwilling to pay bribes - states with high scores on the Bribe Payers Index - will invest in corrupt states at lower level. To operationalize this hypothesis, I interact investor state BPI scores with host state CPI scores in a panel data model to see how the interaction between these variables influences FDI outflows. I anticipate that when both scores are high or when both scores are low, it will have a positive effect on FDI; when the scores are different, it will have a negative effect on FDI outflows. My second hypothesis is that after ratifying the OECD Anti-Bribery Convention, signatories will invest in corrupt states at lower rates than prior to ratifying the
convention. This is because anti-bribery enforcement improved in states that ratified
the treaty, making it more difficult for their corporations to pay bribes. To
operationalize this hypothesis, I interact a dummy variable indicating whether or not
the state ratified the treaty with host state CPI scores. I anticipate that after ratification
investor states will invest in less-corrupt (higher CPI score) states at a higher rate.
Chapter 4. Data and Methods

The data for this project comes from several sources. The FDI outflow and stock data comes from SourceOECD. Control variables (host/investor FDI, host/investor population, etc) come from the World Development Indicators dataset. Proxies for corruption and willingness to bribe come from Transparency International’s Perceptions of Corruption Index and the Bribe Payers Index. Distance between capital cities data – used for the gravity model – comes from the Center for Economic Policy Research. Lastly, the dummy variables that explain whether or not the investor state signed the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and the United Nations Convention Against Corruption come from the OECD and the UN. I compiled the data from each source in a new dataset.

Observations are country dyads over time. I look at foreign direct investment (FDI) flows and stocks between OECD investor states and all other states from 1997 to 2006. I chose these years to get a sense of how the 1999 OECD Convention and the UN Convention (ratifications between 2003 and 2005) affected investing habits. Another consideration was that the Bribe Payers Index did not exist until 1999, and I want to use it as a proxy for willingness to bribe.
The OECD compiles this data for all of its members; unfortunately, bilateral FDI data is not available for non-OECD states for a variety of reasons. There is no central body that requests or compiles this data, and not all individual states require full reports. There are also differences in how states report and evaluate their FDI numbers, limiting their validity. Fortunately, approximately 80% of foreign direct investment outflows originate in OECD investor countries. While there is sampling bias, the results still speak directly to the investing habits of OECD states and patterns of bilateral FDI more broadly, given the amount of FDI flows from OECD states. A further weakness in the data is that there is a large amount of missing FDI stock and outflow data. Missing data may be non-random, potentially biasing the results. Still, given the huge number of observations (more than 70,000), there will still be plenty of useful data for the regression.
**Analysis Plan**

The population for my study is country dyads across time – OECD investor states paired with all host states across ten years, 1997-2006. I did not exclude any observations within the dataset, but due to the limited availability of non-OECD bilateral FDI data, I was unable to include non-OECD investor states. While 80% of FDI flows originate in OECD states, this is a limitation of the data.

Given the nature of the project, my model uses panel data. The first model examines how investor state willingness to pay bribes interacts with host state corruption to determine FDI flows. The second model looks at how OECD Anti-Bribery Treaty ratification interacts with host state corruption to determine FDI flows.

The models (where h is host and in is investor):

1) \[ FDI_{outflow} = B0 + B1OECDConin + B2OECDConin*CPIh + B3UNConin*CPIh + Controls + \alpha + \epsilon \]

2) \[ FDI_{outflow} = B0 + B1BPIn + B2CPIh + B3BPIh*CPIh + Controls + \alpha + \epsilon \]

I used a fixed effects panel data model because regressing pooled data over time has serious validity problems. Pooled data only looks at how investment habits changed over time, without examining how investment habits changed *across states*. 
over time. As a result, if FDI flows increase over time generally and corruption increases over time, it could appear that an increase in corruption causes more investment. Furthermore, pooled models make it difficult to control for unobserved variables. For example, there may be something unique about the United States-Japan that causes it to invest in a certain way, but pooled data cannot account for that, so omitted variables that correlate with the above independent variables will bias the estimate. Another example is that France invests in its ex-colonies at a high rate regardless of corruption. The panel data model controls for this unique relationship. Rather than use OLS on pooled data, I used a two-way fixed effects model, generating dummy variables for each state pair and year to control for \( \alpha \). I also use a gravity model, controlling for host and investor GDP and the distance between the countries, to evaluate the data. Gravity models are commonly used when dealing with foreign direct investment because distance and GDP are strongly significant and must be controlled.
Variables

Dependent Variables:

FDI flows: UNCTAD provides a thorough definition of FDI flows: “FDI flows are on a net basis (capital transactions’ credits less debits between direct investors and their foreign affiliates). Net decreases in assets (FDI outward) or net increases in liabilities (FDI inward) are recorded as credits (recorded with a positive sign in the balance of payments), while net increases in assets or net decreases in liabilities are recorded as debits (recorded with a negative sign in the balance of payments). Hence, FDI flows with a negative sign indicate that at least one of the three components of FDI (equity capital, reinvested earnings or intra-company loans) is negative and not offset by positive amounts of the remaining components. These are instances of reverse investment or disinvestment.”

A positive FDI flow indicates increased investment for that period; a negative FDI flow indicates disinvestment over the same period. Flows are given in U.S. dollars in terms of their value at the time of the investment. I adjusted this data for inflation.
Independent Variables:

**GDP:** This variable comes from the World Development Indicator Index. It reflects the total gross domestic product for the state for each year, adjusted for inflation. It is customarily included as a control (see the Egger and Winner study) because GDP drives investment.

**Inflation Rate:** The average percent change in the cost to the consumer of acquiring a fixed basket of goods (Consumer Price Index). States with higher levels of corruption may tend to also have higher inflation rates, potentially biasing the data if inflation rate is not included.

**Population:** The total population for the state. Population is frequently included as a control (see Egger and Winner) because it is a significant driver of FDI.

**Distance:** Distance between states is measured by kilometers between capital cities. Distance is an important determinant of FDI flows because greater distance translates into greater transportation costs. All else being equal, states that are 500 km apart should have greater bilateral FDI flows than states that are 1000 km apart.
**Bribe Payer Index**: The Bribe Payers Index measures the willingness of a firm from a particular state to pay a bribe while investing abroad. Transparency International compiles its ranking by distributing surveys to business executives in 125 different states. In 2006, 11,232 executives responded to the survey. Respondents are first asked to identify the nationalities of foreign firms that do the most business in their home country. Respondents are then anonymously asked, “In your experience, to what extent do firms from the countries you have selected make undocumented extra payments or bribes?” scoring each state 1 (bribes are common) to 7 (bribes are extremely rare). Transparency International then compiles this data, and scores each state 1-10. The Bribe Payers Index covers the 30 largest exporting states in 1999, 2002, and 2006. The Bribe Payers Index serves as a proxy for investor state willingness to bribe.

**Perceptions of Corruption Index**: This index measures the extent to which public officials, bureaucrats, and politicians are perceived to be corrupt in a given state. States are scored 1 (high perceptions of corruption) to 10 (low perceptions of corruption). The data is created by drawing on 16 polls and 10 institutions, including Columbia University, Economist Intelligence Unit, Freedom House, Information International, International Institute for Management Development, Merchant
International Group, Political and Economic Risk Consultancy, United Nations Economic Commission for Africa, World Economic Forum, and World Markets Research Center. As the data is based on polls and expert opinions, there is a subjective element to it. Still, it is the most used proxy for perceptions of corruption.

Signatory of OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions: This is coded 1 once the state signs the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and a 0 otherwise.
Chapter 5. Results

The results suggest that as bribery becomes more difficult for investor corporations, they care significantly more about the level of corruption in host states. This gives credence to the idea that corporations that are unable or unwilling to pay bribes suffer a disadvantage when investing in highly corrupt states. Since these states are unable to compete with bribe-paying states in corrupt countries, they will likely invest at higher rates in less-corrupt countries.

I measure this in two different ways. First, as states ratify the OECD Anti-Bribery Convention, their corporations should find it more difficult to invest in corrupt states. If a state's laws make it more difficult for their overseas corporations to pay bribes, they should invest more money in low-corruption states. I also use the Bribe Payers Index to examine this effect. As willingness to pay bribes decreases, states should become more concerned with corruption levels in host states, investing more money in states with low levels of corruption.
Model 1: OECD Anti-Bribery Convention Ratification

The first model in Table 1 examines the effect of OECD signatory status without control variables. The second model is a full panel data fixed effects model with control variables. Table 1 shows that if a state is an OECD Convention Signatory, it invests at a higher rate as host states become less corrupt. For each point of host state CPI (higher scores mean less corruption), investment from OECD signatory states increases by approximately $48 million, *ceteris paribus*. Corruption is not significant in itself; it becomes relevant when an investor country ratifies the OECD Anti-Bribery Convention, in theory making it more difficult for its corporations to pay bribes overseas. OECD Anti-Bribery Convention ratification in itself should not be statistically significant. A state should not increase or decrease FDI flows because of its signatory status; what should change is where the state invests. This data supports my hypothesis that states with low tolerance for bribe-paying will invest comparatively less in corrupt states and comparatively more in states with lower levels of corruption. It is significant at the 10% level that OECD signatories invest in a much higher rate as host state corruption decreases than non-OECD signatories. In the model without control variables or a panel data structure, the results are not statistically significant.
Table 1: OECD Convention Ratification Evaluated without controls and with a Fixed Effects Model

<table>
<thead>
<tr>
<th>Variable</th>
<th>Model 1 Coefficient (P Score)</th>
<th>Model 2 Coefficient (P Score)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Perceptions of Corruption Index</td>
<td>-65.66 (0.337)</td>
<td>-77.99 (0.284)</td>
</tr>
<tr>
<td>OECD Anti-Bribery Convention Ratification</td>
<td>-80.91 (0.620)</td>
<td>-124.45 (0.488)</td>
</tr>
<tr>
<td>Interaction Between CPI and OECD Ratification</td>
<td>26.17 (0.135)</td>
<td>47.53* (0.090)</td>
</tr>
</tbody>
</table>

* Significant at the 10% level  
** Significant at the 05% level  
*** Significant at the 01% level
Model 2: Bribe Payers Index

To evaluate the Bribe Payers Index variable, I first examined the effect in a traditional gravity model, using host and investor state GDP (in billions) and the distance between countries, measured as kilometers between capital cities (Model 1 in the table below). I transformed the Bribe Payers Index into an ordinal variable in order to generate meaningful interactions between the dummy variables and host state CPI scores. I divided BPI into three categories – highest third (least willing to pay bribes), middle third, and lowest third (most willing to pay bribes) – and omitted the lowest third category from the model. The categories themselves are not interesting; the question I am examining is not whether a high willingness to pay bribes increases overall FDI outflows. Instead, it is the interaction between host state corruption (CPI) and BPI that is relevant for this study. The interaction variable shows how FDI flows change for the particular category of investor state (high BPI, medium BPI, and low BPI) as CPI scores change in the host state.

The coefficients in this model are not what I predicted: states with a low tolerance for bribe paying are not necessarily more sensitive to corruption than states with a high level of tolerance for bribe paying. If a host state becomes one point less corrupt on the Perceptions of Corruption Index, FDI is expected to increase at the highest rate in states with middling Bribe Payers Index Scores, the second highest rate
in states with low BPI scores, and the lowest rate in states with high BPI scores. This is surprising; I predicted that as host state corruption decreased, states with low willingness to pay bribes would invest at the highest rate, states with middling BPI scores at the second highest rate, and states with low BPI scores at the lowest rate. In the gravity model, the interactions were statistically significant at the 5% level. In a model without any controls, the coefficients remain statistically significant, and the signs are identical.
Table 2: Bribe Payers Index Evaluated with a Gravity Model and a Fixed Effects Model

<table>
<thead>
<tr>
<th>Variable</th>
<th>Model 1 Coefficient (P Score)</th>
<th>Model 2 Coefficient (P Score)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Host GDP</td>
<td>7.81*** (0.000)</td>
<td>6.53*** (0.000)</td>
</tr>
<tr>
<td>Investor GDP</td>
<td>1.62*** (0.000)</td>
<td>3.64 (0.926)</td>
</tr>
<tr>
<td>Distance</td>
<td>-0.07*** (0.000)</td>
<td></td>
</tr>
<tr>
<td>Host CPI</td>
<td>178.93*** (0.000)</td>
<td>-127.45 (0.576)</td>
</tr>
<tr>
<td>BPI in Top Third</td>
<td>617.26* (0.086)</td>
<td>107.27 (0.910)</td>
</tr>
<tr>
<td>Interaction Between CPI and Top Third</td>
<td>-182.87*** (0.003)</td>
<td>-55.59 (0.741)</td>
</tr>
<tr>
<td>BPI in Middle Third</td>
<td>-343.08 (0.222)</td>
<td>-64.69 (0.906)</td>
</tr>
<tr>
<td>Interaction Between CPI and Middle</td>
<td>114.26** (0.034)</td>
<td>78.13 (0.393)</td>
</tr>
</tbody>
</table>

* Significant at the 10% level  
** Significant at the 05% level  
*** Significant at the 01% level

I also ran a fixed effects model (Model 2) to take advantage of the panel nature of the data. When accounting for variation across time and state pairs, the results were not significant. As with the gravity model and the model without controls, the coefficients on the interaction terms were surprising: investor states with middling BPI scores increased their FDI outflows at the highest rate when host states decreased their
corruption, and states with high BPI scores increased their FDI outflows at the lowest rate.

Despite the lack of statistical significance and the odd coefficients, my hypothesis is inconclusive, not necessarily invalid. There are several reasons that Model 2 might be inconclusive. FDI data is far from perfect; missing values make analysis less precise and may bias the results. Also, the Bribe Payers Index only evaluates states in 1999, 2002, and 2006 and does not rate all investor states. Failure to evaluate all of the investor states – even within the OECD – poses a challenge to the model. There are more than 16,000 observations for Model 1 but only 3,000 for Model 2. A better metric for rating investor state willingness to pay bribes could produce a better result.

Another possibility is that other variables are at work. Further research could investigate the conclusion suggested by the gravity model: that states with middling BPI scores are the most sensitive to host state corruption changes. There could be something unique about states with middling BPI scores that the model fails to control for. Alternatively, the effect could be indicative of a real trend.
Chapter 6. Policy Implications

If OECD Convention signatories – presumably states that have reduced the ability of their corporations to pay bribes overseas – invest in low-corruption states at higher rates, it has serious policy implications for host states and investor states. Investor states that pass increased anti-bribery regulation could jeopardize their corporations’ investments overseas. Bribe-paying is a common business expense in high corruption states; preventing corporations from paying bribes will allow corporations from states with looser regulations to out compete them for contracts.

This is not to say that investor states should merely accept corruption and lift restrictions on their corporations, allowing them to compete more effectively. Corruption has severe efficiency costs, inhibits growth, and harms populations in host states, encouraging governments to take contracts based on graft instead of wealth generation. Instead, investor states should seek uniformity in bribe-paying regulations. Since corruption is a negative externality faced by all investors, reducing it leads to absolute gains. If all states refuse to pay bribes, transaction costs will significantly decrease as host states will have no choice but to allow investors to operate in an environment with less corruption. Of course, it is not possible to eliminate bribery completely, but since FDI is a necessary part of developing economies, bribe-paying regulation should seriously reduce corruption.
The problem with universal bribe-paying regulation is that there is a huge incentive for states to cheat. An investor state is best off when all states agree to eliminate bribes overseas but it still allows its corporations to pay bribes. That way, it gets the benefit of lower corruption costs – if 99% of investors refuse to pay bribes, foreign officials will have to accept much lower bribe payments since there will no longer be competition – and can still out compete rival investors for contracts by paying bribes. If investor states perceive cheating to be common amongst their peers, they will likely reduce regulations and cheat. This is a classic prisoner’s dilemma situation: in an absolute sense, states are best off when everyone cooperates, but each state is better off cheating, regardless of how their peers behave.

Strong enforcement of the OECD Anti-Bribery Convention is a good first step towards this goal: if the Convention reduces bribe-paying, investor states achieved absolute gains. As it becomes more effective, these gains increase. To make the Convention more effective, investor states should be required to adopt uniform domestic regulations. Then, to increase transparency and reduce cheating the OECD should have investigators regularly appraise the actual enforcement of these regulations in investor states. As regulation improves over time and cheating decreases, OECD states can develop more stringent regulations and follow the same process.
Another potential problem is that, though 80% of FDI outflows currently originate in OECD states, as developing economies mature this share will decrease. If OECD states hold themselves to a high level of anti-bribery regulation and developing economies like China, India, and Brazil do not, they will not be able to compete as easily for contracts. For this reason, for anti-bribery regulation to truly be successful over time, non-OECD states must also adopt the Anti-Bribery Convention. This is a serious weakness; since OECD states are already working to reduce bribery, developing economies are getting the benefits without having to pay any of the costs. As the amount of foreign direct investment from non-OECD states increases, this will become a significant barrier to further enforcement. As corporations from OECD investor states complain to their governments about being out competed by unregulated states, transparency and regulation will become much less attractive options.

For host states, the policy implications mirror those of the investor states. As investor willingness to pay bribes decreases, host states will need to adjust to the changes, asking for less bribe money and thus reducing corruption. If states that become less willing to pay bribes are more likely to invest in states with low levels of corruption, corruption will become increasingly costly for host states in terms of FDI as more states pass anti-bribery legislation. Failure to reduce corruption could translate into lower levels of FDI relative to states that succeed in reducing corruption.
Chapter 7. Conclusion

While this study is not conclusive, further research should continue to examine how host state corruption impacts different types of investors. The theoretical foundation is straightforward: corruption is an additional investment cost that businesses would prefer to avoid. Still, in order to acquire contracts and maintain a business in certain valuable markets, corporations must be willing to pay that cost. If a multinational corporation’s government prevents it from paying those costs (through regulation, fines, or otherwise), it will be unable to effectively do business in corrupt markets. Corporations from states with strong anti-bribery regulations should find it difficult to compete with corporations from states with weak anti-bribery regulations in markets where bribery is a necessary business expense. As such, states with strong anti-bribery enforcement should invest in corrupt states at a lower rate than states with weak anti-bribery enforcement, all else being equal.

Preliminary research on the OECD Anti-Bribery Convention suggests that this effect may be significant. States that ratified the Convention were considerably more sensitive to corruption than states that did not ratify the Convention. If a host state improved its CPI score by one point, states that ratified the Convention were expected to invest an additional $48 million, ceteris paribus. Since ratification is only a one-time event, a better measure of corruption over time may improve the results as
variation increases. An annual Bribe Payers Index report (or similar metric) would be greatly beneficial to this research, particularly if it included all OECD countries.

If the effects of host state corruption do vary by type of investor state, there are numerous implications. Investor states that strengthen their anti-bribery regulations could make it difficult for their multinational corporations to invest in high corruption markets. On the positive end, as more investor states work together to tighten their anti-bribery regulations, hoping for efficiency gains, host states will be forced to reduce corruption in order to maintain competition for investment. At the very least, the returns to corrupt behavior will decrease because fewer corporations will be capable of competing with bribes. Still, as states that lack virtually any regulations against bribe-paying like China increase their level of foreign direct investment, there may remain a significant market for bribe-paying. Encouraging these states to adopt more stringent regulations is imperative to reducing corruption; otherwise, it will merely make it harder for honest businesses to compete. If reducing bribe-paying behavior in investor states reduces corruption in host states, improving regulation could make the entire world better off.
References


OECD. “Ratification Status of the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.”

http://www.oecd.org/document/21/0,3343,en_2649_34859_2017813_1_1_1_1,00.html. (accessed January, 2009).


World Bank. “World Development Indicators Online Database.”