

**CORRUPTION AND FDI:  
JAPANESE FDI INFLOWS INTO THE EU, 1996-2002**

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What is the link between corruption and foreign direct investment inflows? Prior research has pointed to both positive and negative influences of levels of corruption on levels of foreign direct investment (FDI) inflows. The basic idea behind much of the analyses is that corruption represents a cost: it increases the uncertainty associated with an investment opportunity, which in turn increases the cost of capital and hurdle rates of return for an investment. All other things equal, this increase in the cost of investing, will result in lower levels of investment. At the same time corruption has been thought of as an opportunity, where a firm's managers can exploit weaknesses in a nation's institutional environment to gain advantages in competition.

Before addressing the issue of the net effects of corruption, it is important to recognize that corruption is just one dimension associated with of the transparency of a nation's institutions. National institutional environments comprise the formal rules of a nation as defined by its political and legal institutions as well as the informal rules, as they extend from the social and cultural dimensions of a country. Corruption is a key aspect of the transparency of a nation's political and legal institutions and therefore has an impact on the level of political uncertainty and risk and the burden of regulation as it is related to the extent of market liberalization. Each of these dimensions in turn can influence the levels of FDI inflows, yet each of these dimensions is not separate from one another.

Indeed, corruption is often thought of as extending from, or being a consequence of, other dimensions of a nation's institutional environment. The role played by the regulatory state in the economy has been generally acknowledged as one of the major sources of corruption (Shleifer and Vishny, 1999; Rose-Ackerman, 1999). The political

and bureaucratic allocation of scarce resources through an elaborate system of permits and licenses provides fertile ground for rent-seeking activities that in turn favor the emergence and development of illicit behavior. If excessive regulation stimulates corruption, then policy measures such as deregulation and privatization might reduce levels of corruption, through reductions in opportunities for private rent seeking by public officials (Rose-Ackerman, 1988; Bliss and Di Tella, 1997).

Corruption, in this line of reasoning, emanates from the interaction of corporate decision-makers on the one hand and politicians or regulators on the other. To the extent that politicians/regulators are able to extract legal rents or illicit payoffs from firms, this interaction has a direct bearing on the cost of capital and cash-flow forecasts (Aggarwal and Kyaw, Chapter 12). Pursuing this chain of reasoning, the burden of the regulatory state (of which corruption is a part) leads to a higher of cost of capital, a lower incentive for firms to invest (Lombardo and Pagano, Chapter 13), and consequently a lower economic growth rate (see Overview Figure, Oxelheim, Chapter 1). In this chapter, we focus on the effects of corruption on investment decisions by foreign firms, i.e., on FDI.

Although the intent of our study is not to investigate how corruption levels can be reduced by market liberalization reforms (when those reforms reduce the regulatory burden in an economy), these points do relate to the idea that corruption is not only just one dimension of a national environment, it is a dimension that could plausibly be a consequence of other dimensions. If this is the case, then it is possible that any observed relationship between corruption and FDI inflows might be spurious, or at least contingent on other dimensions of the environment. FDI inflows could possibly be influenced by a dimension that is correlated with corruption levels, or with a dimension that is thought to

be a causal precursor to FDI inflows. We investigate this point in this study, both conceptually and empirically.

We construct this investigation by first reviewing the background literature on corruption, domestic and foreign investment and economic growth. We next move to a discussion of corruption and its correlates in national institutional environments, which is followed by our arguments about our expected relationships between corruption and FDI. We next move to an examination of these ideas using the empirical context of FDI into European countries. As we find in these analyses, both aggregate world FDI inflows as well as subsidiary establishments by Japanese firms were not sensitive to the level of corruption in a European economy. Instead, the level of government effectiveness was the element of the institutional environment most closely tied to FDI inflows. From this, we conclude that the influence of corruption on economic outcomes such as FDI inflows, needs to be considered in the broader context of a more full consideration of a nation's institutions, otherwise the strength of inferences one draws about the influence of corruption, will be less conclusive.