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Are Foreign-Owned Firms More Likely to Pay Bribes than Domestic Ones? Evidence from Emerging Markets

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SUMMARY

An extensive literature exists on the adverse effects of corruption on inward FDI and the impact this may have on economic development but the reverse causality has not been fully explored. Legislation in the US and the EU prohibits firms from engaging in corrupt practices in foreign countries and this suggests that foreign-owned firms might be less likely to pay bribes. However, such legislation may be ineffective because foreign firms have to adapt to local market conditions or risk being uncompetitive. Using firm-level data for 41 emerging countries, a probit model estimates the probability that a firm pays bribes. To allow for possible endogeneity this probit analysis is repeated with an instrument to proxy for endogenous foreign ownership. Then, a propensity score matching technique tests for differences in the propensity to pay bribes by domestic and foreign firms. The paper finds no difference in the behavior of foreign-owned and domestic firms with respect to corrupt practices. Results are robust to different levels of foreign ownership and support the view that foreign-owned firms adapt to local practices and are neither more nor less likely to pay bribes than comparable domestic firms. The paper finds that other variables including bureaucracy, government contracts, and perceived difficulties with civil society (legal and political) do have statistically significant effects on increasing bribery and that some others, such as per capita GDP, tend to reduce bribery. The study concludes that there is no evidence that foreign ownership, after investment has occurred, tends to reduce bribery but it does support the view that foreign-owned firms adopt local behavioral norms.

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1. Introduction

Corruption has been an issue of considerable importance in both the international business and economic development literatures for some time. This interest is not surprising as corruption can both be a barrier to investment (Mauro, 1995) and lead to higher costs to the firm (Shleifer & Vishny, 1993). However, the nature of the relationship between corruption and development has been questioned. The established view is that there is an inverse relationship between corruption and economic growth (Truex, 2011) although this may not be the case where institutions are weak (Méon & Weill, 2010).

The literature on international business has focused on the deterrent effects of bribery on inward investment. There have been only a few studies of the effects of foreign-owned firms on bribery and those that do exist have tended to focus on a single country. The literature on the determinants of corruption comprises a larger body of work but foreign ownership is considered as a possible determinant only in a small number of studies, typically as a dummy variable and as one of several control variables. Thus, the major contribution of the paper is to provide a more focussed examination of the role of foreign-owned firms in bribery practices than exists in either the international business or corruption literature. This study does not consider the role of foreign ownership in isolation but also focuses on bureaucracy, bidding for government contracts, and polity (political instability, crime, corruption, and the courts) in determining corruption. These, too, have been considered elsewhere in the literature but this study adopts a more focused approach to them. In keeping with the literature on corruption this study uses firm-level data for a number of countries. Firm-level data come with the problem of firm heterogeneity which can create a risk of sample selection bias. To address these heterogeneity problems a matching approach is used. As far as the authors are aware this study is the first to apply inverse probability weighted regression adjustment (IPWRA) techniques to the determinants of corruption.

One aspect of the recent literature has focused on the deterrent effect of bribery on inward investment particularly in emerging

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market countries but also more generally. Two important ideas that arise from this motivate this paper. The first concerns the question of whether foreign-owned firms tend to reduce corruption in host countries or simply find themselves compelled to adopt local standards and practices. The introduction of legal requirements in both the US and the European Union to refrain from corruption in foreign countries provides a clear motive for suspecting that the participation of foreign-owned firms in the host country might reduce corruption levels. It is clearly the case that paying bribes might expose them to prosecution in their home country and, hence, alter their behavior. But the opposite may be the case as no matter how worthy home country legislation might be foreign-owned firms face the reality of having to operate according to local standards and practices or risk being uncompetitive. Despite the risk of home country recrimination it is argued that they have little choice other than to compete with local firms even if this involves paying bribes. The second strand of recent research considers that while official corruption is never the first best solution, it may be better than nothing where a particularly obstructive and cumbersome bureaucracy is in place. This reasoning is not the main focus of this study but we do consider the likelihood that corruption and cumbersome bureaucracy are related.

This study does not set out to provide a comprehensive analysis of the determinants of bribery. Its focus is on whether the fact that firms are foreign owned affects bribery or not. Nonetheless, any analysis of the role of foreign ownership affects bribery in host markets only makes sense in the context of a wider model of its determinants. Based on existing literature the study also considers a number of potential firm-level determinants of bribery. These include government contracts, bureaucracy, perceived legal and political obstacles, and indicators of firm competitiveness. A number of country-level determinants are also considered. These include regulatory efficiency, per capita GDP and natural resource rents (as a percentage of GDP). The findings that many of these variables do indeed have statistically significant effects on bribery, and that foreign firms tend to adapt to rather than change local behavioral norms, have obvious policy implications.

This is clearly of interest to policy makers, who are aware of the adverse effects of corruption in international firms on economic growth in emerging and newly industrialized economies. The key question from the policy perspective is whether legislation in home countries has been effective in making foreign firms less likely to pay bribes than domestic ones. It is also of interest to managers of firms from those countries who have introduced legal sanctions at home against firms that engage in corruption in other countries. These firms face a potential dilemma. On one hand, if the legislation is enforced, they risk sanctions in their home country, while on the other hand if corruption is expected in a particular host country it may not be possible for their affiliates or subsidiaries to compete effectively abroad. Therefore, understanding the typical behavior of other foreign firms in this situation is of value for the development of appropriate overseas business strategies.

While is it often asserted that bribery is a particularly acute problem in emerging market countries, this study does not address whether this is or is not an accurate stereotype. The sample is drawn from emerging and newly industrialized markets because that is where corruption is believed to be an important issue although this is not necessarily the case. However, the sample raises two further issues with respect to the quality of governance and level of development. It is important to note that the sample does not include China or India. This is not because these countries are not of major importance but firm-level data are limited and neither is included in the World Bank Enterprise Survey, which is the source of data used here.

The paper proceeds as follows. Section 2 discusses the literature on corruption in the context of international business and economic development and a number of testable hypotheses are developed. Section 3 describes the data and methods used. The next two sections report the results of the probit estimation and propensity score matching followed by a discussion and section 6 concludes.

2. Review of literature and hypothesis development

This study concerns two related and overlapping strands of literature. Its focus is on the role of affiliates of foreign firms. The literature on FDI and corruption has been dominated by analysis of the deterrent effects of corruption on inward FDI (causality: corruption to FDI). An under researched aspect of the literature which has only started to be addressed more recently is the effects of foreign ownership on corruption (causality: foreign ownership to corruption). This paper is one of the few attempts in the FDI literature to assess whether foreign-owned firms offer benefits to host countries in the form of reduced corruption. It is not, as with Rose-Ackerman (2002), an analysis of whether foreign firms should be obliged to reduce corruption but an empirical assessment of whether they do in reality.

The literature from the perspective of the costs and benefits of inward FDI inevitably overlaps with the literature on the determinants of corruption more generally. A small number of studies within the determinants of corruption literature have analyzed the effects of foreign ownership (usually in the form of a dummy variable) on corruption, typically finding no statistically significant effect. This study's focus on foreign ownership as a potential determinant allows a more thorough examination of the role of foreign ownership in relation to other potential determinants of corruption. Firm-level studies such as this have become increasingly used in the determinants of corruption literature, typically with probit (which this study uses) or logit regression models. However, problems of firm heterogeneity have long been recognized as an issue with micro-level data. To address such issues a matching approach is introduced. In addition, we use Inverse Probability Weighted Regression Analysis (IPWRA), a method that to the best of our knowledge has not previously been applied in studies of the determinants of corruption. The results presented here show that it produces clear conclusions from the fog of firm heterogeneity.

Evidence that corruption has had an adverse effect on both investment and economic growth has existed in the economic development literature for some time. For example, in a cross country study Mauro (1995) found that corruption adversely affected both investment and per capital GDP growth. The literature more specifically related to foreign-owned firms is more recent but is still well established. Wei (2000) examined the relationship between FDI and corruption using bilateral country-level data and found that corruption had a negative effect on direct investment similar to an increase in the tax rate. A country-level analysis of FDI by Habib and Zurawicki (2001) found a statistically significant negative impact of corruption on FDI inflows. In a separate study of FDI inflows the same authors found that corruption was a significant and serious obstacle to inward FDI (Habib & Zurawicki, 2002). Globerman and Shapiro (2002) examined the relationship between the quality of governance and FDI flows (inward and outward) at the country level and found good governance to have a significant positive effect on FDI flows. Similarly, in a study of US outward investment good governance was an important determinant of the location choices made by US investors Globerman & Shapiro, 2003).

In a country-level analysis of the relationship between FDI and corruption, Cuervo-Cazurra (2006) found that in general

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