



Birds of a feather: Evidence on commonality of corruption and democracy in the origin and location of foreign investment in Russian regions

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ABSTRACT

We examine the effects of subnational variations in corruption and democratization on the location decisions of foreign investors in Russian regions using firm-level panel data for the period 1996–2007. We link these effects to the level of corruption and type of political regime in the country of origin of a foreign investor. We find a relationship between attributes of foreign investors' home countries and attributes of the regions in which investment takes place: foreign investors from less corrupt and democratic countries tend to invest in less corrupt and more democratic Russian regions, whereas those from more corrupt and non-democratic countries tend to invest in more corrupt and less democratic regions. An inference is that, in Russian regions with high corruption and with autocratic government, foreign direct investment appears driven by the personal interests of controlling regional political elites who collaborate for mutual gain with foreign investors from corrupt and autocratic countries. Our results suggest a general conclusion that origin and location of foreign investment are linked by common political culture.

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Birds of a feather flock together (old English proverb)¹

One fisherman sees another from afar (old Russian proverb)²

1. Introduction

The significance of foreign investment in economic development at national, regional and global levels has led to theoretical and empirical research on the determinants of foreign investment in international economic and business literature. Though most studies point to evidence that corruption reduces foreign investment (in particular, foreign direct investment or FDI) (Cuervo-Cazurra, 2006; Habib and Zurawicki, 2002; Javorcik and Wei, 2009; Nilsson Hakkala et al., 2008; Wei, 2000), other studies support a “helping-hand” role of corruption (see, for example, Barassi and Zhou, 2012; Egger and Winner, 2005).³ With

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¹ Meaning: People of similar taste congregate in groups. <http://www.phrases.org.uk/meanings/birds-of-a-feather-flock-together.html>.

² Meaning: People of similar interests, tastes or characters are attracted to each other and stay close together. <http://www.friends-partners.org/oldfriends/literature/russian-proverbs.html>.

³ Becker et al. (2009) show that at the national level corruption is a regional phenomenon.

regard to political institutions, while the majority of existing empirical studies find that, in general, more democratic countries attract more foreign capital (see [Asiedu and Lien, 2011](#); [Biswas, 2002](#); [Busse, 2004](#); [Harms and Ursprung, 2002](#); [Jakobsen and de Soysa, 2006](#); [Jensen, 2003](#); [Madhu, 2009](#); [Schulz, 2009](#)), there is also evidence to suggest that multinational companies (MNCs) may find autocratic government attractive (see, for example, [Oneal, 1988, 1994](#)).

Although there is a large amount of research on the impact of host-country corruption and the type of political regime on inward FDI, to the best of our knowledge, no previous empirical study has investigated the effects of subnational corruption and democracy development on the distribution of FDI within a single country. In this study we examine how subnational variations in corruption and democratization in the Russian regions affect the location decisions of foreign investors. We further study how the sensitivity of foreign investors' location decisions to the levels of corruption and democracy in the host regions depends on the level of corruption and the types of political regimes in investors' home countries.

Our empirical analysis is based on a sample of 2263 firms with foreign ownership that were registered in Russia during the period 1996–2007. The data come from Rosstat – the Russian State Statistical Agency – which is the most reliable data source of economic statistics on Russia. Focusing on a post-communist economy such as Russia is very suitable for our project, because Russia is a highly corrupt country with both autocratic and democratic features to its political regime and also there is diversity in terms of the corrupt practices and levels of political development across its regions. [Levin and Satarov \(2000, p.122\)](#) propose that “regional authorities exhibit the same vigor as in the federal level in using their powers to grant privileges in exchange for bribes”. In 2002, Transparency International (TI) carried out a public opinion survey titled the Corruption Index for Russian Regions, which assessed 40 out of Russia's 89 regions. The survey showed that levels of corruption differ considerably among Russian regions. A number of factors (institutional, social and structural) explain variations in the levels of corruption in the Russian regions ([Dininio and Orttung, 2005](#)).

Different theoretical approaches (the study of transition, new institutionalism, sociology) can explain subnational variations in democracy development in post-communist countries (for details, see [Lankina, 2010](#)). Several studies have created variables measuring democratization in the Russian regions. [Marsh \(2004\)](#) computed an index of democratization for Russian regions based on the data from gubernatorial elections. Nikolai Petrov and Alexey Titkov of the Moscow Carnegie Center have adapted a Freedom House-type measurement for the Russian regions. Researchers at the Independent Institute for Social Policy (Moscow) have computed an index of democracy for Russian regions based on election data (at both federal and regional levels). All the indices confirm vast differences in the levels of democracy in Russia's regions.

The link between host-country and home-country corruption and foreign investment has attracted attention only recently ([Cuervo-Cazurra, 2006](#); [Wu, 2006](#); [Aleksynska and Havrylychuk, 2013](#)). In general the conclusion is that investors from less corrupt countries and with strict anti-corruption legislation tend to invest less in highly corrupt countries, whereas investors from highly corrupt countries are undeterred by high levels of corruption in host countries. In this paper we propose and empirically test the hypothesis that less corrupt countries tend to invest in less corrupt Russian regions, whereas more corrupt countries tend to invest in more corrupt regions.

Most previous studies investigate the impact of the level of host-country democracy on inward FDI from developed and democratic countries into developing countries and, in general, conclude that this impact is positive. We further connect political institutions and FDI inflows via the interaction between the types of political regimes of the host and home countries (and, hence, government policies) and foreign investors' decisions. In particular, we propose and empirically test the hypothesis that democratic countries tend to invest in more democratic Russian regions, whereas non-democratic countries tend to invest in less democratic regions.

The paper is structured as follows: [Section 2](#) discusses theoretical arguments and testable hypotheses. [Section 3](#) describes the research design for the empirical analysis. [Sections 4 and 5](#) present and discuss the empirical results at the regional and firm levels. [Section 6](#) concludes the study.

2. Literature review and theoretical hypotheses

2.1. Host-country versus home-country levels of corruption and location decisions of foreign investors

Only a few papers examine the relationship between host-country and home-country levels of corruption on the one hand and foreign investment on the other. [Cuervo-Cazurra \(2006\)](#) observes that anti-corruption legislation in the home country that prohibits local businessmen from being involved in corrupt activities abroad increases the cost of engaging in corrupt practices abroad for a foreign investor. In this situation, the cost of bribery includes the cost of the penalties and the damage to the investor's image in the home country. FDI in highly corrupt countries is consequently deterred.

Beyond the existence of anti-bribery legislation for transactions abroad, the level of corruption in the home country is important. Countries with low levels of corruption are also equipped with means and the will to enforce the legislation, while in highly corrupt countries legislation will tend to be ineffective. For example, Egypt signed the OECD Anti-Bribery Convention⁴ in 2005, but a review by the OECD of corruption in Egypt in 2009 suggests that little has been done legally to curtail corruption in the country.

⁴ Officially, the *OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions* introduced in 1998.

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