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# Foreign direct investment and governance quality in Russia

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ABSTRACT

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This paper studies the effect of poor governance quality on foreign direct investment in Russia. Using a survey of businesses across forty administrative districts, we find that higher frequency of using illegal payments and higher pressure from regulatory agencies, enforcement authorities, and criminals, negatively affect foreign direct investment. Our identification strategy builds on the exogenous cross-regional variation in worker strikes during 1895–1914, the period before the October Revolution. We find that moving from the average to the top governance quality across Russian regions more than doubles the FDI stock. *Journal of Comparative Economics* **xxx** (xx) (2014) xxx–xxx. New Economic School, Nakhimovsky pr., 47, Office 1721, Moscow 117418, Russia.


## 1. Introduction

What are the reasons for the large heterogeneity in investment across cities, regions, and countries? Why do some of them prosper while others struggle in attracting investors and developing in the long term? In this paper, we explore how quality of governance affects a specific type of investment – foreign direct investment. Foreign direct investment is a very important source of economic growth, especially for developing countries. It allows them to overcome the local deficiencies in capital, technologies, and expertise, and has strong and long-lasting effects on growth – through both direct and spillover channels (Borensztein et al., 1998; Javorcik, 2004; Gorodnichenko et al., 2014; among many). The analysis of the determinants of FDI is popular among academic researchers; see Blonigen (2005), Blonigen and Piger (2011) for a review.

The existing empirical research, especially the one based on cross-country variation in governance quality, is not entirely convincing. Henisz (2000), Wei (2000), and Javorcik and Wei (2009) find a negative correlation between institutional measures, such as corruption and political risk, and foreign direct investment, Wheeler and Mody (1992) and Bevan and Estrin (2004) find no significant relation, and Egger and Winner (2005) suggest that bad institutional quality positively associates with FDI by facilitating its promotion in the presence of abundant regulation and administrative barriers.

We contribute to the empirical literature on institutions and foreign direct investment in three important dimensions. First of all, we establish a causal link between governance quality and foreign direct investment. In particular, we find that bad governance quality, as measured by higher frequency of using illegal payments and higher pressure from regulatory and

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enforcement agencies, and higher pressure from criminal community as well, negatively affect foreign direct investment. To estimate the impact of governance quality on FDI we propose to use the intensities of worker strikes more than a century ago, across different Russian regions, as a plausible source of exogenous variation. To the best of our knowledge, there are few other studies that show a causal effect of quality of governance on FDI. The only exception is the study of Hines (1996) who uses the passage of the 1977 U.S. Foreign Corrupt Practices Act to show that US multinational activity fell sharply in bribe-prone countries with the implementation of large penalties for illegal payments.

Second, in our study we rely on cross-regional, rather than cross-country variation in institutions. We measure governance quality within the same country – Russia – therefore allowing for a relatively high homogeneity of expectations and social norms across regions and reducing the concerns for different subjective attitudes of respondents. In this respect, our study is a part of the growing literature that uses cross-regional variation in institutions, such as Boermans et al. (2011) for China, and Ledyaeva et al. (2013) for Russia, which however do not attempt to establish the direction or the presence of a causal link. Our cross-regional governance quality data is also fitting for our research analysis in that it represents the views of actual businesses that deal with institutional problems on a daily basis, rather than those of external experts.

We clean the data on FDI by distinguishing between the real inward FDI and the so called round-tripping investment that first originates as outward FDI from Russia. In particular, we find that the positive effect of governance quality on FDI is only present for FDI that originates from regular, non-offshore countries. In contrast, for FDI that originates from offshore financial centers – countries such as Luxembourg and British Virgin Islands – there is an insignificant and negative effect of governance quality, supporting the view that the motive behind such FDI may be entirely different (e.g. money-laundering). Although such a separation is especially important for Russia, with about half of its foreign direct investment coming from these offshore financial centers, it may also be relevant for other countries. Specifically, our results imply that bundling together FDI flows that have different motives may be one of the reasons for the mixed or insignificant effects of institutions on FDI in the previous literature.

Russia presents an excellent laboratory to analyze the effect of governance quality on FDI. Over the last decade it has accumulated significant amounts of FDI stock, becoming one of the top destination countries. More interestingly, in Russia, which consists of more than 80 administrative districts, there is a considerable heterogeneity within the country in terms of the inward FDI stock, which ranges from just a few cents in some regions to tens of thousands of $US per capita in others. At the same time, many regulatory interactions between investors and government authorities are delegated to the district level, providing naturally for a large variation in terms of the business climate as well (as documented for example by CEFIR, 2007, and World Bank, 2012, 2013). These differences in governance quality are at least partly responsible for a substantial diversity in FDI flows. We find that FDI increases by more than 150% when the region improves from the average to top level of governance quality. In this regard, our finding on the significant effect of governance quality on foreign direct investment across Russian regions is in line with the "new comparative economics" literature started by Djankov et al. (2003).

Certainly, there may exist other reasons why governance quality and FDI relate to each other in the data. For example, it is likely that richer regions that have attracted lots of FDI can afford to have better governance quality. Such reverse causality concerns illustrate the importance of using some exogenous variation that could help clarify the exact direction of the link – the one from governance quality to FDI.

Fortunately, Russian history provides with an interesting instrumental variable. Specifically, we use the intensity of worker strikes in 1895–1914 as an instrument for current governance quality. Our argument for the use of this variable is that the presence of a conflict of interests between the business owners on the one side and the workers on the other side, which intensified in the 1890s with unprecedented industrial growth, may act as a revealed indicator of government authorities being involved in securing the interests of the business owners. In particular, the fewer worker strikes there are, the less likely it is that the capitalists may have unfairly teamed with the government authorities to act against the workers. In such a case, more trust in the government authorities on the side of both workers and business owners occurs, translating naturally into better governance quality overall, which, as long as such incentives persist, survives over decades (Acemoglu and Robinson, 2006). Our paper thus continues the tradition of using historical arguments in the research on economic development (Hall and Jones, 1999; Nunn, 2008).

Another very important strand of the literature that deals with the historical roots of the state regulation is the legal origin theory (La Porta et al., 2008). Djankov et al. (2002), Botero et al. (2004) provide empirical evidence on the differential effect of legal principles, namely common vs. civil law traditions, on the extent of regulation that governs firms' entry and labor market. The civil law is usually associated with higher burden of regulation outstretched over businesses and markets.

In all political regimes that Russia experienced over last two centuries its legal system were invariantly based on French civil law. So neither historical reference nor cross regional approach of our study deal with the issue of legal origin per se. Nevertheless we find several insights essential to our research. First, La Porta et al. (2008) propose a broad concept of the legal origin as a "style of social control of economic life". Second, legal origin theory considers human capital and beliefs of participants of legal system to be the important means to ensure its persistency over time. These two assumptions can well be applied to the way the same formal regulation is enforced in different regions of the same jurisdiction. Yakovlev and Zhuravskaya (2013) provide evidence of regulatory enforcement differences across Russian regions. Given the same legal framework the differences in enforcement can be a proxy for the extent of social control of economic life. Then, the cross-regional variation in the historical circumstances that shaped the origin of regulatory enforcement and its persistency over