Corruption and Cross-Border Investment in Emerging Markets: Firm-Level Evidence

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Summary

We study how the volume of foreign direct investment and its ownership structure may be affected by the extent of corruption. Corruption makes obtaining local licenses and permits more costly for foreign investors. Having a local partner lowers the transaction cost (e.g., the cost of securing local permits). At the same time, sharing ownership may lead to technology leakage. Both costs of local permits and losses from technology leakage are positively related to the extent of corruption in a host country. When the corruption level is sufficiently high no investment will take place. When corruption is low enough so that investment can take place, the foreign investor with more sophisticated technology prefers a wholly-owned form, but, holding the technological level constant, the investor is more inclined to have a local partner in a more corrupt host country.

We test these hypotheses using a unique firm-level data set from 22 transition economies. Our main results can be summarized as follows. We show that the probability of investment taking place is negatively related to the extent of corruption in a host country. Conditional on FDI taking place, the data suggests that foreign investors are more likely to take on a local joint venture partner in a corrupt host country, possibly to save the transaction cost of dealing with local government officials. Under one set of point estimates, a decrease in corruption incidence from the level found in Azerbaijan to that prevailing in Estonia is associated with an increase in the probability of investment from 4 to 19 percent. Conditional on FDI taking place, the same amount of reduction in corruption is associated with an increase in the probability of investment taking the form of a wholly-owned subsidiary (rather than a joint venture) from 24 to 44 percent. However, other things equal, the data shows that foreign investors with more sophisticated technologies are more likely to retain full ownership of their projects rather than to engage in joint ventures. There is some limited evidence suggesting that this effect is stronger in more corrupt host countries.