

Prospectus: FDI, corruption, and the effect on private sector development

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1 Empirical Puzzle

In recent decades, foreign direct investment (FDI) global flow has steadily increased, rising to over \$1.5 trillion dollars in 2014. For developing countries, FDI flow is also remarkably robust to global downturn, leading to enthusiastic endorsement by major international organizations as a key factor to economic development (Figure 5).¹ This assumption is also shared widely within political science, where much of the literature starts with the assumption that countries want to seek FDI for its many benefits. The question that these works focus on is *how* countries can attract FDI, not *whether* they want to do so (Jensen 2003; Li and Resnick 2003; Li 2006; Ahlquist 2006).²

Underlying this mode of thinking is the assumption that FDI brings various benefits to developing countries, including capital and employment. However, the most important promise that FDI holds to growth is the spillover of productivity between foreign firms and domestic firms. This can happen if local firms hire workers that were trained in a foreign firms, improve productivity through backward and forward linkages, or imitate foreign technology. According to growth theory, it is FDI's spillover, not capital or employment, that brings the technological innovation that is requisite for economic growth (Findlay 1978). In this view, FDI is also a public good, providing spillover benefits to the local firms in ways that foreign firms do not take into account in their private calculations. This provides the justification for countries' using investment incentives to rectify the undersupply of FDI, closing the gap between private and social returns.

Despite this prevailing view, there is little conclusive evidence of FDI having a positive effect on growth (Nair-Reichert and Weinhold 2001; Carkovic and Levine 2002) or poverty reduction (Guerra et al. 2009) (Figure 2). A substantial literature has developed to explain this puzzle, concluding that the growth-enhancing and spillover effect of FDI is conditional on the absorptive capacity of local firms. Cross-nationally, scholars find that FDI is more likely to have a positive growth effect when the technological gap between the local and foreign firms are small (Nunnenkamp and Spatz 2004) and when host countries have strong financial

¹<http://www.imf.org/external/pubs/ft/fandd/1999/03/mallampa.htm>, <http://www.weforum.org/reports/foreign-direct-investment-key-driver-trade-growth-and-prosperity-case-multilateral-agreement>

²Two recent exceptions are Pinto (2013); Pandya (2013), which are the first to investigate the demand for FDI.

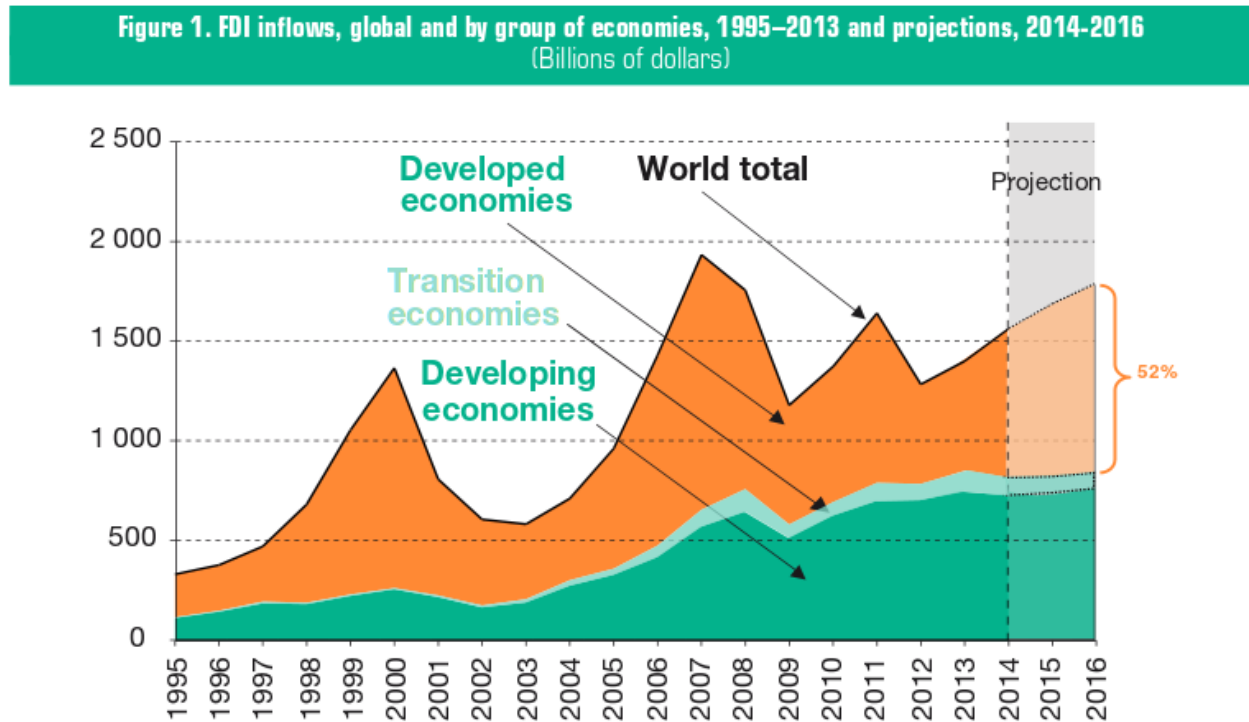
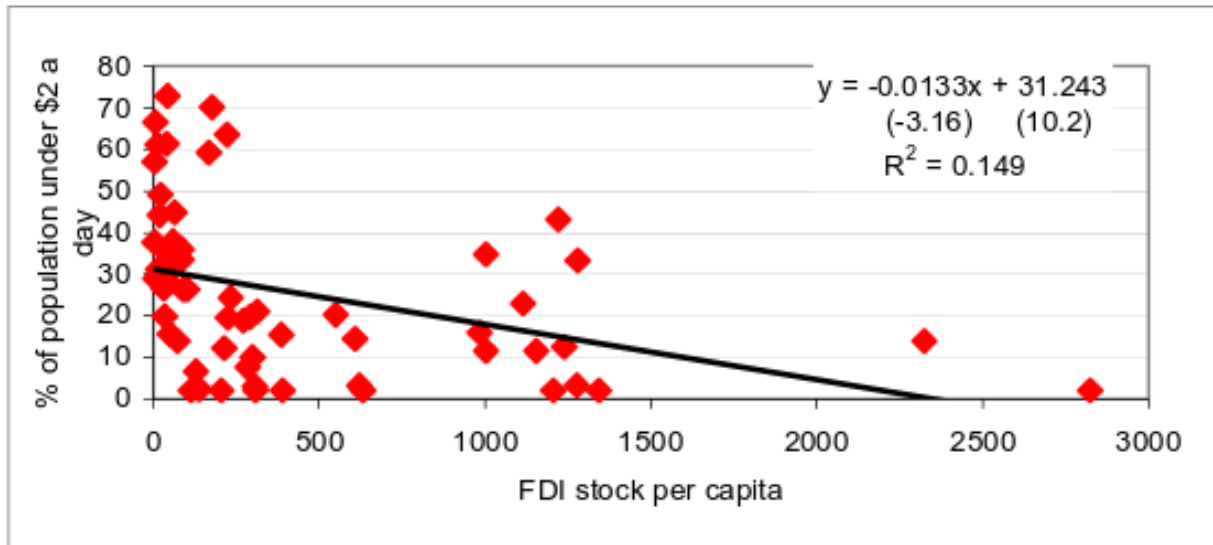


Figure 1: Source: World Investment Report, 2014

and institutional development (Durham 2004). Similarly, absorptive capacity, measured by the level of schooling in host economy, conditions the transfer of technology between foreign and local firms across regions in China (Fu 2008) and countries in Latin America (Willem 2004).

Despite the resounding conclusion that the effect of FDI is highly conditional and that investment incentives do not work, why do countries still fixate so much on bringing in FDI instead of developing local absorptive capacity (Blomström 2002)? For example, Ireland provided foreign investors with lower tax rate, lower land price, and cash grants for R&D that do not need to be repaid. China also used a tax holiday (two years of no tax and three year of half the normal tax rate) in special economic zones to attract more foreign firms (Telford and Ures 2001). We see the same widespread use of investment incentives in Southeast Asia (Fletcher 2002). In Vietnam, the race to offer incentives to foreign firms rages on even among sub-national units, as provincial governments defied the central government's directive and offered extra-legal incentives to FDI firms (Anh et al. 2007). Not only do these measures not work in attracting more FDI, they also deprive countries of revenues that could be spent on improving the local labor quality and investment climate, which are much more conducive to spillover effect and growth.

Thus, my dissertation project focuses on this empirical puzzle: if the positive effect of FDI is uncertain, why is there so much focus on attracting it? If developing absorptive capacity is so crucial to making FDI growth-enhancing, why is it often neglected? To understand this puzzle, I propose that we need to take into account the calculus of the individual bureaucrats



Source: Own elaboration, from UNCTAD and UNDP data (data for the year 2000). T-statistics in brackets.

Figure 2: Relationship between FDI and poverty

and government officials, who may be more interested in the potential rents from foreign firms than the spillover and growth-enhancing effect of FDI. This is a potential reason why we often see countries (i.e. government officials) being so enthusiastic about attracting FDI, yet not so passionate about developing the local capacity that enables FDI to actually have a positive effect on growth.

Starting with this empirical puzzle, my project also sheds light on various related issues. First, it investigates the collusion of FDI firms and host countries' officials, a understudied phenomenon as the existing literature often assumes a foreign firm trying to fend off extortion and harassment from host countries. Second, it examines the political drivers behind private sector development, an issue whose welfare impact is well-known yet whose political determinants are ill-understood. Third, my project looks at the treatment of foreign firms versus domestic firms from a fresh angle. The majority of political science literature has considered FDI the underdog, unfamiliar with the location, susceptible to expropriation, and threatened by the lobbying effort of domestic firms. However, when FDI firms are big and resourceful, they can be an equal partner in the collusive relationship with corrupt officials to the detriment of the domestic sector.

2 Tentative evidence

In this section, I present some evidences that motivate the puzzle.

- The spillover effect of FDI on growth is highly variable. For example, FDI is found to be growth-enhancing in East Asia, but not in Latin America (Zhang 2001). Similarly, the effect of FDI on domestic investment also varies across countries and regions. FDI

is found to crowd in investment in some countries (e.g. Ghana, Senegal, South Korea, Pakistan, Thailand, etc.) but crowd out in others (Agosin and Machado 2005).

- Despite the prevalent concern with discrimination against foreign firms, the Wold Bank Enterprise Survey finds that foreign firms actually face fewer obstacles while doing business (Batra et al. 2003). The gap in the treatment of foreign and domestic firms also varies across countries (Figure 3).
- The correlation between corruption and FDI is negative. However, there is a lot of unexplained variance at the high end of FDI. Countries with low level of FDI are always very corrupt, but countries with high level of FDI can be as well (Figure 4).

3 Theory

My theory aims to explain the gap in the treatment of domestic firms versus foreign firms. The argument will be laid out in three steps:

1. I argue that for FDI to have a spillover and growth enhancing effect, the domestic sector must also be healthy. Therefore, if we see the a gap in the treatment of domestic firms versus foreign firms, it must mean that the government is attracting FDI for reasons other than growth.
2. I argue that corruption (i.e. rent from foreign firms) is one such reason. If that is the case, the testable implication is that a large presence of FDI in corrupt countries (sectors) is associated with a large gap in the treatment of domestic versus foreign firms in those countries (sectors). At this step, the level of corruption in a country (sector) is treated as exogenous.
3. I endogenize the choice of the officials to engage in corruption by explicitly considering their utility maximization. To get a handle on the options available to the officials, I hold the political system constant by focusing on the case of Vietnam. With its provincial variation in FDI and private sector development, Vietnam serves as an insightful microcosm of the cross-national differences. I argue that, in Vietnam, whether the domestic sector is discriminated depends on the choice of the provincial official to choose between the rent of FDI firms and promotion to the central government, of which private sector development is an important criterion).

It is important to note that the dependent variable is *not* the size of the domestic sector. Conceptually, the size of the domestic sector is a poor proxy for the government's discrimination against domestic firms in favor of foreign firms. Empirically, it is also a highly endogenous variables because there is definitely reverse causality between the presence of FDI (a key independent variable) and the size of the domestic sector.

3.1 The spillover effect of FDI depends on having a strong domestic sector

There are several channels through which spillover can happen, all of which require a strong domestic sector.

- imitation: domestic firms may reverse engineer a production or management technique (Wang and Blomstrom 1992). This requires 1) a small, surmountable technological gap (Kokko et al. 1996), and 2) backward linkage between local and foreign firms (Javorcik 2004). Therefore, it is necessary to have technologically competent local firms that are able to supply inputs to foreign firms.
- skills acquisition: workers trained in foreign firms bring along their human capital when they move to domestic firms (Djankov and Hoekman 2000). This presumes a healthy domestic sector that can offer competitive wages to workers.
- competition: similar to arm's length trade, the presence of foreign firms put pressure on domestic firms to reduce inefficiency (Glass and Saggi 2002). For this mechanism to work, the domestic sector must survive instead of being squeezed out of market by foreign firms.
- export demonstration: foreign firms are more knowledgeable about exporting, which involves high fixed cost to set up a distribution and transport infrastructure, or learning about foreign taste and regulatory environment. Domestic firms can learn this "export know-how" from foreign firms (Aitken et al. 1997). This process, too, requires a strong domestic sector that is able to engage in commercial linkages with foreign firms.

In sum, the spillover effect of FDI depends on a strong domestic sector. Therefore, if a government is truly interested in FDI for its spillover and growth-enhancing effect, the government must be equally interested, if not more, in nurturing the absorptive capacity of domestic firms. Holding constant firm characteristics (size, sector, technological capacity, etc.), if we find that domestic firms receive worse treatment by the government, this can be evidence that the government is not primarily interested in the spillover effect of FDI, but potentially for corruption.

Anticipating alternative explanations, there are yet reasons for countries to attract FDI other than growth and corruption, such as jobs, capital, and balance of payments. Fortunately, these alternative explanations can be controlled for. In addition, these factors may account for the enthusiasm of the government towards FDI, but cannot fully explain the discrimination against domestic firms in favor of FDI. Indeed, many factors that are attractive to foreign firms (e.g. skilled labor force, good infrastructure, good governance) has high fixed cost but low marginal cost, and thus should be easily extended to domestic firms. Therefore, if these were the reasons the government wants FDI, the domestic sector would benefit instead of being discriminated against.

3.2 FDI and corruption

My hypothesis that host country officials engage in corruption with foreign firms to the detriment of domestic firm is a novel contribution to the IPE literature of FDI and corruption.

So far, the literature has been predominantly dominated by studies showing that a high level of corruption deters FDI (Wei 2000; Hakkala et al. 2008; Al-Sadig 2009). But what about firms that choose to invest in a highly corrupt environment nonetheless? One strain of the literature argues that foreign firms can help reduce corruption in host country via regulatory pressure effect, demonstration effect, and professionalization effect (Kwok and Tadesse 2006); or via competing away the rents of the domestic firms, reducing the supply of bribes (Sandholtz and Gray 2003). On the other hand, some argue that foreign firms, disadvantaged by their foreignness, have to bribe more and exacerbate corruption (Hellman and Hellman 2002). In all of these works, corruption between the host government and the foreign firm is conceptualized as *predatory*.

My theory advances the literature by arguing that corruption between the host country and the foreign firm can be *collusive*. Not all foreign firms are underdog, forced to bribe to equalize the playing field. If foreign firms enjoy regulatory privilege, they do not want to relinquish it. If foreign firms are themselves in collusion with the government, there is by definition no demonstration or professionalization effect. Indeed, foreign firms have bribed to get an upper hand in the local market³ or to pursue rent in protected industries (Malesky et al. 2015). In these cases, the foreign firm and the government enter a collusive relationship, resulting in the maltreatment of domestic firms.

The sequencing of the game is as follows:

1. At the start of the game, the level of corruption in a country (sector) is given.⁴
2. If the level of corruption is high, the government is mainly interested in FDI as a source of rent, not as a source of growth. There are several reasons why the government is interested in seeking rent from FDI firms instead of domestic firms. First, if foreign firms are more profitable than domestic firms, they have more rent to be extracted. Second, if foreign firms are larger than domestic firms, they facilitate coordination and allow corruption to be better kept secret among fewer actors. Third, if the interests of firms and the government misalign in the future, foreign firms have both the options of “exit” and “voice”, whereas domestic firms only have “voice”. The government would much prefer an exiting foreign firm to a domestic firm voicing its interest. The first and second reasons indicate that my theory is most applicable when the entering FDI firms are large.
3. The foreign firm weigh the cost of corruption against the benefits of entering the country (sector), such as natural resource, local market, or cheap labor. If the benefit outweighs the cost, the firm enters the country (sector).⁵

³<http://www.nytimes.com/2012/04/22/business/at-wal-mart-in-mexico-a-bribe-inquiry-silenced.html?pagewanted=all>

⁴This assumption is not totally implausible. High level of corruption in a country may be largely the result of a political system that fails to produce accountability. Such political system is more likely to be the cause than the result of the maltreatment of domestic firms. Similarly, high level of corruption in a sector may be largely due to the nature of that sector, e.g. resource-intensive, high fixed cost leading to natural monopoly, etc. which is exogenous.

⁵Figure 4 shows that among countries with a lot of FDI, the level of corruption runs the full gamut. This confirms that foreign firms often enter a country despite the cost of corruption.

4. Since the government brings in this foreign firm for rent, not for spillover, it does not care about the development of the private sector in this country (sector). Therefore, we will see a gap in the treatment by the government of the domestic firm versus the foreign firm in this country (sector).

The theory leads to two testable hypotheses:

Hypothesis: The presence of large FDI firms in corrupt countries is associated with a large gap in the government’s treatment of domestic firms and foreign firms.

Hypothesis: The presence of large FDI firms in corrupt sectors is associated with a large gap in the government’s treatment of domestic firms and foreign firms.

3.3 Endogenizing government officials’ decision to engage in corruption with foreign firm

The theory in the previous section starts with the level of corruption as a given parameter. To advance the theoretical contribution even further, it is important to endogenize the decision by the government officials’ to engage in corruption with foreign firm. However, “why is a country corrupt?” is a big and difficult question to study with a cross-national design due to an insurmountable degree of endogeneity.

To get a handle on this question, we need to know the utility calculation of the government officials, which in turn requires knowing the options offered by the country’s political economic system. Therefore, in the next step of the theory, I focus on the case of Vietnam, whose sub-national variation in FDI flow and private sector development serves as an excellent testing ground.

In addition, a cross-national study of corruption suffers from well-known conceptual and measurement issues. Conceptually, corruption means different things in different countries (Rosen 2010). Empirically, even if we restrict corruption to a narrow but clear-cut definition, i.e. the act of bribery in exchange to public goods that should be freely available, it is still very difficult to measure corruption well due to sensitivity bias in surveys. Focusing on the case of Vietnam does not only keep constant the locale-dependent definition of corruption but also takes advantage of a survey list experiment conducted by Malesky et al. (2015) to accurately measure the level of corruption across provinces and sectors without bias.

The theory is as follows. I argue that the key to the variation in provincial corruption is the principal-agent relationship between Vietnam’s central and the provincial governments. Since most FDI projects are approved at the provincial level, it is the provincial government, not the central, that holds valuable services for sale to foreign firms. This is especially true because the implementation of central law varies widely across sub-national units in Vietnam (a situation common among developing countries) (Meyer and Nguyen 2005).⁶ The central government, therefore, is more removed from direct contact with FDI firms and thus less likely to benefit from corruption than provincial leaders. At the same time, the central government is much more concerned with overall economic growth, which is central to the

⁶Vietnam’s variation in implementation generalizes well to other developing countries (Thun 2006)

longevity of the regime (Malesky 2008). Therefore, the central government is more interested in the spillover effect of FDI, which necessitates the development of a strong domestic sector as discussed. On the other hand, each provincial leader is incentivized to free-ride on the developmental effort of other provinces and of the central to keep the entire regime stable.

Therefore, provincial leaders care more about private rents from FDI. In contrast, central leaders care more about the spillover effect of FDI on private sector development.

Fortunately for the central government, the principal-agent problem in this context is partially solved because monitoring is not too difficult. Indeed, the central government can observe the economic performance of the provinces and use personnel management to punish and reward provincial officials (Sheng 2007; Li and Zhou 2005).⁷ Therefore, the principal-agent problem is only severe when the provincial officials are not interested in further promotion to the central government. This suggests that there will be a variation in private sector development across provinces according to the provincial officials' interest in promotion. By looking at this variation in the career interest of sub-national actors, my theory contributes a fresh angle to the current literature on the relationship between decentralization and corruption, which has only postulated a one-way relationship: either decentralization increases bribery (Fan et al. 2009) or reduces it (Guerra et al. 2009).

Two key assumptions in the theory above deserves further examination:

1. Why wouldn't Vietnam's central government worry that a developed private sector may lead to social change that undermines its position?

First, there is a large scholarship showing that authoritarian regimes are very adept at using institutions to manage regime outsiders in general and business in particular (Gandhi and Przeworski 2006; Gandhi 2008; Wright 2008; Le 2015). Second, if the legitimacy of the regime rests heavily on delivering economic growth, then the short-term risk of an economic downturn creating instability features much more prominently than the long-term concern with social changes. Third, it is possible to foster economic growth while restricting political freedom (e.g. Singapore). Indeed, growth can make a regime, both democratic and authoritarian, more stable, and creates room for political control (Przeworski et al. 1997).

2. Why don't provincial leaders seek rent from the domestic sector?

First, Vietnam's private sector is still very small, especially so when FDI was first allowed into Vietnam. It is much harder for the officials to co-ordinate and maintain secrecy when engaging in corruption with multiple domestic SMEs than with one big foreign firm. Second, ironically, if officials want to grow the private sector for future rent-seeking, they must promote a enabling business environment that are free from rent-seeking. In contrast, corruption with large and existing FDI firms is much more convenient. Essentially, Vietnam's provincial officials have shifted the cost of building a thriving domestic sectors to the home countries of FDI firms and now extract rents from the high productivity and high profitability of these firms.

⁷Shih et al. (2012) recently argue that economic performance does not matter to cadre promotion. However, they investigate all members of the Chinese Central Committee, including the central party apparatus, the army, and the central economic bureaucracy. These actors are not the important decision-makers in our theory.

In sum, I propose a hypothesis about variation across Vietnam’s provinces:

Hypothesis: High concentration of FDI in provinces where provincial leaders are not interested in promotion is associated stunted domestic firms in those provinces

4 Research design

4.1 Hierarchical model using cross-national, cross-sectoral data

To measure corruption, FDI concentration, and treatment of firms across countries, I utilize the World Bank’s Enterprise Survey (ES), which includes a wealth of firm-level data across 125 countries, spanning various topics from investment, labor, to business-government relation (World Bank 2015). The Enterprise Survey uses stratified random sampling (using three strata: firm size, business sector, and region) in order to ensure representativeness. The survey data comes from face-to-face interviews with upper management and is anonymized to ensure confidentiality at all times.⁸ This dataset has a wealth of firm-level data that helps us operationalize key concepts as detailed below.

Recall our hypothesis:

Hypothesis: High concentration of FDI in corrupt countries is associated with stunted domestic firms in those countries.

Hypothesis: High concentration of FDI in corrupt sectors is associated with stunted domestic firms in those sectors.

Operationalization:

- FDI in countries: available via UNCTAD data on FDI flows and stocks to countries. Concentration can be measured as the ratio of FDI to GDP.
- FDI in sectors: available via the Enterprises Survey dataset. Concentration can be measured by constructing a Herfindahl-Hirschman Index based on the size of sale, labor, or capital of firms.
- Corruption: can be measured in two ways. 1) Firms’ perception about corruption as an obstacle. This measure is frequently used but the least accurate since firms’ perception of corruption depends not only on the level of corruption but also the characteristics of firms. 2) Hard measure of prevalence and depth of bribes, e.g. “Was an informal payment expected or request (when applying for a license)?”, “How much do establishments like this one give in informal payments?”

⁸For more on the methodology of the Enterprise Survey, visit <http://www.enterprisesurveys.org/methodology>

- The development of the domestic private sector: can be measured by 1) experience of domestic firms with the business environment. However, this measure may simply capture the overall governance quality instead of showing that officials have neglected domestic firms to pursue rents with FDI firms. Therefore, a better measure is 2) the gap between the experience of domestic and foreign firms. This measure is also biased against our hypothesis, since foreign firms that self-select into investing (and thus show up in our survey sample) are more similar to domestic firms than foreign firms that decide not to invest.

4.2 Cross-sectoral and sub-national variation in Vietnam

Despite the wealth of firm-level, cross-national data in the ES dataset, it suffers from two fundamental issues.

First, its measure of corruption is still plagued by a host of measurement issues. Asking directly about firms' experience with corruption is unlikely to get an accurate answer due to sensitivity bias (Coutts and Jann 2011). Researchers, including the ES team, often address this problem by framing the question about the experience with corruption of "firms like yours." However, with this technique, firms may not read between the lines and actually answer about the experience of others (Ahart and Sackett 2004).

Second, since the development of the domestic sectors is a major factor why the government resorts to foreign firms for rents, its development matters in the sequencing of the game.

I can remedy these problems with a research design focusing on the case of Vietnam, taking advantage by a survey list experiment by Malesky et al. (2015), which uses unmatched count technique to accurately measure the experience of firms with corruption while avoiding sensitivity bias.

Operationalization:

- FDI in province: Provincial statistics of FDI flow
- FDI in sectors: PCI-FDI survey (can the survey sample be used to estimate the population's FDI?)
- Corruption: list experiment (Malesky et al. 2015)
- Interest in promotion:
 - years until retirement (retirement age is 60 for male, 55 for female)
 - appearance in centrally controlled newspapers
- The development of the domestic private sector:
 - PCI survey question: "Do you think that the provincial officials prefer FDI?" (Question H3)
 - The gap in the experience of domestic and foreign firms regarding the pro-activeness of the government in helping business (Form H for domestic firms and Form J for foreign firms)

4.3 Conjoint analysis

While the crucial causal mechanism is the preference of provincial officials, observational data can only partially get at this because what the leaders want sometimes may not be fulfilled due to external factors (endowment, central policies). These factors can be controlled to some extent, yet the risk of mis-modeling is always present. Furthermore, what an official wants from a FDI firm is often hard to completely teased out. A big FDI firm is an attractive source of rent, but it also brings job and technology. Indeed, perhaps this high correlation is why it is so easy for officials to extract rent from FDI under the guise of promoting economic development.

To truly get at the preference of provincial leader, I plan to conduct a survey experiment using conjoint analysis to ask provincial officials about their preference between two hypothetical FDI firms (Hainmueller et al. 2014). The characteristics of these will be randomly varied across five dimensions: 1) industry, 2) size of labor force, 3) capital, 4) technology age, and 5) land, which proxies for corruption opportunities, since this is a key resource to firm that is controlled by provincial officials. If desired, it is possible to:

- adjust the design so that implausible hypotheticals will not appear (i.e. there should not be a high-tech company with very small capital).
- randomize the ordering of the characteristics between respondents to test for the ordering effect (i.e. knowing a firm’s industry first changes how the respondent thinks about the other characteristics)

I am mainly interested in the “average marginal component effect” (AMCE) of *land*, which is the marginal effect of *land* on the likelihood of a project being accepted, averaged over the distribution of all the other components. This allows us to back-out the what provincial officials truly want from FDI project.

4.3.1 Experimental design

Please read the following description carefully. Then, please indicate which project you prefer to grant investment license (cap gay phep dau tu).

	Project 1 (Du an 1)	Project 2 (Du an 1)
Industry		
Labor force		
Capital		
Land		
Technology age		

If you have to choose, which project do you prefer to grant investment license? Project 1 / Project 2

- Industry: textile, electronics, automobile, consumer product
- Labor force: 5, 50, 100, 200, 500 employees

- Capital:
- Land:
- Technology age:

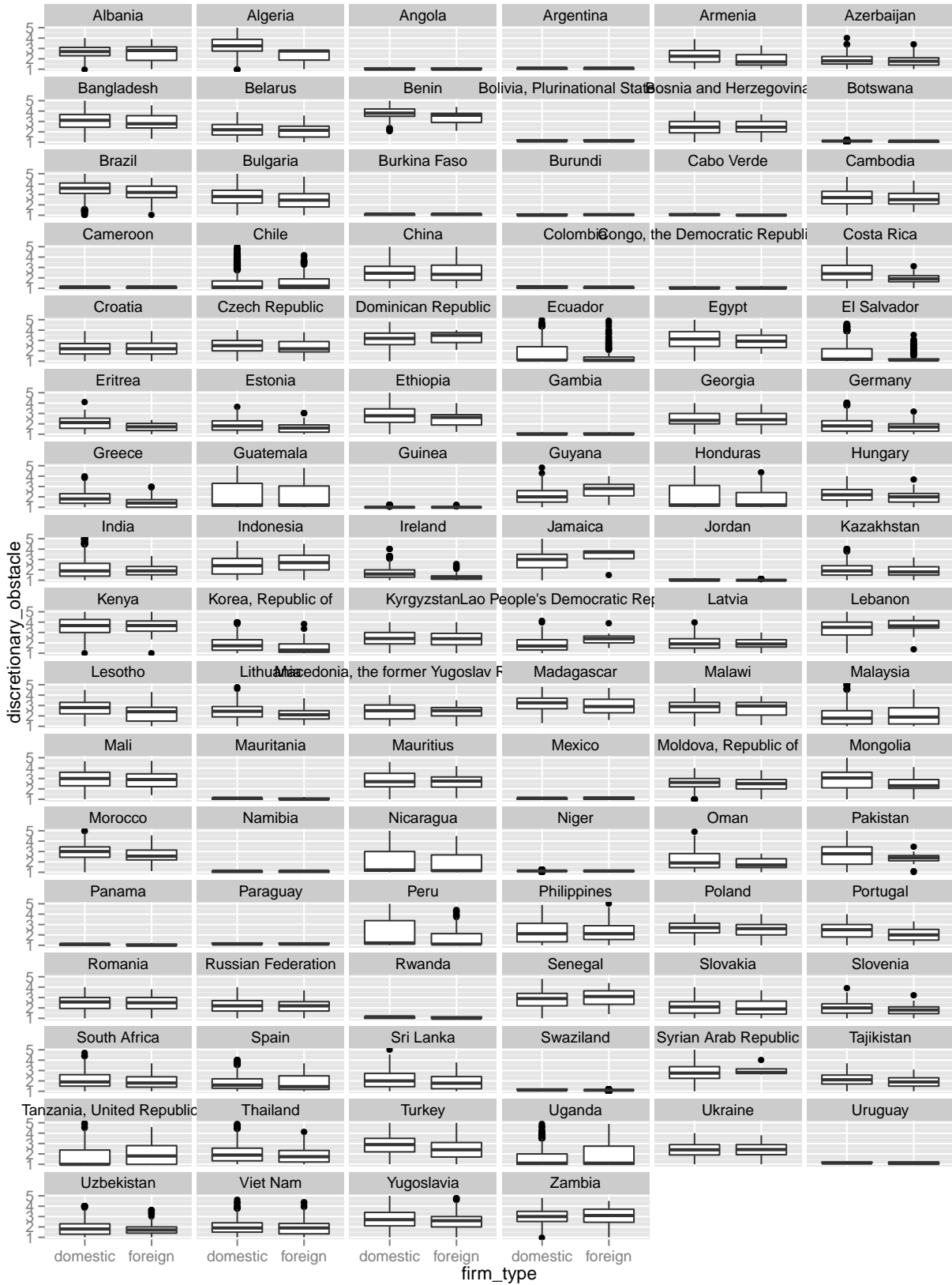


Figure 3: The treatment of FDI and domestic firms across countries

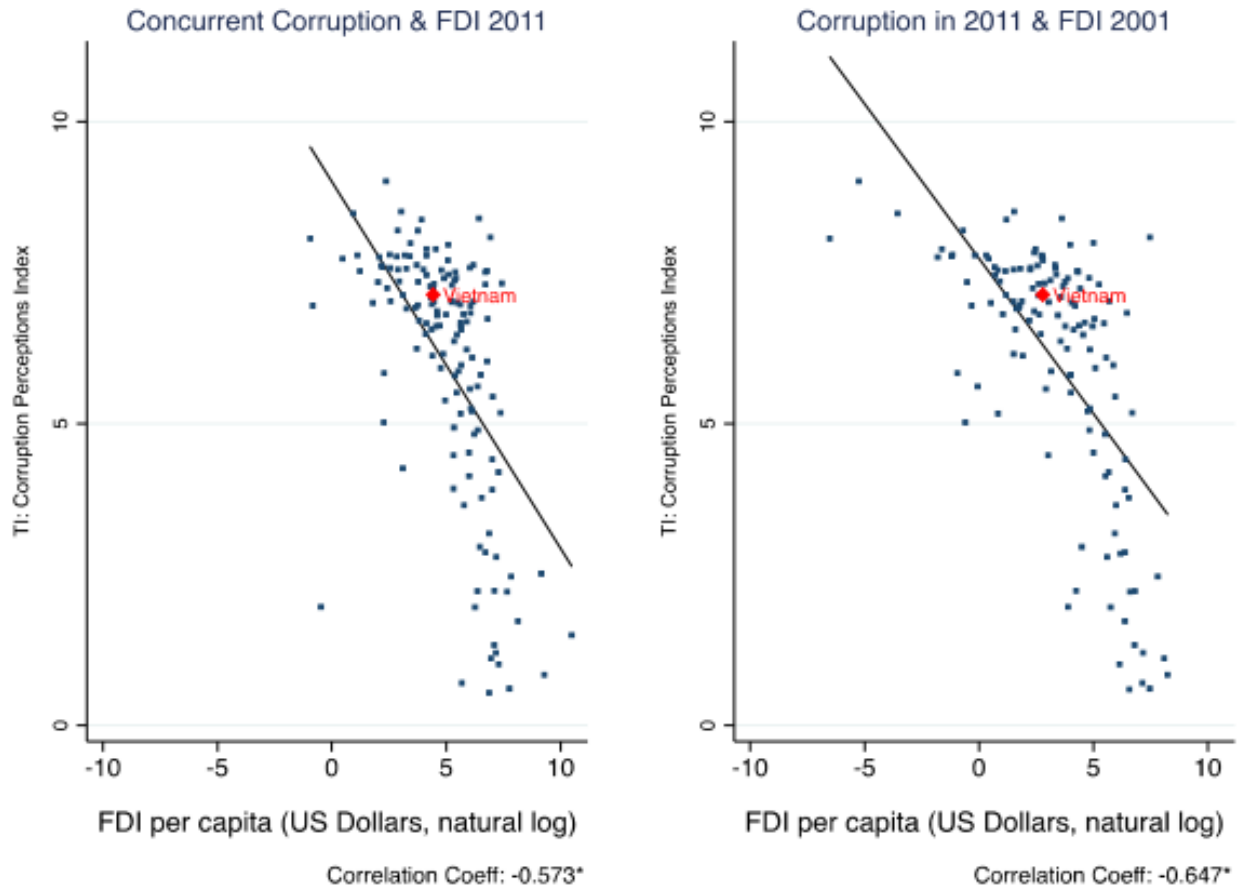


Figure 4: Source: (Malesky et al. 2015)

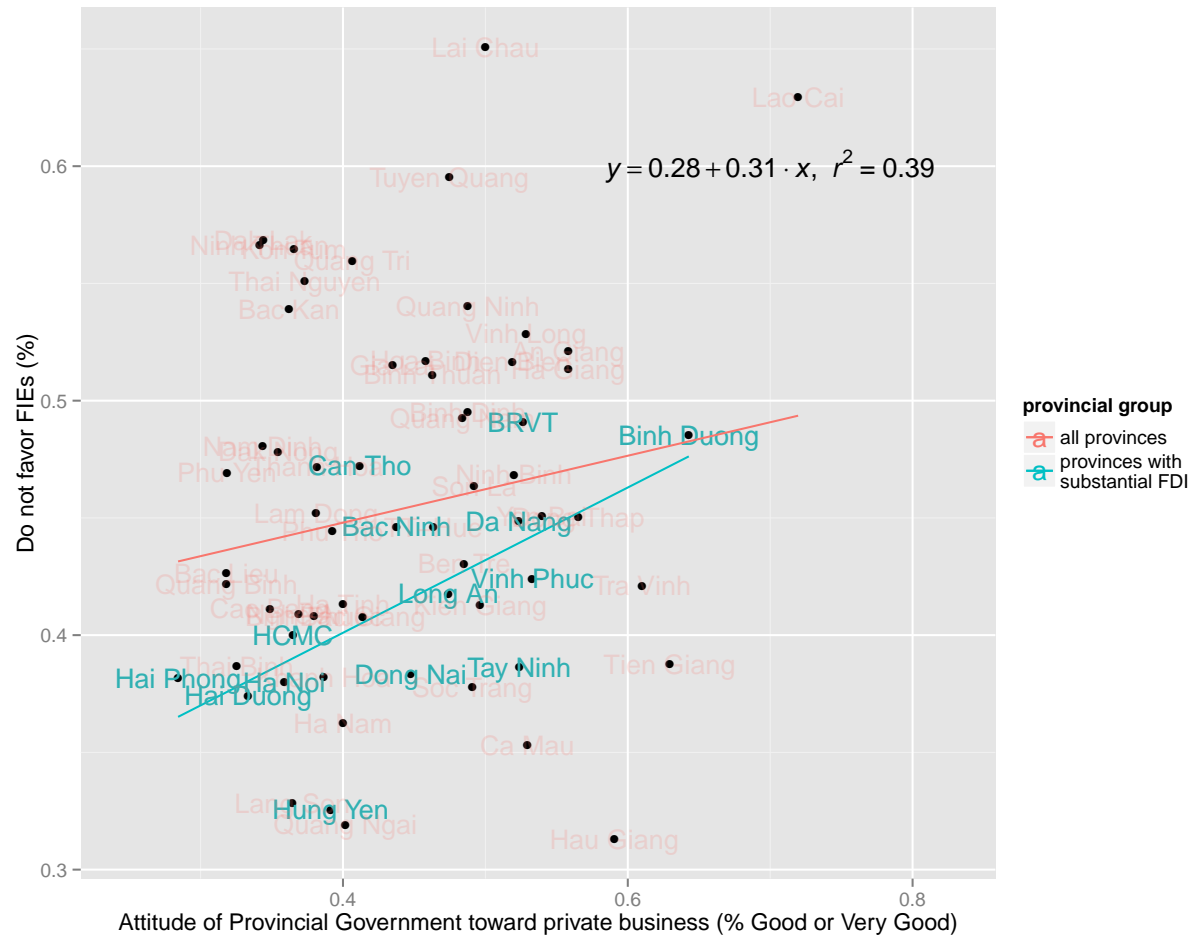


Figure 5: The relationship between FDI bias and private sector development

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