Paper title

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1 Puzzle: FDI does not lead to development

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 (Figure 1). Moreover, FDI is important not only because of its volume, but also because it has been enthusiastically advocated by major international organizations as a key factor to economic development.[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 various benefits to developing countries, such as capital and employment. However, the most important promise that FDI holds to growth is the spillover of productivity between the foreign firms and the domestic firms. This can happen if local firms hire workers that were trained in a foreign firms, improve productivity through backward and forward linkage with foreign firms, or imitate foreign technology. According to growth theory, it is FDI's spillover, not capital or employment, that serves as a major channel for the technological innovation that is a requisite for economic growth (Findlay 1978). In this view, spillover from FDI is also public good, providing benefits to the local firms in ways that the foreign firms do not take into account in their private calculations. This provides the justification for countries' giving investment incentives to FDI firms in order to rectify the undersupply of FDI, closing the gap between private and social returns.

And yet, there is no 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 absorptive capacity of local firms. Crossnationally, scholars find that positive growth effect of FDI is more likely when the technological gap between the local and foreign firms are small (Nunnenkamp and Spatz 2004), and when host countries have strong financial and institutional development

[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

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

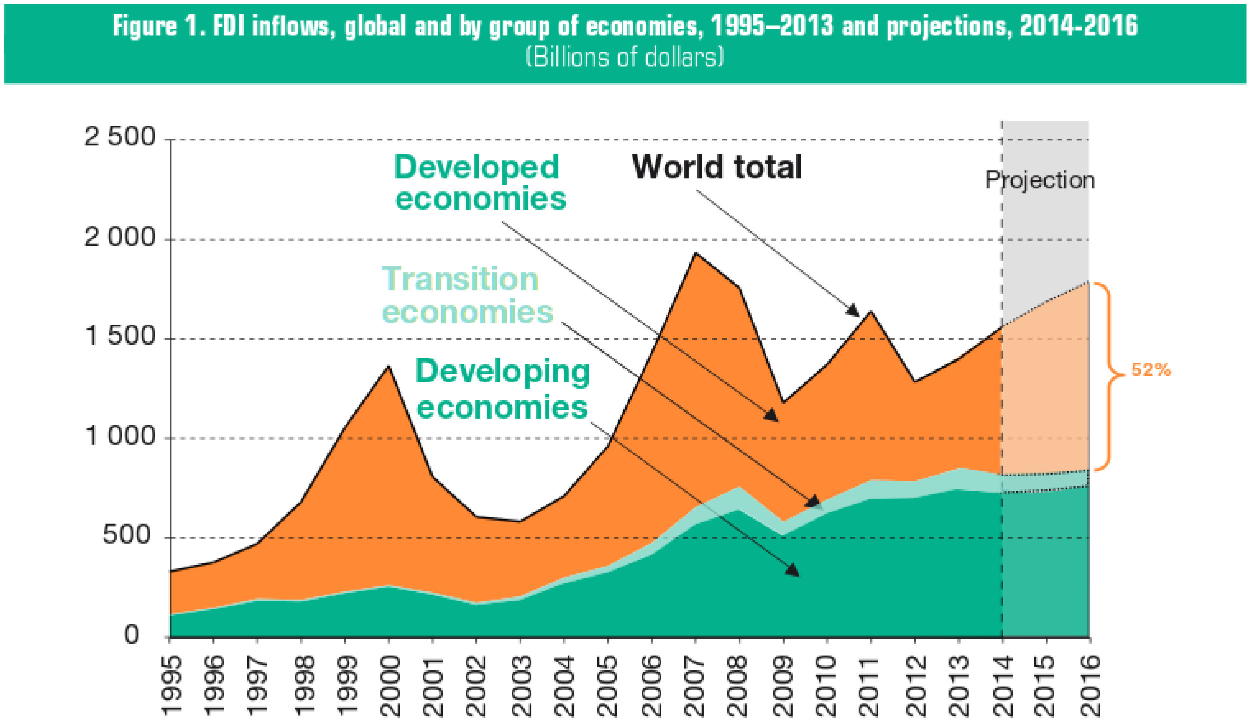


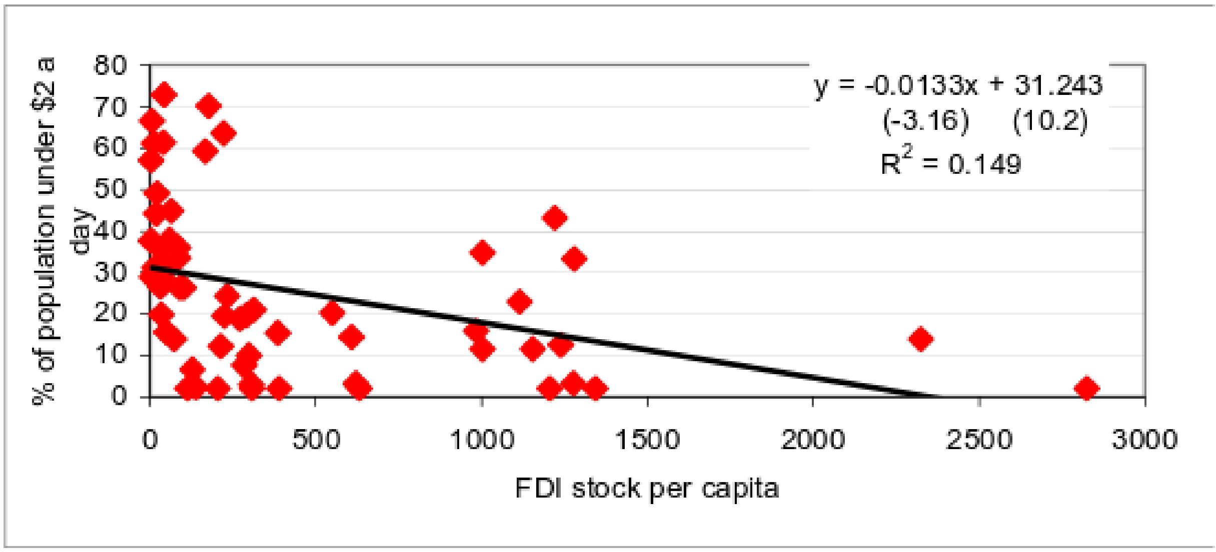
Figure 1: Source: World Investment Report, 2014

(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 this 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 the 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 their 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, where 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, 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.

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 even at the expense of generating revenues?[3] If developing absorptive capacity is so crucial to making FDI growth-enhancing,

[3] Countries lose revenue not only through offering financial incentives but also because FDI firms can



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

Figure 2: Relationship between FDI and poverty

why is it often neglected? To understand this puzzle, I propose that we need to take incorporate the calculus of the individual bureaucrat 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. Both the empirical puzzle and the hypothesis have not been considered by scholars in political economy.

This study looks at the interesting phenomenon of FDI engaging in corruption, something that the literature is un-equipped to deal with (except Malesky). It also looks at the issue of private sector development politically, having important welfare and social impact here.

It also contributes a fresh look into the treatment of FDI vs domestic firms. Most of what we have seen consider FDI as the underdog, unfamiliar with the location, susceptible to expropriation. This presumes a political environment in which bureaucrats and governments official are accountable to the interest of domestic firms. However, we forget that when FDI is big and resourceful, they can transform the relationship with corrupt officials into "mutual hostages". It is possible to see FDI being treated better than domestic firms.

2 Theory

In this section, I discuss the different steps in my causal chains, and specify the testable hypotheses along the way.

easily dodge corporate income tax with transfer pricing (Bartelsman and Beetsma 2003).

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 between local and foreign firms (Javorcik 2004). Therefore, technologically competent local firms that are able to supply inputs to foreign firms is necessary.

- 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 government needs to set up a regulatory environment that treats all firms equally.

- 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 sectors that are able to engage in commercial linkages with foreign firms.

Therefore, if a government is truly interested in FDI for its spillover and growth-enhancing effect, it must be equally interested, if not more, in developing a strong domestic sectors via equal treatment of firms, investment in labor force. All else equal, if we find that domestic firms report worse treatment, worse labor quality, or export less, this can be evidence that the government is not primarily interested in the spillover effect of FDI.[4]

2.1 FDI and corruption

Our hypothesis that bureaucrats and government 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 the 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, 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, another view is that foreign firms, disadvantaged by their foreignness, have to bribe more and contribute to corruption (Hellman and Hellman 2002).

[4]Discuss the selection bias of foreign firms in domestic markets, which depresses the difference in **reported** treatment between foreign firms and domestic firms.

Our theory advances the literature by thinking about micrologic of different types of foreign firms. Not all foreign firms are underdog, forced to bribe to equalize the play field. If foreign firms enjoy regulatory privilege, they do not want to put it away. If foreign firms are in collusion with government, there is by definition no demonstration effect or professionalization effect. Indeed, as South-South FDI has increased greatly in recently years, if foreign firms come from equally corrupt home countries, they may be no less well-versed than local firms in the dark arts.

However, our theory also improves upon the simple hypothesis that "FDI firms bribe too." It is not the case that foreign firms are necessarily underdog, but they can also bribe to get an upper hand in the local market,[5] or to pursue rent in protected industries (Malesky 2015). This is especially true of the foreign firm is big, in high-rent sectors, or from home countries with institutions similar to that of the host countries. Going beyond the participation of foreign firms in the corrupt activities, we tie this explanation back to the empirical puzzle of a stunted domestic sector.

> Hypothesis: FDI in corruption countries stunt the development of the domestic private sectors

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2.2 Bureaucrats and corruption

- local central literature (China)

Political decentralization increases bribery (Fan et al. 2009). Uncoordinated corruption, more tiers of governments, increase corruption.

Fiscal decentralization reduces corruption (Guerra et al. 2009)

> Hypothesis: FDI in provinces where provincial leaders are more interested in rent than promotion will stunt the development of the domestic private sector

3 Hypothesis: Rent seeking

4 Research design

Hypothesis: In sectors / countries where there is a lot of corruption between the politicians and FDI, there will be less private sector development (i.e. more time dealt with government, worse access to land, etc.) However, this could just be a measure of corruption overall! Then we look at the gap between FDI and domestic firms – then we know that the outcome does not just reflect the overall quality of that sector.

- corruption between the politicians and FDI:

+ Vietnam case: 1) sectors with protection against FDI (group A)

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

+ Vietnam + crossnational: 2) sectors with natural monopoly / high degree of profitability. Natural monopoly / profitability = access is more valuable means more incentive to bribe, small numbers of firms means easier coordination. (But why wouldn't the bureaucrat want to collude with the domestic firms instead? Perhaps because there are no big enough domestic firms. We can control for this by pre-FDI private sector)

- private sector development = measured on discretionary treatment measure (time deal with officials, officials' attitude, tax rate), not so much on infrastructure

4.1 Crossnational

Countries with a lot of corruption + a lot of FDI will see larger gap between the treatment of FDI and domestic firms.

Corruption alone is not enough. FDI alone is not enough.

What about corruption reducing FDI? Is there a sample of countries with high FDI and high corruption? (a graph would be neat)

INSERT GRAPH HERE

4.2 Provincial leader vs central

(Malesky 2008) Straight ahead on red – central incentive is growth

(Sheng 2007) China's central government exert more control over provinces that has high FDI (through party organization channel)

Proxy provincial leader's need to promotion with age?

4.3 Sectoral

(Malesky 2015) discusses how foreign firms in Group A restricted industries have to pay more bribes (telecommunications, radio and TV broadcasting, transportation, and distribution). We can use this as a measure of FDI corruption, especially since some of the restrictions applies to foreign firms only.

4.4 Conjoint analysis

- Selection bias (if a countries disriminated against FDI, then the surveyed firms are already more capable)

Foreign firms often face fewer obstacles

Asia crowding in (SK, Thailand, pakistan), Latin America crowd out (crowdin or crowdout). Paper does not discuss the policy nor the motivation

Colombia, Mexico, Hong Kong, Indonesia, and Taiwan

Argentina, Brazil,Colombia, Korea, Malaysia, Thailand in Asia

Evidence is mixed across regions / countries DOES FOREIGN DIRECT INVESTMENT PROMOTE ECONOMIC GROWTH? EVIDENCE FROM EAST ASIA AND LATIN AMERICA

in Latin America, high corruption = high FDI http://www.ccsenet.org/journal/index.php/jms/article/v

http://www.nytimes.com/2012/04/22/business/at-wal-mart-in-mexico-a-bribe-inquiry-silenced.html?p
(Walmart bribe in Mexico)

4.5 Alternative hypothesis

Fertility rate to control for the job hypothesis

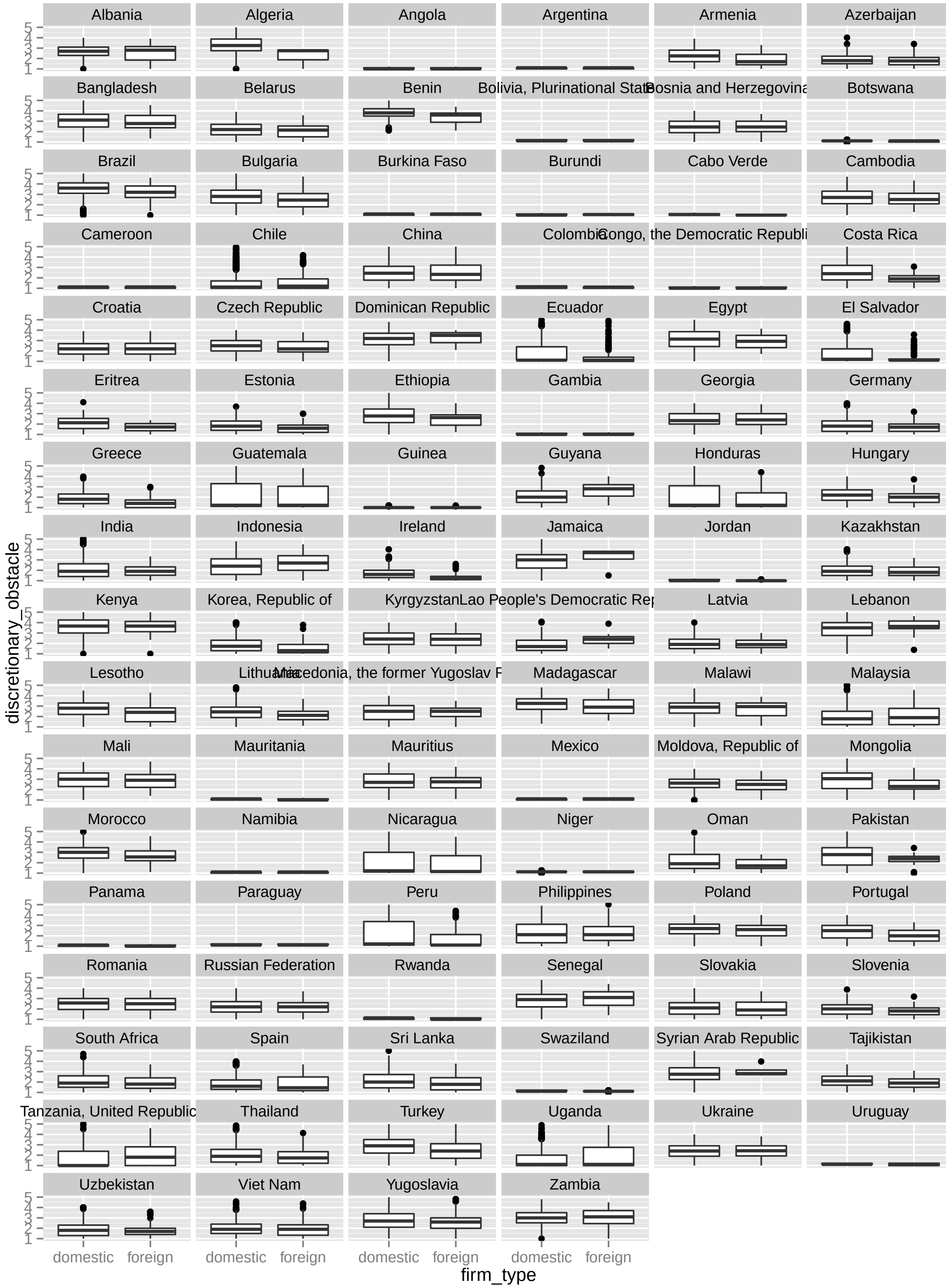

Figure 3: The treatment of FDI and domestic firms

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