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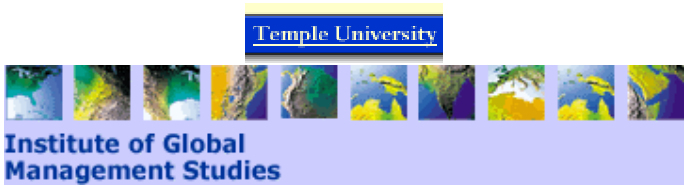

DISCUSSION PAPER 04-522 (REVISED)

MARKET LIBERALIZATION, CORRUPTION AND FDI: A RENT SEEKING APPROACH

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Abstract

In this paper we are interested in examining the inter-linkages between the various forms of opportunism in emerging markets economies and their impact on the activities of multinational corporations as represented by FDI flows. We argue that much of the opportunism in such economies can be seen as various forms of rent-seeking behavior and as rational responses to a given institutional environment. Our arguments have several important implications. First many 'legal' (e.g., lobbying) and 'illegal' (e.g. corruption) opportunistic behaviors are theoretically identical. Second, most of existing literature that reports a strong negative effect of corruption on FDI is based on a misspecification, since corruption is an effect underlying institutional factors and not a primary cause.

Three different strands of literature are related with our study. The first concerns the effects of corruption on the investment location decisions (MNCs). The second literature relevant for this paper analyzes the link between regulation and corruption. Finally, the third line of research that is connected with our study focuses on the political determinants of economic reform. We hypothesize that the electoral and legislative institutions in place are the prime explanatory factors underlying the level and pace of economic deregulation that in turn determines the extent of corruption. Finally, it is this level of economic regulation (or lack of economic freedom) together with the extent of corruption that explains the direction and extent of FDI flows. We use a sample of emerging market economies where the institutional set-up is still fluid to study our hypotheses. We find that once corruption is treated as endogenous (an effect rather than a cause), its effect on FDI flows is miniscule compared to the effect the regulatory burden.

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1. INTRODUCTION

Cross-country empirical evidence reveals that corruption is more widespread in some countries than in others (Treisman, 2000; Paldam, 2002). Although many theoretical hypotheses have been proposed to explain the palpably different incidence of corruption across nations, the role played by the regulatory state in the economy has been generally acknowledged as one of the major sources of corruption (Shleifer and Vishny, 1999; Rose-Ackerman, 1999). It has been argued that the political and bureaucratic allocation of scarce resources through an elaborate system of permits and licenses provides fertile ground for rent-seeking activities that in turn favor the emergence and development of illicit behavior. In this framework, one of the most effective measures to fight corruption would be increasing competition in the economy through deregulation and privatization. Such economic policy measures are expected to lower the level of opportunistic behavior of state officials and reduce corrupt activities (Rose-Ackerman, 1988; Bliss and Di Tella, 1997). However, the political environments within which politicians carry out their policy choices ultimately determine the extent of market liberalization reforms (Fernandez and Rodrik, 1991; Mudambi, Navarra and Paul, 2002). More specifically, since political institutions provide the set of rules within which policy decision are taken alternative electoral and legislative institutions provide the political micro-foundations that explain policy change (Persson and Tabellini, 2003; Tsebelis, 2002).

In this paper, we examine the inter-linkages between the restrictions placed on economic activities and corruption in emerging market economies and their impact on the activities of multinational enterprises (MNEs) as represented by foreign direct investment (FDI) flows. We argue that much of the corruption in such economies can be seen as various forms of rent-seeking behavior and as rational responses to a given institutional environment.

The research question that is central to our study is whether the corruption level generated by the political determinants of regulatory reform affects FDI in emerging market countries.

The effects of corruption on both the magnitude and the composition of FDI have been analyzed in the literature (Hines, 1995; Wei, 2000; Smarzynska and Wei, 2002; Habib and Zurawicki, 2002). However, in these studies corruption has been considered as an exogenous variable unaffected by other social, political and economic conditions in place in the economies under investigation. The novelty of our approach is to endogenize corruption as determined by the interplay between policy choices and the political institutions that govern the process of collective decision making. In line with public choice theory, we hypothesize that much of the scope for corruption can be traced by government intervention in the economy (Djankov, La Porta, de Silanes and Shleifer, 2001). Policies aimed at liberalization, deregulation and privatization can sharply reduce the opportunities for rent-seeking behavior and corruption. However, implementation of such policies depends on the electoral calculus of incumbent governments. Thus, legislative and electoral institutions affect the implementation of policy changes aimed at reducing regulatory pressure of the state on economic agents. These institutions, then, indirectly affect both the level of corruption and the location of FDI by MNEs.

The paper is structured as follows. In Section 2 we review the literature linking on institutions, corruption and FDI. In Section 3, we develop our theory and hypotheses. In Section 4, we describe our data, estimation and empirical results. Finally, we offer some concluding remarks in Section 5.

2. LITERATURE REVIEW

Our paper is based on three main bodies of literature that have developed on separate and parallel research paths with only occasional cross-references. The first line of research

focuses on the political determinants of economic policies. The underlying idea is that the political institutions that regulate the process of decision-making at the national level affect policy change (McCubbins, Noll and Weingast, 1989).[1] These institutions represent the rules of the game in which public officials formulate their policy choices. The second line of inquiry explores the links between economic regulation and corruption. The public interest view of public policy points out that unregulated markets exhibit frequent failures that can be corrected by regulation from the public sector (Pigou, 1947; Maidment and Eldridge, 1999). This idea has been challenged by public choice theorists who consider governments as less benign and regulation as socially inefficient (see for e.g., Buchanan and Tullock, 1962). Many studies have demonstrated both theoretically and empirically that increased competition in the economy discourages corrupt activities and promotes economic growth. Finally, the third area of research concerns the effects of corruption on the investment location decisions of MNEs. Corruption is viewed as a source of uncertainty that affects both the costs and the benefits of investment projects and therefore impacts on the strategic decisions of MNEs when they are confronted with the prospects of operating in a foreign country. In this section of the paper we review these three strands of literature and highlight the issues involved in our study.

Political Institutions and Economic Policies

Over the last ten years a new theoretical and empirical literature in economics has developed dealing with the analysis of the role played by political institutions in shaping economic policy (Mudambi, Navarra and Sobbrio, 2001). In this intellectual endeavor political institutions are seen as the rules of the game that determine the incentives and constraints that policy-makers face when they interact in the creation of collective choices (Brennan and Buchanan, 1985). They are designed externally, made explicit by legislation

[1] Such decision making may occur through legislatives and executives in democratic systems or through more arbitrary processes in autocratic systems.

and regulations and are formally enforced by an external authority such as the government or, more generally, the state. Examples of this type of institution are civil law, the form of government and the electoral system (North, 1990; Furubotn and Richter, 1998).

Several scholars, mostly from economics, have analyzed the political microfoundations of economic policy focusing on the role played by electoral rules and regime types on the process of collective decision-making. In the main, they have focused on the effects of political institutions on macroeconomic policies such as taxes, public spending and income re-distribution (Austen-Smith, 2000; Milesi-Ferretti, Perotti and Rostagno, 2001; Lizzieri and Persico, 2001; Persson and Tabellini, 2003). In contrast, international business scholars have focused on the effects of formal and informal institutions on international investment and trade. These studies have examined the effects of politico-economic institutional differences on the choice of entry mode and the dynamic of entry strategies, the magnitude of investment, the probability of survival and a wide variety of international expansion strategies (Henisz, 2000; Delios & Henisz, 2000).

Cross-national variation in the institutional environment adds uncertainty to new foreign operations that in turn raises the hurdle rate of return and discourages entry. Facing this situation, investors are more likely to enter countries where the future policy regime is relatively easy to predict (Loree & Guisinger, 1995; Gastanaga, Nugent, & Pashamova, 1998; Wei, 2000). Unstable polities lead to variability in the policy decision-making process. Such political instability produces uncertainty, both about the policy decisions taken by the outgoing government and about the policies initiated by the incoming government. Such political instability can exacerbate the effects of such well-known problems as the obsolescing bargain (Vernon, 1971; Ramamurti, 2000, 2003). This is because a new government is even less likely to be bound by commitments made an MNE investor than a continuing one. Such

turbulence on the political front has motivated researchers to take a close look at the impact of political instability on international business (Vernon, 1971).

Political instability is only one of the institutional characteristics influencing market strategies in international business. Another important determinant of firm behavior in international exchanges is the sensibility of a given country's political institutions to lobbying. Several scholars suggested that in countries with more easily manipulated political regimes, the attainment of substantial economic returns depends more heavily on political activities (Dailami & Leipziger, 1998; Zelner & Henisz, 2000; Henisz & Zelner, 2001).

Although this literature is growing fast, few scholars have studied the link between alternative political institutions and regulatory policy. There is evidence that such a link is important. Djarkov *et al*. (2001) analyzed the regulatory hurdles that firms needed to surmount in order to set up a new business in 75 countries. They demonstrated how regulation pursued for the benefits of bureaucrats and politicians seems to explain the cross-sectional variation in the regulatory costs (in terms of resources as well as time) that firms face in starting new market operations in foreign countries. Li, Qiang and Xu (2001) empirically evaluated the political economy of privatization and competition in the telecommunications sector. Their investigation distinguishes between democratic and non-democratic countries and concludes that policy reform is more likely in under democratic regimes since private interest groups are able to exercise more influence.

This brief overview of the literature that studies the relationship between political institutions and economic policy choices highlights how the rules governing the process of public decision-making play a crucial role as they constrain the set of available policy choices and, thus, significantly determine the outcome of policy change. Therefore, a closer look at the dynamics of the mechanism through which collective choices are made can shed more light on the relationship between the functioning of the political system and its impact on

economic policy change (Noll, 2001; McCubbins *et al.*, 1989; Mudambi, Navarra and Paul, 2002).

Economic Regulation and Corruption

Economic regulation is one of the policy decisions that matters the most for the functioning of the economy. This issue concerns the extent of state intervention in the market economy and the degree of discretionary power of bureaucrats. According to the traditional public interest view (Pigou, 1947), economic regulation should be considered as the response to market failures ranging from monopoly power to externalities. These inefficiencies can be alleviated through benevolent governmental intervention. However, many scholars have criticized this approach as unrealistic and have questioned the appropriateness of assuming a government composed of selfless public servants (Stigler, 1971). This alternative view suggests that regulation is essentially a redistributive process influenced by self-interested individuals who attempt to gain specific benefits by the means of governmental intervention.

This 'public choice' view sees regulation as a political process in which specific interest groups express their demands for political intervention as a way of redistributing rents to themselves. This theory predicts that different groups in the polity, according to their size, strength and organization, try to capture the regulatory agency to appropriate the rents generated by public intervention in the market (Tullock, 1967; Peltzman, 1976; Becker, 1983). According to this approach, the assignment of licenses for monopolies over new technology, quotas for imports of particular products, regulation that affects competition in a given industry and lucrative public sector contracts all involve both political and economic logic. As the role of politics in these assignments increases, substantial financial and managerial resources are diverted from economic activity to political rent-seeking (Krueger, 1974; Bhagwati, 1982). This shift in resource allocation implies lower investment in tangible

economic assets and greater investment in political assets. These political assets may even be used to protect illegitimate activities like grey and black-market operations.

With minor exceptions, it is widely recognized that well-established market institutions, characterized by clear and transparent rules, fully functioning checks and balances and a robust competitive environment reduce rent-seeking opportunities and, in turn, the incentives for corruption. Less competition leads to a situation in which firms enjoy higher rents so that bureaucracies with high control rights over them, such as tax inspectors or industry regulators, have greater incentives to engage in malfeasant behavior (Bliss and Di Tella, 1997). Ades and Di Tella (1997, 1999) found that corruption is higher in countries where domestic firms are sheltered from foreign competition by natural or policy-induced barriers to trade, with economies dominated by a small number of firms with low levels of product market competition and where antitrust regulations are not effective in preventing anticompetitive practices.

The legal obstacles that a would-be entrepreneur faces in order to operate a firm legally are among the main impediments to a well-functioning market system in many countries. Shleifer and Vishny (1999) suggest that these legal obstacles are entry restrictions, implemented and maintained by corruptible politicians because of their rent seeking potential. The basic idea is that politicians have temporary monopoly rights and may use their position to distort economic policy to generate large rents for themselves (Bardhan, 1997). However, one important condition for inefficient economic policies resulting form corrupt activities is the persistence of low levels of electoral accountability (Coate and Morris, 1999). In this framework, corruption is seen as a symptom of the underlying weakness of the state in controlling its bureaucrats, in protecting property and contract rights and in providing the institutions that underpin an effective rule of law.

Another type of corruption arises when a public interest oriented government wants to regulate the economy with the aim of eliminating market failures, but has imperfect information about compliance (Acemoglu and Verdier, 1998, 2000). For example, in the interest of efficiency, the government may want to subsidize efficient firms and close down inefficient ones. However, it does not have the expertise to distinguish between good and bad firms. Experts are specialized officials who may be corruptible and may withhold information for an assigned price (Laffont and Tirole, 1993). In this respect, some scholars suggest that the problem of corruption lies in the low salaries that bureaucrats receive relative to those in the private sector with comparable responsibilities. Accordingly, they argue that corruption can be minimized by raising the salaries of public servants to be on a par with their counterparts in the private sector (Klitgaard, 1988; Besley and McLaren, 1993).

Political Institutions, Market Liberalization and Foreign Direct Investment

In the traditional international business literature, location attributes form one of the dimensions of Dunning's OLI paradigm. These attributes were originally meant to include economic factors such as the size and growth of the market, the availability of labor and its costs, the inflation level, the degree of foreign indebtedness and the state of the balance of payments. However, more recently, the work of scholars such as Williamson (1985) and North (1991) has been applied in the international business literature so that location advantages are being interpreted more broadly to include market and political institutions (e.g., Delios and Henisz, 2000).

The importance of these institutions in the international business literature derives from the fact that institutions represent the major immobile factors in a globalized market. In such an international environment characterized by a sensational mobility of firms and factors of production, legal, political and administrative systems tend to be the internationally immobile framework whose characteristics might determine significantly the international

attractiveness of a location. These institutions are viewed as important elements that affect the capacity of firms to interact and therefore their relative transaction and coordination costs of production and innovation (Mudambi and Navarra, 2002).

Various authors have postulated an important relationship between political institutions and location decisions of MNEs. There is a line of research that emphasizes the concept whereby autocracies provide a better environment for domestic capital accumulation, foreign investment and growth. More specifically, autocrats are seen as shielding foreign capital from popular pressure for higher wages, stronger labor protection or less capital-friendly taxation (Huntington and Dominguez, 1975; O'Donnell, 1988). However, although the business climate that an authoritarian ruler may offer to foreign investments might be favorable, potential investors face a considerable risk of policy reversal driven by the dictator's own distributional interests or the need to gather support through populist measures and/or the violent transformation of the entire system by a revolution (Gross and Trevino, 1996; Tallman, 1988; Kobrin, 1979). In this framework, Olson (1993) and McGuire and Olson (1997) argue that well-established democracies, independent judiciaries and electoral challenges help to guarantee property rights, ensuring that investments are secure for the long haul. Since these contrasting views do not give rise to an unambiguous hypothesis about the impact of democracy on foreign investments, an empirical literature has emerged aimed at analyzing the effect of democracy on FDI with a particular emphasis toward developing countries.

Oneal (1994) examined whether foreign firms invest more and collect more profit in authoritarian countries than in democracies. He found that the relationship between regime type and FDI flows is not statistically significant and that returns on investment are best in developed democracies but greater in authoritarian countries. Resnick (2001) analyzed the relationship between democratic transition and FDI and found that transition to democracy

has a statistically significant negative effect on foreign investment inflows. However, Harms and Ursprung (2002) demonstrated that political and civil liberties have a significant positive impact on per capita FDI in developing countries and that a greater degree of unionization seems to attract foreign investors. Their findings contradict the widespread perception whereby multinationals would prefer to invest in countries where political rights are repressed and workers' representation is curtailed. Thus, the empirical literature does not seem to yield unambiguous results either. As far as MNE investors are concerned, the net impact of democratic institutions on FDI is contingent upon the relative strength of its positive (stable property rights) and negative effects (populist pressures).

Other scholars have focused on the relationship between market liberalization policies and countries' locational attractiveness for FDI. There is broad consensus about the fact that technological progress is a crucial determinant of growth. Borensztein et al. (1998) argue that FDI by MNEs is considered as one of the main transmission channels of advanced technology from advanced to lagging countries. Therefore, developing countries are expected to compete for FDI in the global market through market reforms that improve their economic appeal. We specifically refer to those reforms that decentralize economic decision-making from government-owned to privately owned enterprises and from highly regulated to deregulated private enterprises. To carry out these reforms, governments may lower trade barriers, reduce price controls and relax capital account restrictions on companies' market entry and exit.

Several papers have focused on the effects generated by liberalization policies on location decisions by MNE. Corporate tax rates are an important factor in explaining location decisions by U.S. and U.K. MNEs (Wheeler and Mody, 1992; Mudambi, 1995). Even within a single country, tax incentives can influence the location of MNE investment (Tung and Cho, 2001). Bengoa and Sanchez-Robles (2003) set up a two-equation model to estimate the effect economic freedom on the location decision of foreign investors and the impact of the

incoming FDI on economic growth in 18 Latin American countries. They found that FDI are positively correlated with economic growth in the host countries. Further, they suggest that governments in the host country should strive to achieve a high level of political stability, together with a market-oriented environment to attract FDI and benefit from long-term capital flows.

Corruption and Foreign Direct Investment

Multinational enterprises often encounter corruption, particularly when they enter emerging market economies (Smarzynska and Wei, 2000). Theoretically, the impact of corruption on the level of FDI is unclear. This is because, from the perspective of the MNE investor, corruption can be seen as having both positive and negative effects. On the positive side, it has been argued that corruption can provide a means of bypassing inefficient regulations and so improve efficiency. As noted by Huntington:

> "In terms of economic growth, the only thing worse than a society with a rigid, overcentralized, dishonest bureaucracy is one with a rigid, overcentralized, honest bureaucracy."
>
> [Huntington, (1968): 368]

Thus, when official regulations prohibit or constrain productive activities, paying officials to overlook them can be beneficial (Kaufmann and Wei, 1999).

On the negative side, corruption increases the direct costs of doing business. Further, due to its illegality and the consequent requirement for secrecy, business undertaken under the umbrella of corruption is risky since investors have limited protection from expropriation (Shleifer and Vishny, 1993). Thus, corruption also introduces greater uncertainty into the outcome of business decisions.

However, it has been recognized that corruption is complex phenomenon. It encompasses many categories of activities and can be measured along several dimensions. However, in the literature, corruption is generally defined to be 'the abuse of public power for private benefit' (Tanzi, 1998). This is taken to mean a transfer from private firms or

individuals to government officials or politicians in exchange for preferential treatment in a regulated environment. Two crucial dimensions for measuring corruption are its pervasiveness and its arbitrariness (Rodriguez, Uhlenbruck and Eden, 2002).

As defined by Rodriguez et al (2002), pervasiveness is a probabilistic measure and refers to the likelihood that an entering firm will encounter corruption in its dealings with government officials and/or politicians in the host country. A high level of pervasiveness indicates that firms are highly likely to encounter corruption as a part of undertaking normal business activities. Arbitrariness is a measure of ambiguity and refers to the range of expected outcomes associated with corrupt practices. A high level of arbitrariness indicates that the interpretation of laws and regulations is capricious (Ahlstrom, Bruton and Lui, 2000), so that even after acquiescing to corrupt practices, the firm is unable to determine the likelihood of achieving its aims, i.e., '… important features of corrupt transactions are likely to be … unpredictable, as they do not emerge from a stable underlying structure or process' (Rodriguez, et al, 2002).

It has been suggested that MNEs cope with corruption by either avoiding locations where they encounter it or by adjusting their entry modes to reduce their exposure (Doh, Rodriguez, Uhlenbruck, Collins and Eden, 2003). More specifically, if corruption pervasiveness grows, MNEs are more likely to choose arm's length entry strategies. On the other hand, as arbitrariness of corruption increases, MNEs are more likely to engage with local partners who bring an understanding of the corruption framework in which they expect to operate. Further, the MNE itself has a better understanding of the corruption framework in the host country when it is similar to that obtaining in its home country (Aharoni, 1966; Oliver, 1991). In both these cases, bringing knowledge of the local corruption environment reduces the risks associated with engaging with it.

Does increasing corruption reduce the level of FDI? The evidence here is mixed. Several studies have failed to find a significant link between the extent of corruption and the level of FDI (Hines, 1995; Wheeler and Mody, 1992). However, more recent studies tend to find a consistent negative effect of corruption on FDI location decisions (Wei, 2000; Habib and Zurawicki, 2002). As argued above, the extent of corruption in a host country affects a foreign direct investor's entry strategy. In other words, MNEs might choose a mode of entry so as to mitigate the risk associated to corruption. Smarzynska and Wei (2002) empirically demonstrated that corruption reduces FDI and shifts the ownership structure toward joint ventures. They pointed out that corruption makes the local bureaucracy less transparent and increases the value of using a local partner to cut through the bureaucratic maze. On the other hand, however, corruption decreases the effective protection of an investor's intangible assets and reduces the probability that disputes between foreign and domestic partners will be adjudicated fairly, thus reducing the value of having a local partner. As the investor's technological sophistication increases, so does the importance of protecting intangible assets, which tilts the preference away from joint ventures in a corrupt country.

3. THEORETICAL HYPOTHESES

It is clear from our foregoing discussion that political institutions, market liberalization and corruption are closely related. If the inter-relationships amongst these factors are accepted, then neither market liberalization nor corruption can be treated as exogenous. Yet in the existing literature, each has been studied as independently affecting FDI. Such estimates are likely to be biased due to the fact that they use endogenous regressors. Therefore in the model developed in this paper, market liberalization, corruption and FDI are jointly determined endogenous variables (see Figure 1).

Political Institutions and Market Liberalization

It is generally accepted that political institutions provide the framework within which public decision-making takes place (Brennan and Buchanan, 1985). Therefore the nature of these institutions has a powerful effect on observed policy outcomes in general and on the level of regulation and state intervention in the economy in particular. We hypothesize that since individual politicians take into consideration the electoral and political incentives associated with the policies they decide to support, regime types and electoral systems can provide political micro-foundations that explain policy change. Specifically, such political institutions have an impact on the extent of the regulatory state. We argue that alternative forms of government and electoral rules create different levels of opportunity and incentives for political rent seeking. The greater the extent of these rent seeking opportunities the more difficult is the task of reduce the burden of the regulatory state by implementing market liberalization. This is because freer markets reduce politicians' ability to use the state to carve out divisible benefits for important constituents. Market liberalization directly threatens the ability of politicians to grant favors to supporters and thus undercuts the viability of political strategies upon which they have to come to depend.

Political environments with low levels of competition provide constituents with no alternative to the existing regime. In such situations, few limits are placed upon the rent seeking activities of incumbent politicians. Therefore they are free to impose a high regulatory burden on the economy with a low risk of being removed from office. As political competition increases, viable alternatives to the current government appear and constraints are placed upon the extent of rent seeking activities that incumbent politicians can undertake. Thus, we expect autocracies to display higher levels of economic regulation (and lower levels of market liberalization) than democracies.

Hypothesis 1: Autocratic regimes will display lower levels of market liberalization than democratic regimes.

In democracy the people choose their governments through elections. However, democracies vary widely in terms of their electoral systems, i.e., the mechanism through which citizens' votes are translated into representation in elected assemblies. All electoral systems fall into one of two broad classes – plurality (PL) and proportional representation (PR). The distinction between PR and PL systems is mainly a distinction between single-member and multi-member districts. PL systems are characterized by single-member districts, i.e., smaller districts where only one seat is awarded. In contrast, PR systems are characterized by multi-member districts, i.e., larger districts where multiple seats are assigned.

PR and PL systems generate differing electoral incentives. In elections governed by a PL system with single-member districts, a representative's electoral campaigning is oriented to general issues affecting a wide range of voters. This strategy is pursued with the goal of gaining more support than that obtained by the best of one's rivals. Such wide-focus campaigning limits the scope for pursuing regulation and rent seeking. This is because rent seeking occurs through transfers from one specific group of voters to another. Losing the block support of any group of voters is costly in such a system.

However, in PR systems, an individual representative's electoral campaigning is particularistic and aimed at obtaining the support of a section of the electorate sufficient to guarantee one of the seats awarded in a multi-member district (Hinich and Ordeshook, 1970; Navarra and Lignana, 1997). Therefore PR systems provide fertile ground for narrow-focus electoral campaigns. Rent seeking in the form of pork barrel benefits for a representative's core group of supporters is encouraged, since politicians are willing to alienate other groups

of voters. The greater such narrow-focus incentives the more difficult is the path to market liberalization (Mudambi, Navarra and Paul, 2002).

Hypothesis 2: PL electoral systems with single-member districts are more conducive to deregulation and market liberalization than PR electoral systems with multi-member districts.

Market Liberalization and Corruption

As noted above, the literature is virtually unanimous in pointing to regulatory state as one of the sources of corruption (Bardhan, 1997). Tanzi (1998) has pointed out that corrupt activities take place more often in environments where laws and procedures are opaque, so that administrators enjoy excessive discretionary power. Stigler (1971) analyzes the manner in which regulation creates rents and leads to the wasteful expenditure of resources in the pursuit of these rents, i.e., rent seeking. As noted by Shleifer and Vishny (1993), regulations provide opportunities for politicians and government officials to engage in corrupt activities, e.g., the extortion of payments from private businesses and citizens in exchange for licenses. This implies that a larger body of regulation directly increases the scope for corrupt practices. Conversely, market liberalization policies, interpreted as a reduction in the scope and extent of state regulations reduce opportunities for engaging in corruption.

Hypothesis 3: The greater the extent of market liberalization, the lower the prevalence of corruption in the economy.

Market Liberalization, Corruption and Foreign Direct Investment

We have seen that there is an emerging literature pointing to the existence of a relationship between market liberalization and FDI. We have also noted the recent literature documenting the link between corruption and FDI. We posit that these relationships are two sides of the same coin. Specifically, we suggest that the literature on corruption focuses excessively on legal status. For example, Shleifer and Vishny (1993) argue that corruption imposes a greater burden on the economy than taxation because of the secrecy that is

necessarily associated with an illegal activity. We do not dispute this point. Taxes reduce welfare by distorting resource allocation, but they can also have positive welfare effects, for example, in terms of the provision of public goods.

Our point is that it is the broader category of rent seeking activities that hamper the efficient functioning of the economy. Rent seeking activities can be legal or illegal, but in both cases have no net positive effects on an economy. For example, an MNE can lobby or bribe a government official to obtain a license. While lobbying may be legal and bribery is illegal, both cases are examples of rent seeking. Both represent means to achieve the same end, namely the grant of the license. From an economic standpoint, it is the necessity of obtaining the license that imposes costs on the firm and so can deter FDI.

This argument suggests that market liberalization has both a direct and indirect effect on FDI. The direct effect works through lowering the (perfectly legal) expenses of complying with regulatory procedures and red tape. The indirect effect works through the hypothesized (H3) negative relationship between market liberalization and corruption. As regulations are removed, the scope for (illegal) corrupt activities shrinks, reducing the costs of operating in the host country. The direct effect implies the following hypothesis:

Hypothesis 4: The greater the extent of market liberalization, the higher the level of FDI inflows into the host economy.

The indirect effect is an implication of Hypothesis H3. Corruption is an endogenously determined explanatory factor of MNE location decisions. We can therefore state the following hypothesis:

Hypothesis 5: The greater is the prevalence of corruption in the host country, the lower the level of FDI inflows.

Our proposed model, including our hypotheses, is depicted in Figure 1. It may be seen that the model represents a system in which both market liberalization and corruption are

endogenously determined explanatory factors for the level of FDI inflows into the host country.

4. DATA, ESTIMATION AND RESULTS

All the data used in this study was macro data drawn from secondary sources. In keeping with the objectives of the study, we focused on emerging market economies. This led to the inclusion of 55 countries in the data set, with four panels of data covering the period from 1986 to 2000. The data was drawn from a variety of sources, both print and online. The complete details and description of all the data as well as data sources used in the current study are presented in the Data Appendix. Summary statistics related to all variables used in this study are presented in Table 1.

The three primary endogenous variables are the level of market liberalization, the extent of corruption and the level of FDI inflows. We measured the level of market liberalization with the economic freedom index generated by the Fraser Institute. The level of corruption is measured using the widely used (e.g., Rodriguez *et al*, 2002) survey-based measure generated by Transparency International. It is worth emphasizing that this variable is measured so that the highest values are indicative of the *lowest* extent of corruption. The level of FDI flows is measured in terms of the flow value of investments.

Estimation and Results

The model depicted in Figure 1 implies the simultaneous determination of three endogenous variables. This leads to a simultaneous equation system of three equations:

(1) ECFR $= f_1$[Political and electoral institutions, C_1]

(2) CORRUPT $= f_2$[ECFR, C_2]

(3) FDI $= f_3$[ECFR, CORRUPT, C_3]

where C_1, C_2 and C_3 are vectors of control variables. Our model implies that estimating the effects of institutional factors on FDI requires such a simultaneous equations approach. However, prior studies of FDI flows (e.g., Habib and Zurawicki, 2002; Harms and Ursprung, 2002) have focused on estimating a single equation like (3). In order to investigate the effect of our hypothesized institutional effects, we first present estimates of equation (3) alone. These estimates appear in Table 2.

We estimate equation (3) alone using a panel data approach. The Hausman test suggests the use of the fixed effects model and the presented estimates are from this model. We present 3 alternative specifications. The first is a parsimonious one including only location factors (column 1). The second includes both location and institutional factors (column 2), while the third, full specification includes institutional controls as well (column 3). On balance, the second specification (column 2) seems to fit the data best, a result that illustrates some of the problems of ignoring the institutional inter-relationships, as well become apparent below. However, the specifications in columns 2 and 3 are extremely close.

The estimates in column 2 demonstrate that we are able to reproduce the negative effect of corruption on FDI that is reported in much of recent literature (Habib and Zurawicki, 2002; Wei, 2000). We are also able to reproduce, albeit weakly, the positive impact of democratic institutions on the level of FDI (Harms and Ursprung, 2002). Both the dummies associated with democracy – plurality and proportional representation systems are positive and marginally significant. However, we also find a positive marginal effect associated with increases in the level of autocracy, in line with the predications of some earlier literature (Huntington and Dominguez, 1975).

Having reproduced the findings of the literature in this area, we proceed to examine the estimates of the entire system of equations (1) – (3). We estimate this system of equations

using two-stage least squares (2SLS), since these estimates are known to be robust.[2] The results of this estimation are presented in Table 3. We also reproduce the estimates from the full specification of equation (3) alone in the first column of Table 3 for purposes of comparison.

In estimating the first equation, i.e., the level of market liberalization, we use measures of autocracy and of electoral systems to operationalize hypotheses 1 and 2. We control for other institutional factors – macroeconomic factors are introduced using income levels and the inflation rate and socioeconomic factors are introduced using broad location groupings (Latin America and Africa) as well as the rate of adult literacy.

In estimating the second equation, i.e., the extent of corruption, the level of market liberalization appears as an (endogenous) explanatory factor. The underlying institutional factors therefore affect corruption indirectly. Further, the level of civil liberties and the legal institutions of the country are used as controls.

Finally, in estimating the third equation, the level of FDI flows, both the level of market liberalization as well as the extent of corruption appear as (endogenous) explanatory factors. In addition, we control for standard location attractiveness factors like the extent of market (proxied by GDP), the growth rate of the market (proxied by the growth rate of GDP) as well as macroeconomic stability as proxied by the inflation rate and the level of market specific financial risk, as well as demand sophistication as measured by adult literacy.

We begin by noting that our estimates are extremely good, both in terms of fit and in terms of statistical significance. The adjusted R^2 for all three equations is high and the regressions are extremely significant, both in terms of the F as well as the likelihood ratio. Beginning with the first equation where the regressand is the level of economic freedom, we find that all the political institutional variables are highly significant. Both types of

[2] We also generated iterated three-stage least squares (3SLS) estimates that are fully efficient since they utilize all the information in the system variance-covariance matrix in generating the estimators. These results are qualitatively identical to the 2SLS results, but are not presented as they tend to be less robust.

democracies – plurality (PL) and proportional systems (PR) are associated with higher levels of economic of freedom than non-democratic regimes, a result that is extremely significant. In addition, higher levels of autocracy (AUTOC) are associated with lower levels of economic freedom, a result that is marginally significant. Taken together, this provides evidence in support of Hypothesis 1. Further, the coefficient associated with plurality systems (PL) is higher than that associated with proportional systems (PR). Carrying out the appropriate difference of means test, this difference found to be statistically significant. Thus, plurality systems are associated with higher levels of economic freedom than proportional systems. This provides evidence in support of Hypothesis 2.

Turning to the control variables, we find that neither of the location dummies (Latin American countries – LATIN and African countries – AFRICA) are significant. Higher levels of inflation (INFLATION) are associated with lower levels of economic freedom. However, higher levels of income (GDP) are associated with higher levels of economic freedom. Here income can be thought of as a proxy for the general state of institutions in the country. Longer periods of independence (YRSIND) are associated with increased economic freedom, but increased literacy (LITERACY) does not appear to have a significant effect. (It should be noted that income and literacy are correlated, and this reduces the explanatory power of the latter.)

In estimating equation (2), where the regressand is the extent of corruption, we find that the endogenous regressor, the level of economic freedom (ECFR) is positive and extremely significant. This means that higher levels of economic freedom (and a lower level of regulation) are associated with lower levels of corruption. This provides evidence in support of Hypothesis 3. Further, the control variables are all highly significant. More civil liberties (CIV) are associated with lower levels of corruption. As noted by Shleifer and Vishny (1993), the illegality of corruption means that it requires secrecy. This means that

open societies with high levels of civil liberties are unlikely to be conducive to such behaviors. Both UK and French legal systems are associated with higher levels of corruption. This may be a continuing residual effect of colonialism. Alternatively, it may indicate a deeper institutional acceptance of corruption may prevail in societies that were colonized, i.e., common factors may underlie both higher corruption and a colonial past.

Turing to equation (3), where in regressand is the level of FDI inflows, both of the endogenous variables, the level of economic freedom (ECFR) and the extent of corruption (CORRUPTION), are positive and highly significant. Thus, higher levels of economic freedom and a lower prevalence of corruption are both associated with higher FDI inflows. This provides evidence in support of Hypotheses 4 and 5. However, it is important to note the contrast between the estimates in columns (1) and (4) in Table 3. In the estimation of equation (3) by itself, corruption has a significant negative effect, i.e. lower scores are associated with lower levels of FDI. However, economic freedom does not emerge as significant. However, in system estimates in column (4), not only are both corruption and economic freedom highly significant, but the coefficient associated with the latter is an order of magnitude larger than the former. Thus, once we account for the endogeneity of economic freedom and corruption, we find that it is the former that is much more important. The regulatory burden of the state has a much stronger negative impact than corruption, which is merely an outcome whose marginal impact is relatively small.

The control variables perform as expected. Both the extent of the market as measured by national income (GDP) as well as the openness of the economy as measured by trade as a percentage of GDP (TRADEPCT) are positive and significant. However, neither macroeconomic stability (INFLATION) nor the growth of the market as measured by the GDP growth rate (GRGDP) is found to exert significant effects in this data set.

5. CONCLUDING REMARKS

The previous literature has studied the linkages amongst institutions and economic freedom, corruption and FDI. However, we contend that such simple relationships do not capture the complexity of the inter-relationships amongst the factors. Thus, we argue that institutions affect corruption only through their effects on economic freedom and its antonym, economic regulation. Further, FDI is not directly affected by institutions but rather is affected indirectly through effect of these institutions on the level of economic freedom and the extent of corruption.

Estimating a simultaneous system of equations, we find strong support for our hypotheses. Our results underline the crucial importance of political and more particularly, electoral factors in determining a country's regulatory burden. We demonstrate that it is this regulatory burden that has the strongest effect on the level of FDI inflows. Once corruption is treated as an effect of the regulatory burden, rather than an exogenous factor, its direct effect on FDI is rather small.

DATA APPENDIX
Emerging and Developing Economies

Countries in the data set: Argentina, Bolivia, Botswana, Brazil, Cameroon, Chile, P.R. China, Colombia, Congo Dem. R., Costa Rica, Dominican Rep., Ecuador, Egypt, El Salvador, Gabon, Ghana, Guatemala, Haiti, Honduras, India, Indonesia, Iran, Jamaica, Jordan, Madagascar, Malawi, Malaysia, Mali, Mauritius, Mexico, Morocco, Nigeria, Pakistan, Panama, Papua New Guinea, Paraguay, Peru, Philippines, Poland, Rwanda, Senegal, Sierra Leone, South Korea, Sri Lanka, Syria, Thailand, Togo, Trinidad & Tobago, Tunisia, Turkey, Uganda, Uruguay, Venezuela, Zambia, Zimbabwe

Variable	Definition	Source
	Endogenous Variables	
ECFR	Economic Freedom Index (Higher values = more free)	The Fraser Institute*
CORRUPT	Corruption Index (Higher values = less corrupt)	Transparency International**
FDI-IN	Foreign Direct Investment Inflows in constant 1986 US$ (millions)	UNCTAD^
	Exogenous Variables	
PL	Democracy, plurality electoral system (dummy)	www.electionguide.org
PR	Democracy, proportional electoral system (dummy)	www.electionguide.org
AUTOC	Level of autocracy (Scale 0 to 10; higher values = more autocratic)	The Freedom House+
YRSIND	Years since independence	*The CIA World Factbook*
LATIN	Latin American country (dummy)	
AFRICA	African country (dummy)	
OIL	Major oil exporter (dummy)	OPEC web-site
INFLATION	Annual inflation rate (percentage)	The IMF
GDP	GDP per capita in constant 1986 US$ (millions)	The World Bank#
GRGDP	Average annual growth rate of GDP	The World Bank#
TRADEPCT	Trade as a percentage of GDP	UNCTAD^
FINRISK	Country financial risk rating (Scale 1 to 100, higher values = lower risk)	The World Bank#
LITERACY	Adult literacy rate (percentage)	UNESCO@
CIV	Index of civil liberties (Scale 1 to 7; higher values = more civil liberties)	The Freedom House+
LEGUK	Legal institutions – UK (dummy)	National sources
LEGFR	Legal institutions – France (dummy)	National sources

* Gwartney, J. and Lawson, R. (2003). The index is composed of five dimensions of economic freedom:
(1) Size of government – Expenditures, taxes, and enterprises
(2) Legal structure and security of property rights
(3) Access to sound money
(4) Freedom to exchange with foreigners
(5) Regulation of credit, labor, and business

** Transparency International online database.
+ The Freedom House (2000-2002).
^ *The World Investment Report* (various issues).
# *The World Development Report* (various issues).
@ UNESCO Institute for Statistics, Montreal, Canada. Online database.

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TABLE 1
SUMMARY STATISTICS

Variable	Mean	S.D.	N
Endogenous Variables			
ECFR	5.4431	1.3432	220
CORRUPT	3.4667	1.4112	218
FDI-IN	1406.4886	4822.6825	220
Exogenous Variables			
PL	0.3454	0.4766	220
PR	0.4000	0.4910	220
AUTOC	2.5324	3.1444	216
YRSIND	91.8682	111.3372	220
LATIN	0.3091	0.4632	220
AFRICA	0.2727	0.4464	220
OIL	0,0727	0,2603	220
INFLATION	14.3965	97.7202	216
GDP	2812.7280	2093.2673	220
GRGDP	3.2037	2.5231	218
TRADEPCT	8.3620	16.8246	220
FINRISK	59,1256	11.3194	207
LITERACY	28.4529	20.4946	212
CIV	4.0454	1.4580	220
LEGUK	0.2909	0.4552	220
LEGFR	0.6545	0.4766	220

TABLE 2
FDI INFLOWS
FEM Panel Estimates[3]

Regressand: LN(FDI-IN)

	(1) Location factors only	(2) Location and institutional factors	(3) Location factors, institutional factors and controls
ECFR		0,021 (0,18)	0,281 (0,25)
CORRUPT		**0,570×10^{-3} (2,20)**	*0,479×10^{-3} (1,73)*
LATIN	**-0,609 (2,49)**	-0,335 (0,96)	-0,201 (0,54)
AFRICA	*-0,612 (1,96)*	-0,341 (1,02)	-0,404 (1,11)
OIL	0,439 (0,77)	*0,660 (1,68)*	*0,690 (1,80)*
INFLATION	-0,151×10^{-3} (1,01)	-0,144×10^{-3} (1,00)	-0,148×10^{-3} (1,05)
LN(GDP)	**1,056 (7,83)**	**0,890 (5,99)**	**0,906 (5,56)**
GRGDP	0,502×10^{-3} (0,56)	*0,195×10^{-2} (1,86)*	-0,184×10^{-2} (1,54)
FINRISK	**0,979×10^{-3} (2,68)**	*0,739×10^{-3} (1,82)*	0,585×10^{-3} (1,44)
TRADEPCT	**0,059 (6,41)**	**0,057 (7,10)**	**0,055 (5,39)**
PL		*0,558 (1,84)*	*0,490 (1,62)*
PR		*0,579 (1,64)*	*0,628 (1,78)*
AUTOC		**0,014 (2,09)**	*0,012 (1,84)*
CIV		-0,090 (1,01)	-0,047 (0,53)
LN(YRSIND)		**0,448 (2,93)**	**0,474 (3,23)**
LITERACY			0,293×10^{-3} (0,55)
LEGUK			-0,815×10^{-2} (0,13)
LEGFR			-0,424 (0,64)
Diagnostics			
Adj.R^2	0,6123	0,6487	0,6473
F stat.; (d.f.) ('p' value)	32,45; (11, 195); (0,000)	23,46; (18, 189); (0,000)	21,14; (21, 185) (0,000)
Akaike I.C.	3,711	3,642	3,658
LM: Panel vs. simple OLS	117,95; p=0,000	29,88; p=0,000	30,64; p=0,000
Hausman: FEM vs. REM	-26,31; 8 d.f.; p=0,000	-26,34; 15 d.f.; p=0,000	-26,81; 18 d.f.; p=0,000
Log-L.	-396,2125	-381,6148	-380,3936
Rest. Log-L.	-506,1161		

NOTES:
(1) All equations contain fixed effects. Time fixed effects are all significant and decline monotonically in absolute value.
(2) Estimates significant at the 10% level appear in *italics*. Estimates significant at the 5% appear in **bold**. Estimates significant at the 1% level appear in **bold underline**.
(3) 't' statistics are computed using White's heteroskedasticity-consistent variance-covariance matrix.

TABLE 3
ECONOMIC FREEDOM, CORRUPTION AND FDI INFLOWS
OLS Estimates vs. 2SLS Estimates

Regressand: LN(FDI-IN)

	(1)	(2)	(3)	(4)
Regressor	**FEM Panel Estimates**[3]	**2SLS**[3]		
		ECFR	CORRUPT	LN(FDI-IN)
Constant	**-**	0,078 (0,11)	**7,203 (6,11)**	**-5,665 (6,44)**
ECFR[4]	0,281 (0,25)	-	**0,552 (8,89)**	**0,431 (4,45)**
CORRUPT[4]	*0,48×10^{-3} (1,73)*		-	**0,101×10^{-2} (2,20)**
LATIN	-0,201 (0,54)	0,197 (0,76)		
AFRICA	-0,404 (1,11)	-0,100 (0,50)		
OIL	*0,690 (1,80)*			0,678 (1,29)
INFLATION	-0,15×10^{-3} (1,05)	**-0,27×10^{-3} (3,98)**		0,89×10^{-4} (0,69)
LN(GDP)	**0,906 (5,56)**	**0,502 (5,44)**		**1,019 (7,38)**
GRGDP	-0,18×10^{-2} (1,54)	0,14×10^{-3} (0,32)		-0,22×10^{-3} (0,24)
FINRISK	0,58×10^{-3} (1,44)			**0,11×10^{-2} (2,62)**
TRADEPCT	**0,055 (5,39)**			**0,064 (6,54)**
PL	*0,490 (1,62)*	**0,762 (3,77)**		
PR	*0,628 (1,78)*	**0,643 (2,76)**		
AUTOC	*0,012 (1,84)*	-0,57×10^{-2} (1,61)		
CIV	-0,047 (0,53)		**1,060 (6,22)**	
LN(YRSIND)	**0,474 (3,23)**	**0,253 (3,76)**		
LITERACY	0,29×10^{-3} (0,55)	0,33×10^{-3} (1,48)		
LEGUK	-0,81×10^{-2} (0,13)		**-0,451 (4,77)**	
LEGFR	-0,424 (0,64)		**-0,545 (6,03)**	
Diagnostics				
Adj.R^2	0,6473	0,3797	0,2361	0,5811
F stat.; (d.f.) ('p' value)	21,14; (21, 185); (0,000)	14,41; (10, 195); (0,000)	17,92; (4, 202); (0,000)	38,98; (8, 198); (0,000)

NOTES:
(1) All equations contain year dummies.
(2) Estimates significant at the 10% level appear in *italics*. Estimates significant at the 5% appear in **bold**. Estimates significant at the 1% level appear in **bold underline**.
(3) 't' statistics are presented in parentheses. The 2SLS 't' statistics are computed using IV standard errors. In the case of the OLS estimates, White's heteroskedasticity-consistent variance-covariance matrix is used.
(4) Endogenous regressor.

Figure 1

THE MODEL