FOREIGN DIRECT INVESTMENT, CORRUPTION, AND THE RESOURCE CURSE: AND EMPIRICAL STUDY

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Overview

Corruption can reduce economic output by lowering private investment but it could also be expected to have distorting effects on the provision of public infrastructure and services, tax revenues, rent-seeking, and the composition of government expenditure. Moreover, corruption tends to be more likely in environments where government interventions lead to the presence of excessive profits with the availability of rents as prerequisite for excessive rent-seeking behaviour (Mauro, 1998). In this regard, foreign direct investment might incentivise corrupt activities, as it is often associated with large infrastructure projects and privatization programs, where economic rents are sufficiently large to encourage rent-seeking behaviour (Larraín and Tavares, 2004). Some rents, however, arise inherently in the absence of government interventions or large infrastructure programs: the extraction of natural resources for instance offers enormous profits to those who extract them which might encourage rent seeking behaviour, too. With foreign direct investment concentrated in extractive industries within resource exporting countries (Asiedu and Lien, 2011), to what extent a country is dependent on natural resource revenues may influence the relationship between foreign direct investment and corruption. Moreover, empirical evidence suggests, that countries with higher natural resource rents suffer from increased levels of corruption (Bhattacharyy and Hodler, 2010). Against this background, the aim of this paper is to empirically test, if foreign direct investments increases corruption for higher levels of resource dependency.

Data and Methodology

We use data from the World Development Indicators (WDI) covering the period 1995 to 2016 in annual frequency on 188 countries which obtained rents from natural resources in the period covered. Our panel is unbalanced but without gaps in the time dimension. To proxy corruption, we use a measure of government integrity which is part of the rule of law component of the measure for economic freedom from the Heritage Foundation. Total natural resources rents are the sum of oil rents, natural gas rents, coal rents (hard and soft), mineral rents, and forest rents and serve as our proxy for resource dependency.

Empirical specification: $GOV_{it} = \beta_1 + \beta_2 FDI_{it} + \beta_3 R_{it} + \beta_4 (FDI_{it} \times R_{it}) + \beta_5 GDP_{it} + \beta_6 T_{it} + u_{it}$

The dependent variable Government integrity (GOV) is measured on a 0 to 100 scale with higher values indicating greater integrity of the government. We control for GDP measured in constant 2010 USD (GDP), trade-openness (T) measured in percent of GDP, Foreign direct investment (FDI) net inflows (BoP, current US$), and total natural resources (R) measured in percent of GDP. All variables except for government integrity and resource rents are transformed into logarithms. To let the partial effect of government integrity with respect to foreign direct investment depend on the magnitude of resource rents, we include an interaction term between both variables.

Preliminary results

The table below reports the results for both a fixed and random effects estimation to obtain the coefficients:

	Government integrity (GOV) is the dependent variable	
	fixed effects	random effects
FDI	0.297841*	0.3192115*
R	0.7450269***	0.7258216***
(FDI×R)	-0.0427338***	-0.0442601***
GDP	3.734364***	3.882462***
T	3.308782***	4.627572***
Const.	-69.82131***	-78.84135***
Hausman test	chi2(5)	Prob>chi2
	36.67	0.0000

Notes: *,**, and *** indicate significance at the 10%, 5%, and 1% levels respectively.

All coefficients are statistically significant at any conventional significance level. The coefficients on all explanatory factors except for the interaction term between foreign direct investment and resources rents are positive in magnitude. Thus, increasing levels of foreign direct investment, resource rents, GDP, and trade-openness on average positively impact government integrity. However, the sign of the significant interaction term between foreign direct investment and resource rents is negative in magnitude. This first indicates that the partial effect of government integrity with respect to foreign direct investment significantly depends on the magnitude of resource rents. Moreover, increasing levels of foreign direct investment are associated with a lower average increase in government integrity for higher levels of resource rents.

Preliminary conclusions

Foreign direct investment affects the level of government integrity in different ways. Under certain circumstances, this however can lead to reductions in government integrity. The preliminary empirical results indicate that increasing levels of foreign direct investment on average tend to a lesser extent increase government integrity when resource dependency is high. A final conclusion that can be drawn from the present text is that the relation between FDI and corruption is much more complex than what many pundits and scholars are willing to accept. It might be the case for instance that the effect of foreign direct investment on government integrity depends only on certain types of minerals or differs among regions.

References

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