Fortune or Evil? The Effect of Inward Foreign Direct Investment on Corruption

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We analyze how one of the central drivers of globalization, foreign direct investment (FDI), relates to the prevalence of corruption. According to received wisdom, the link between globalization and corruption depends on the presence of proper political institutions and practices. We develop an alternative explanation that looks at the effect of inward FDI on host market dynamics, which in turn affect the opportunities for rent creation. We argue that, in less developed countries, FDI inflows can increase market concentration, resulting in higher rents that public officials can demand from market actors. Yet, the positive association between inward investment and corruption is mitigated in more developed economies. There, foreign entry into a market populated by productive indigenous firms promotes competition and reduces rents. This lowers opportunities for corrupt behavior. We test this nonlinear relationship between FDI and corruption in an instrumental variable two-stage least squares setting. The results indicate that FDI is indeed associated with higher levels of corruption in less developed countries, but not in developed countries. Our findings highlight the role of globalization in shaping host countries’ market dynamics, which often set the parameters of political outcomes.

The causes and consequences of globalization are central themes in comparative and international political economy. Scholars write extensively on how economic integration—through trade and finance—affects politics and policymaking around the world. Global integration is supposed to broaden the set of economic opportunities for countries embracing the world economy; moreover, globalization may also result in the diffusion of ideas of good governance. Yet, some forms of integration are associated with a deterioration of local standards and practices. Recent changes in the organization of economic activities have brought international investment and multinational corporations (MNCs) to the attention of politicians, pundits, and researchers. There now exists a large body of literature on the political causes and consequences of global integration through foreign direct investment (FDI) and the activities of MNCs (among others, Jensen et al. 2012; Jensen and Rosas 2007; Jensen 2006; Johns and Wellhausen 2016; Li and Resnick 2003; Pandya 2013; Pinto 2013; Zhu 2012). However, we still know little about the consequences of FDI on corruption in host countries.

We investigate the link between inward FDI and grand corruption—the type of corruption involving the highest-ranked public officials and leaders.1 We argue that the effect of FDI on corruption depends on whether the entry and presence of foreign investors alter market dynamics, and hence the opportunities for creating and extracting rents in host countries. Higher rents will lead to more corruption; lower rents are associated with better governance (Ades and Di Tella 1999). Our argument runs counter to received wisdom, which sees the effects of FDI as either always positive (increasing corruption) or always negative (reducing corruption).

Understanding the link between foreign investment and corruption requires a closer look at the determinants of FDI. Firms engage in FDI to protect intangible assets such as brand names, managerial skills, and production technology. These proprietary assets are inefficient for licensing or subcontracting in arm’s-length markets and will be more productive when under the control of a parent company (Caves 1996). Yet, it is costly for firms to set up and manage affiliates abroad; only the most productive—and usually the largest—ones are able to afford these extra costs (Bernard et al. 2009; Melitz 2003; Yeaple 2009). Direct investment by these highly productive firms is expected to generate positive spillovers in the host country, including access to technology, efficient resource allocation, and crowding-in of domestic investment. But inward FDI can also generate negative consequences, such as market concentration, economic volatility, and uneven distribution of benefits (Aitken and Harrison 1999; Hymer 1976; Kobrin 1987; Moran 1978). Scholars demonstrate that whether these positive or negative spillovers materialize depends on the absorptive capacity of the host

1Corruption is traditionally defined as the “use of public office for private gains” (Bardhan 1997, 1321).

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country—itself a function of the country’s level of development and market structure (see Agosin and Machado 2005; Blostrom et al. 2001; Borensztein et al. 1998). We should, thus, expect the effects of inward FDI on corruption to vary with local conditions in the host. Prevailing analysis overlooks this relationship.

We posit that the link between inward investment and corruption depends on how FDI affects market dynamics in host countries. In less developed countries, local firms are likely to be less productive than their foreign counterparts. Thus, the entry of foreign firms would crowd out domestic investment and stifle market competition (see Bloström and Kokko 2003; Kosová 2010; Bloström et al. 2001; Caves 1986), resulting in a more concentrated market and higher profit margins or economic rents. Higher rents, in turn, increase the benefits that government officials and investors expect when demanding and paying bribes, respectively (Ades and Di Tella 1999). Consequently, inward FDI will be associated with high corruption in developing countries. This positive association between FDI and corruption will be mitigated in developed economies, where foreign investors compete with more productive domestic firms, driving economic rents away, and thereby decrease the expected benefits of engaging in corruption.\(^2\) For this reason we examine the link between FDI and corruption for countries at different levels of development.

Efforts to analyze the relationship between FDI and corruption face difficult technical issues, including endogeneity. To address this problem, we implement an instrumental variable (IV) estimation: we use remoteness—the weighted geographical distance between the host country and the richest economies in the world—as “an instrument” for inward direct investment. We find strong and robust evidence that inward FDI is associated with higher corruption levels in less developed countries, but the positive marginal effect of FDI on corruption disappears as countries reach a certain threshold of economic development. Furthermore, we analyze the sensitivity of our results by examining potential violations of the IV exclusion restriction, using different measures of corruption, and exploring alternative mechanisms. Our findings suggest that the nonlinear relationship between FDI and corruption remains strong in both statistical and substantive terms.

Our research also speaks to a broader literature on the domestic political consequences of economic interdependence. Scholars write extensively on how global economic forces, trade and finance in particular, can affect domestic politics and policymaking (for example Gourevitch 1986; Hafner-Burton 2009; Keohane and Milner 1996; Mosley 2003; Simmons and Elkins 2004). More recently, contributions in the new interdependence tradition show how transnational interactions affect domestic institutional changes (see Farrell and Newman 2014). We extend this research by identifying a significant link between globalization and governance, showing that cross-border direct investment can alter market dynamics in host countries, thereby changing the expected benefits of corruption.

### Foreign Investment, Rents, and Corruption

The relation between economic development and governance has received ample scholarly attention. Most literature focuses on the link between international trade and corruption. It holds that imports tend to create competition in the marketplace. This reduces the opportunities to extract rents and thus the expected benefits of corruption (Ades and Di Tella 1999; Sandholtz and Gray 2003, 765–66; Sandholtz and Koetzle 2000). By contrast, regulating and restricting trade through the distribution of import licenses and quotas facilitates bribery, graft, and corruption (Krueger 1974). Moreover, studies find that exports of fuels, metals, and minerals are positively correlated with the level of corruption (Ades and Di Tella 1999; Treisman 2000). Yet, the existing literature overlooks the connection between foreign investment and corruption.

We argue that the link between foreign investment and good governance depends on the effect of FDI on market dynamics in host countries. Whether FDI results in higher or lower rents depends on the availability of local resources and the difference in productivity between foreign and domestic firms. FDI inflows will correlate with higher rents, and hence higher corruption in economic environments in which FDI crowds out domestic investment and competition is restricted. We first need to establish how the presence of foreign investment affects the conditions that make corruption more prevalent. Studies on the determinants of corruption show that political and economic conditions create the incentives that “shape opportunities for corrupt behavior” (Montinola and Jackman 2002, 149; Ades and Di Tella 1999; Treisman 2000, 2007). The incentives to engage in corruption increase with the availability of rents associated with the exploitation of natural resources or with restricted competition in product markets (Ades and Di Tella 1999). The payoffs for corrupt behavior increase under market conditions conducive to creating rents, which can be shared between public and private agents participating in this exchange.\(^3\) Therefore, we need to identify how foreign investment affects the benefits and opportunities of engaging in corruption.

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\(^2\)The argument that foreign investment can lead to negative political conditions, including corruption, is not novel. It is present in the *Dependencia* and *Triple Alliance* scholarship, in vogue during the late 1970s (see Evans 1979; Kohrín 1987; Moran 1978). Our argument deviates from this literature by focusing on the endogenous consequences of globalization on opportunities for rent creation and extraction.

\(^3\)The benefits of engaging in corruption can be mitigated by the costs associated with the probability of getting caught, which is partly affected by the incentives and constraints created by domestic and international institutions. Abuse of public office for private benefits is more likely in political systems where leaders and public officials are less accountable to the public, or less likely to be caught and/or punished when participating in illegal activities. We explore this alternative mechanism in Section F of the Supplementary Information.
The existing literature presents several explanations about why we should expect FDI inflows to reduce corruption. First, when facing high demands for bribes and payments, foreign investors who have the ability to move internationally would choose to exit, or stay out (Wei 2000). Second, as they compete for foreign capital, governments are forced to reform their regulatory environment, leading to a “race to the top” in governance standards (Malesky et al. 2008; Sandholtz and Gray 2003). Third, FDI inflows may promote the diffusion of pro-business norms and ideas that lead to the adoption of good governance practices, property rights protection, and rule of law (Gerring and Thacker 2005; Kwok and Tadesse 2006). Last, foreign investment may generate greater competition in the marketplace. Increased competition results in a more efficient allocation of resources and dissipation of rents. Yet, corruption does not always deter foreign investors. Many investors aptly adjust to local practices, as reflected in the profuse anecdotal evidence of foreign investors actively engaging in corruption (see Hellman et al. 2002; Søreide 2006).

In contrast to these arguments, we focus on the potential of foreign investment to disrupt market conditions. The entry and presence of MNCs may alter market dynamics and thus the level of economic rents generated in host countries. The ensuing rents from changing market conditions, in turn, shape the incentives to demand and pay bribes. Identifying when FDI will result in higher or lower corruption requires a closer look at the reasons why investors choose to set up and manage affiliates abroad.

FDI involves the flow of investment capital across national borders, in which the investor, usually an MNC, retains a controlling stake over an affiliate established in a different country (Caves 1996). The choice of establishing an affiliate abroad derives from the existence of intangible assets such as brand names, managerial skills, and production technology. These valuable assets are vulnerable to hold-up problems under arm’s-length relations. Transaction costs associated with protecting those intangible assets justify the extra burden of setting up a hierarchical structure of control over an affiliate operating abroad (Caves 1996; Dunning 1992). Only the larger and more productive MNCs are able to incur these extra costs and remain profitable (Bernard et al. 2009; Melitz 2003; Yeaple 2009). The entry, presence, and expansion of the larger and more productive MNCs can potentially alter market dynamics. Whether foreign investment stifles or promotes market competition depends on the productivity differences between foreign and local firms operating in that country. When the difference in productivity between foreign entrants and indigenous firms is small, market competition increases, resulting in rent dissipation. When the difference in productivity between foreign investors and local firms is large, the entry of foreign firms can crowd out domestic firms, leading to lower competition, a more concentrated market, and a higher level of rent creation.

The productivity and competitiveness of local firms closely relates to a country’s level of economic development. Developing economies lag behind developed countries in innovation and technology. They have less competitive markets for goods, services, and factors of production. When foreign investors enjoy a productivity advantage over their local counterparts, the crowding-out effect of the entry of foreign firms dominates. As foreign firms with more advanced technology and lower marginal costs of production enter into a developing country, the market share of domestic firms falls. A shrinking market share increases the average production costs of the remaining domestic firms and leads to a decline in their profitability, pushing the least productive firms out of the market. In such cases, foreign entry will result in less competition because of the exit of less productive firms, and higher rents due to the ability of the most productive firms to increase their markups over marginal costs. Moreover, foreign investors’ capital, technology, and know-how help relax the constraints faced by host governments in exploiting local resources, which would otherwise remain idle or under-exploited in the absence of MNCs. Increasing rents, in turn, lead to more opportunities and greater incentives for corruption, as those rents could ultimately be shared between investors who help create them, and government officials who are in positions to regulate investors’ presence and activity, grant or deny licenses and permits, and uphold restrictive market conditions.

Sharing the rents with local leaders is costly to foreign investors who would rather pocket those rents themselves. Yet, the expected returns of engaging in corruption could be worth these costs wherever the opportunities for rent extraction are large. Thus, we expect that inward FDI will lead to higher levels of corruption in less developed countries. In developed economies, MNCs are likely to co-exist with incumbent firms with similar capacities, technologies, and know-how. In such cases, the entry of foreign investors tends to increase competition, and leads to a dissipation of economic rents. FDI inflows intensify competitive pressures, force all firms to cut prices, and further reduce the opportunities for rent creation and appropriation.

We derive the predictions linking productivity differences to higher rents in a simple monopolistic competition setup (see Supplementary Information A). The exercise shows that the effect of entry on firms’ profits depends on the productivity differential between incumbent firms and the new entrant. Note that the effect does not depend on the motivation for investment, whether it is vertical or horizontal, market- or export platform-oriented. More productive firms are able to produce more output and earn higher profits than less productive firms irrespective of the sector where they operate. Thus, the main driver is the difference in productivity between foreign and domestic firms. To the extent that economic development...

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1Egger and Winner (2005) find that corruption can act as a “helping hand” to foster FDI in unfavorable institutional environments. Other accounts suggest that corruption “greases” the wheels of commerce, and allows investors to engage in highly profitable endeavors (see Kaufmann and Wei 1999, 3).

2Atten and Harrison (1999) interpret this as the market-stealing effect or negative technology spillover of MNCs.

3Initial investment in resource rich countries in Africa, for instance, exemplifies this trend.

4If the economy remains open to foreign investment, local market participants who want to stay competitive have an incentive to demand institutions to restrict the ability of elected officials to engage in graft and demand bribes.

5In the presence of fixed costs, more productive firms (i.e., firms with lower marginal costs) are able to produce more output, and charge a higher markup (even while lowering prices), allowing them to earn higher profits. While some firms are able to endure the competition from a high-productivity entrant, the least productive firms (i.e., those with higher marginal costs) can be priced out of the market (Melitz and Trefler 2012, 100).
serves as a proxy for the competitiveness and productivity of local firms, we expect a positive correlation between foreign investment and corruption in less developed countries, but not in developed economies. We can derive the following testable hypothesis:

**Hypothesis:** Higher inward FDI increases corruption in less developed economies.

A counter-argument is that rising competition may create incentives for incumbent firms to engage in corrupt practices to stay ahead. When facing high competitive pressures, private actors may lobby for policies and regulations that allow them to carve out a market niche for themselves. We believe this effect is less likely to be observed above a threshold of market competition, since more firms will be negatively affected by corruption and could push back. Furthermore, the saliency of this quid pro quo exchange is likely to be magnified when the firm engaging in corruption is foreign.

We underscore the attenuating effect of development and competition on rent creation, therefore reducing corruption. Others emphasize the incentives to engage in corruption to stay competitive. Both sets of hypotheses are theoretically plausible. Yet, we think the former is more likely to be reflected in the reduction of grand corruption and the latter in petty corruption. Which effect dominates is, ultimately, an empirical issue. The task, thus, is identifying empirically the conditions under which foreign investment will result in higher or lower corruption in host countries.

**Empirical Strategy**

We fit a series of models to assess the empirical content of our hypothesis that the effect of FDI on corruption depends on the economic environment in host countries. We regress corruption on FDI per capita, real GDP per capita (logged), democracy, and other controls. To capture the nonlinear effect, we include an interaction term between FDI and GDP per capita. The model is set up as follows:

\[
\text{Corruption}_i = \beta_0 + \beta_1 \text{FDI}_i + \beta_2 \ln(\text{GDP cap}_i) + \beta_3 \text{FDI}_i \times \ln(\text{GDP cap}_i) + \epsilon_i
\]

(1)

**Data Description and Sources**

To test our hypothesis, we need a measure of the incidence of corrupt behavior across a large number of countries at different levels of development. However, objective measures of corruption are hard to come by (Olken and Pande 2012). The reason is simple: Corruption is a very sensitive behavior and extremely hard to observe directly. Available measures are usually not amenable to cross-country comparisons. Moreover, experience-based measures tend to capture instances of petty corruption and suffer from sensitivity and social desirability biases (see Jensen et al. 2010). Well-executed list-experiment designs and micro-level analysis of corruption (for example Malesky, Gueorguiev, and Jensen 2015) are able to overcome the sensitivity and social desirability biases. However, they are less likely to capture instances of grand corruption and by design are only suitable for a within-case analysis.

Perception-based corruption indices are constructed by aggregating surveys and measures of experienced corruption where available. They typically have a wider coverage. Measures of perceived and experienced corruption correlate, but they differ in systematic ways (Donchev and Ujhelyi 2014; Treisman 2007). Perception-based measures of corruption are better at capturing instances of grand corruption—our concept of interest. In any event, perceptions of corruption reflect the general consensus about the underlying level of grand corruption in different countries, and can have highly real-world consequences on political and economic behavior. For these reasons we use Transparency International’s (TI) annual index of “perceived corruption” as our main dependent variable. To help address concerns about measures of perceived corruption, we conduct robustness tests using experience-based measures from the World Bank Enterprise Surveys (WBES).

TI’s Corruption Perception Index (CPI) ranges from 0 (most corrupt) to 10 (least corrupt). In order to simplify the interpretation of results, we reverse the values so that higher values represent more corruption. CPI has missing values for some countries and years. To maximize the data coverage, we follow Sandholtz and Gray (2003) and average the scores from 2000 to 2004 for each country that has observations during this period.

The main explanatory variable is the average real FDI stock per capita (PPP adjusted) over a five-year span (2000–2004). To ease the interpretation of our results, we rescale it to 1,000 constant 2000 international dollars. The choice of FDI stocks as our main explanatory variable requires justification in light of recent debates on available measures of FDI (Jensen 2015; Kerner 2014, 2015; Li 2015). The central point in this debate is the need to identify the relevant measure of foreign investment activity that matches the theoretical mechanisms to be tested. Kerner (2014), for instance, suggests that in order to test hypotheses about the role of political risk in MNC activity, the appropriate measure is fixed capital investment, which

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9Perceptions of corruption correlate with political and economic conditions (Donchev and Ujhelyi 2014; Treisman 2007). Where data are available, it has been shown that after controlling for legal systems, religion, and economic and political development, perceptions of corruption are not sensitive to experienced corruption (Donchev and Ujhelyi 2014).

10CPI is widely used in earlier studies. See, in particular, Sandholtz and Gray (2003) and Treisman (2000).

11In Supplementary Information G, we present results based on alternative perception-based measures of corruption from the World Bank and the International Country Risk Guide.

12CPI codes instances of grand corruption, graft, and petty corruption. Yet, our argument is about grand corruption and makes no prediction on the effect of foreign investment on petty corruption. According to Transparency International, CPI is a good proxy for grand corruption, which is at the center of the organization’s activities. They note, however, that the incidence of grand corruption and petty corruption are likely to go hand in hand. Thus, CPI could be considered as a coarse proxy of the underlying level of grand corruption in the host country, the concept of interest in our study.

13An alternative empirical strategy would exploit the within-unit variation in the dependent and independent variables. Unfortunately, this strategy is not feasible at this stage for several reasons: first, none of the available measures are amenable to time-series cross-sectional analysis due to changes in coding, coverage, and other data collection problems. See detailed discussions in Treisman (2007); second, in the CPI dataset, corruption levels in a country change very little during the time frame for which the measures of corruption are available; and last, aside from limitations in the available data, we believe that the effect of FDI on corruption should be apparent in the cross-section setting, and the empirical results support this claim.
captures the amount of illiquid assets exposed to government opportunism. We argue that the entry and presence of more productive foreign firms may contribute to rent creation in less developed countries, and hence higher corruption. In this sense, we are interested in capturing the presence and activity of MNCs in the host country, not necessarily fixed investment. Inward FDI stocks—flows—are more relevant to our theory, since they include both liquid and illiquid assets. The measure used by Kerner (2014, 2015), fixed capital expenditures, is too narrow for our case. It is only available for majority-owned foreign affiliates of US MNCs. In our main specifications, we report results using FDI stock data. Results using FDI inflows are substantively and statistically the same. This should be no surprise, since, despite being collected from different sources, both measures are closely related.

Regarding other covariates, economic development is measured by real GDP per capita (PPP adjusted). We take the natural log of GDP per capita to account for its skewed distribution. The data come from the Penn World Tables and are averaged for a five-year span from 2000 to 2004. We mean-center this variable to simplify the analysis and interpretation of the results, particularly those on the interaction terms.

Standard Polity IV scores are used to capture host countries’ degree of democracy. We take the difference between Democracy and Autocrat as a measure of democracy that varies from −10 to +10, representing from strongly autocratic to strongly democratic (Marshall et al. 2014). We rescale the variable to a range of −1 to 1 and average the values for the 2000–2004 interval.

We control for religion, legal origin, and ethno-linguistic fractionalization. The data come from La Porta et al. (1999). Religious affiliation is measured by the proportion of the Protestant, Catholic, and Muslim populations in each country in 1980. Legal origin is captured by three dummy variables: British, French, and other legal systems (base category). The variable measuring ethnicity is created by averaging five different indices of ethno-linguistic fractionalization (see La Porta et al. 1999, 238). In addition, we include natural resource endowments and trade openness in the regression. To proxy for countries’ raw material endowments, we use the proportion of exports consisting of fuels, metals, and minerals (see Ades and Di Tella 1999; Treisman 2000). We measure trade openness using the sum of imports and exports of goods and services as a share of GDP. To deal with its skewed distribution, we take the natural log of openness.

We start with “naïve” OLS regressions and present the results from these analyses in Table 1. First, we simply regress corruption on FDI, real GDP per capita, and democracy, controlling for other covariates identified in the literature. In this setting, we are able to reproduce the findings from earlier studies, which show a negative correlation between FDI and corruption. To account for the nonlinear effect posited in our hypothesis, we add an interaction term between FDI and GDP per capita. The regression signs of FDI and GDP per capita and their interaction term are consistent with our expectation that the effect of FDI depends on the level of economic development; the coefficients do not attain statistical significance, however. Moreover, endogeneity concerns should make these results suspect.

In the ensuing sections, we present our strategy for dealing with the problem of endogeneity. First, we discuss the construction of an instrumental variable for FDI. Next, we move to the two-stage least squares (2SLS) results. We evaluate whether the effect of FDI on corruption is linear—as proposed by received wisdom—or nonlinear—as derived from our theory.

14 Results using FDI inflows are reproduced in Supplementary Information C.
15 FDI stocks data are calculated using different methods in different countries—at market value, at historical cost, or by cumulating FDI flows depending on the source. Data on FDI flows, on the other hand, are recorded on national accounts and are often more complete and reliable, albeit more volatile. However, FDI inflows highly correlate with FDI stocks as prior investment activity is a strong predictor of investment inflows. Moreover, averaging over a five-year interval further reduces the volatility in both series. The Pearson correlations between real FDI inflow per capita and real FDI stock per capita during the period of 2000–2004 are 0.98 and 0.96 in our samples with and without outliers, respectively. This suggests that they are essentially capturing the same underlying concept.
16 The link between legal systems and good governance is quite controversial and recent work contradicts the results (see Lederman et al. 2005). Yet, we add them as controls following the existing literature.
17 See La Porta et al. (1999, 238). The original data are in percentages, ranging from 0 to 100. To ease the interpretation of results, we have converted the data to decimals.

Table 1. OLS regression results: FDI stocks and corruption (CPI)

<table>
<thead>
<tr>
<th></th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>FDI Stock per Capita</td>
<td>-0.09***</td>
<td>-0.09***</td>
<td>0.01</td>
</tr>
<tr>
<td>GDP per Capita (log)</td>
<td>-1.16***</td>
<td>-1.16***</td>
<td>-1.17***</td>
</tr>
<tr>
<td>FDI per Capita \times GDP per Capita</td>
<td></td>
<td></td>
<td>-0.06</td>
</tr>
<tr>
<td>Democracy (Polity IV)</td>
<td>-0.07</td>
<td>-0.05</td>
<td>-0.05</td>
</tr>
<tr>
<td>Fuel, Metal, &amp; Minerals Exports</td>
<td>1.03**</td>
<td>1.05***</td>
<td>1.04***</td>
</tr>
<tr>
<td>Trade Openness (log)</td>
<td>0.34</td>
<td>0.33</td>
<td>0.25</td>
</tr>
<tr>
<td>Ethno. Fractionalization</td>
<td>0.23</td>
<td>0.27</td>
<td>0.34</td>
</tr>
<tr>
<td>Protestant</td>
<td>-3.05***</td>
<td>-3.13***</td>
<td>-3.10***</td>
</tr>
<tr>
<td>British Legal Origin</td>
<td>-0.11</td>
<td>-0.17</td>
<td></td>
</tr>
<tr>
<td>French Legal Origin</td>
<td>-0.25</td>
<td>-0.26</td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>4.72***</td>
<td>4.82***</td>
<td>5.10***</td>
</tr>
<tr>
<td>$N$</td>
<td>95</td>
<td>95</td>
<td>95</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.82</td>
<td>0.82</td>
<td>0.82</td>
</tr>
<tr>
<td>Adj. $R^2$</td>
<td>0.80</td>
<td>0.80</td>
<td>0.80</td>
</tr>
</tbody>
</table>

Note: Standard errors in parentheses; * significant at 10%, ** significant at 5%, *** significant at 1%.

This data are from the World Bank’s World Development Indicators, averaged for the 2000–2004 interval.

Data on openness come from the Penn World Tables.
Endogeneity and Instrumental Variable Estimator

One possible solution to endogeneity is fitting an instrumental variable model in a 2SLS setting. The basic strategy in instrumental variable estimation is to find an instrument that is contemporaneously uncorrelated with the error term in the original model and correlates (preferably highly so) with the endogenous regressor for which it serves as an instrument; furthermore, the instrument should not have a direct effect on the dependent variable (Wooldridge 2002, 83–4). Recent studies on the consequences of foreign investment have proposed different instruments for FDI. Malesky (2009), for example, uses the predicted exchange rate as an instrumental variable for cumulative stocks of FDI. He finds that FDI has a strong influence on the progress and institutionalization of economic reform. Jensen and Rosas (2007), on the other hand, use geography (distance to the US border) to instrument for inward FDI into Mexico to study its effect on inequality. The identification strategy in these studies exploits variation in either economic conditions or geography in the host country. These are sensible choices given their samples, but not for ours.

We construct an instrumental variable for inward FDI, based on a measure of remoteness, namely the weighted geographical distance between the host country and the richest twenty economies in the world for the period of 2000–2004.20 The use of remoteness as an instrumental variable is grounded in recent literature on the determinants of FDI and loosely based on the gravity model of investment: while most of the world’s FDI originates from the wealthiest economies in the world, the amount received by host countries indirectly relates to their distance to these source countries (see Carr et al. 2001; Loungani et al. 2002; Markusen 1995). The logic of the choice of remoteness is as follows: investors are more likely to invest in those destinations that are closer to their home country, and wealthier countries are more likely to be sources of FDI.21

Larrain and Tavares (2004) adopt a similar strategy. They use geographical and cultural proximity to the largest countries in the world weighted by the source countries’ levels of exports and investment outflows to instrument FDI inflows in host countries. While distance to the largest economies is, in theory, exogenous to corruption in the hosts, economic integration (exports and FDI outflows), and the cultural factors included in the first-stage regression (such as common religion and language) could have a direct and independent effect on corruption in the second-stage regression, thus violating the IV exclusion restriction.

In abstract, our measure of remoteness could violate the IV exclusion restriction. Distance from the twenty wealthiest economies where corruption is less prevalent could proxy for the ease of diffusion of sound institutions, practices, norms, and values that may help reduce corruption. However, remoteness and proximity alone do not necessarily result in the diffusion of those institutions, practices, norms, and values. We need to identify the mechanisms through which these best practices are transmitted. One such mechanism is economic interdependence, including trade and investment flows. Weighted distance from the richest countries does not seem to be a good instrumental variable for trade. The correlation between our instrumental variable and imports as a percentage of GDP is low ($r = 0.12$). It is not statistically significantly different from zero.22 This is consistent with Treisman’s (2000, 2007) finding that weighted distance between a country and the twenty largest exporters is not a good instrument for trade openness.23

Instrumenting FDI with our measure of remoteness is equivalent to identifying MNCs as the vectors for diffusion of political practices. These effects, we argue, depend on the motivations for engaging in FDI and are likely to be affected by conditions in the host country. This is an additional difference from Larraín and Tavares’s (2004) study, which does not allow for the effect of FDI to vary with levels of economic and political development, as is central to our argument.

An alternative mechanism for diffusion of governance may be the existence of cultural and colonial links, which may vary with geography. Yet, note that our operationalization of remoteness includes countries from different regions of the world with different languages, values, legal traditions, institutional backgrounds, and colonial statuses.24 Moreover, this possibility is not a serious concern to our identification strategy. The effect of diffusion of good practices through legal traditions and cultural links is hypothesized to be linear, and will bias our results

20We use the summation of the reciprocals of bilateral geographic distances between the host country and the twenty wealthiest economies, weighted by the latter’s real GDP per capita in 2000–2004. The list of the twenty economies is Australia, Austria, Belgium, Canada, Denmark, France, Germany, Hong Kong, Iceland, Ireland, Luxembourg, the Netherlands, Norway, Qatar, Singapore, Sweden, Switzerland, United Arab Emirates, the United Kingdom, and the United States. We exclude Bermuda, Macao, and Brunei from the list of the top twenty economies. Note that the top twenty wealthiest economies account for 74.11% of the world’s cross-border investment outflows during this period.

21Distance from a source of investment could have different effects, depending on the motivation for investment. Vertical FDI, for instance, exists to take advantage of factor price differentials across countries. It is thus explained by arguments based on factor proportions. Horizontal FDI arises when high trade barriers make exports to foreign markets costly. Consequently, firms set up similar production facilities in more than one country to cater to local consumers (Markusen 1995). The latter also refers to the “tariff-jumping” FDI, and hence tends to correlate positively with distance. See Grossman and Helpman (1996) and Helpman (1984). Historically, most FDI flowed among countries with similar endowments, that is, horizontal FDI; see Lipsey (2001) and Markusen (1995). Therefore, instrumented FDI could be interpreted as capturing the average treatment effect of horizontally motivated flows. Yet, Hanson et al. (2001) show that vertical FDI is becoming increasingly more important. Slaughter (2003) also documents a higher prevalence of vertical FDI in recent years. In any event, we should expect that given two potential destinations, investors are likely to choose the closer one.

22Note that the correlation between the instrument and the log of trade openness (the ratio of total imports and exports to GDP) is statistically significant. This suggests that the effect is through exports, which could be attributed to direct investment. To further check whether our instrument captures the variation of trade openness, we have constructed two different instruments for FDI and trade flows, respectively. We weight the bilateral distance between a host country and the richest twenty economies (in terms of GDP per capita) by their FDI outflows as an instrument for the country’s inward FDI. Similarly, we weight the bilateral distance between a country and the twenty largest economies (in terms of GDP or population) by their exports as an instrument for the country’s imports. Again, the former predicts FDI well, but the latter is not significantly correlated with imports.

23Alternatively, we weight distance by the log of the population of the largest twenty economies, obtaining substantively and statistically similar results. One potential advantage of using population is that it serves as a proxy for real GDP, while it is unlikely to have a direct effect on corruption in host countries. Larger populations can result in lower capital to population ratios, that is, lower capital endowments. These results, available upon request, are substantively and statistically the same as those reported here.

24The correlation between our instrument and British legal origin is relatively low, $r = -0.23$, significant at the 95% level in the sample when outliers (Ireland and Singapore) are excluded ($N = 93$). The correlation coefficient is -0.21 in the sample of 95 observations.
downward in less developed and autocratic countries. This is because Western models traditionally associated with best practices and control of corruption are less likely to influence governments and individuals in more remote countries. In such a case, we underestimate the positive coefficient of FDI in less developed and autocratic countries (see more discussions in Supplementary Information E).

Another potential critique of our instrument is that even if remoteness does not affect corruption in host countries, distance may have an effect on the variance of the information available to researchers at the TI, World Bank, or PRS Group to construct the indices of perceived corruption. This may result in a more precise measurement of the underlying level of perceived corruption in places in which MNCs are active. This is less of a concern in the WBES’s bribery indices, as they are based on firms’ experiences. The problem is also mitigated in TI’s Corruption Perceptions Index. The index also uses surveys of residents and local sources that are supposed to have more objective knowledge of local corruption. Furthermore, Fisman and Miguel (2007) find that perception-based measures of corruption correlate significantly with actual corrupt behavior (for example parking violations). This provides some validation of the subjective measures of corruption used in our analysis. Additionally, instrumented FDI enters the second-stage regression in a nonlinear form, further mitigating the concern of information exposure. If geographic closeness leads to lower ratings of perceived corruption (i.e., less corruption) in host countries, we will underestimate the positive effect of FDI in less developed countries, similar to the case of diffusion of good governance through cultural and colonial links discussed above. In any event, we control for legal traditions and religion, and perform a series of sensitivity and robustness tests to mitigate these concerns.25 We have good reasons to believe that our instrumental variable presents an improvement over those used in earlier studies on the consequences of FDI.

First Stage Results: Remoteness and FDI

In the first-stage regression, we fit the following model:

\[
F_{i} = \alpha + \psi Z_i + X_i \beta + \epsilon_i \quad (2)
\]

\[
Z_i = \sum_{j=1}^{20} \frac{1}{dist_{ij}} \times GDP \text{ per capita}_j \quad (3)
\]

where \( i = 1, 2, \ldots, N \) and \( j = 1, 2, \ldots, 20 \).

In equation (2), \( \psi \) is the coefficient to be estimated for the instrumental variable \( Z_i \) (inverse of geographic remoteness), \( z \) is the intercept, and \( X_i \) is a vector of \( k \) exogenous variables included in the second-stage regression. Bilateral distance is the inter-capital distance between pairs of countries.26 For countries that are not among the top twenty (i.e., \( i \neq j \)), their real FDI per capita should correlate positively with the inverse of the weighted distance to the wealthiest economies.27 Ancillary tests suggest that our instrumental variable is strong and valid (see discussion in Supplementary Information B).

We identify two statistical outliers in the first-stage regression: Ireland and Singapore receive substantially more FDI per capita than the rest of the countries in the sample. To formally check the existence of outliers, we calculate the Cook’s distance for each observation in the sample for the first-stage regression. Results suggest that these two countries are indeed statistical outliers (see Supplementary Information B). We adopt two modeling strategies to deal with the statistical outliers. First, we simply drop these influential observations in main specifications. Second, we add a dummy variable of these observations to the first-stage regression as robustness checks.28

The Effect of Instrumented FDI on Corruption

Models 4 and 5 in Table 2 estimate the effect of FDI on corruption in a 2SLS setting. These results show that the effect of instrumented FDI stocks is both negative and statistically significant, in line with the findings by Larraín and Tavares (2004). The coefficients of other controls are generally consistent with those in the OLS regressions. A higher level of economic development and a larger Protestant population are strongly associated with lower corruption levels, while countries rich in natural resources tend to be more corrupt.

Yet, these models ignore our hypothesis that the effect of FDI on corruption depends on the host country’s level of economic development. In less developed economies—where incumbent firms are less competitive—the entry of foreign investors crowds out domestic firms, increasing opportunities for rent creation, and hence higher levels of corruption. On the contrary, developed economies are more diversified, and have more robust and competitive local businesses. In such cases, the crowding-out effect of foreign investment is less prevalent. Moreover, the entry of multinationals may even increase competitive pressures, further reducing the opportunities for rent creation and appropriation. Thus, we expect the marginal effect of FDI on corruption to vary with the host country’s economic development, which is proxied by GDP per capita.

Estimating the coefficient of the interaction term presents an additional technical challenge. Since FDI stock per capita is endogenous to corruption, the interaction term between FDI and GDP per capita is also endogenous to corruption. The estimates obtained by directly multiplying an instrumented endogenous variable with another variable are inconsistent and the interaction term “must be purged as a single variable, not piecemeal” (Achen 1986, 143; see also Kelejian 1971). For example, suppose we define a reduced form for an endogenous variable \( x_i = (X, Z) \). \( Z \) represents the excluded instruments, and \( X \) represents the included exogenous variables from the second stage. The reduced form for \( x_{i2} \) is \( x_{i2} = \hat{x}_i \beta + x_i \theta \). A consistent estimate of the reduced form predicting \( x_{i2} \) can be obtained by estimating this equation. Then, the purged values of the interacted terms can be included in the second-stage regression, while

25Following Conley et al. (2012), we have done additional sensitivity analysis on the extent to which our results are sensitive to the possible violation of the exclusion restriction. See discussions in Supplementary Information E.

26We calculated bilateral distance data using the ArcGIS 9.2 program. In the case of Hong Kong, we take the distance between the city and the capitals of other sovereign countries.

27For each of the twenty wealthiest economies (i.e., when \( i = j \)), we set the term \( 1/dist_{ij} \times GDP \text{ per capita}_j = 0 \). It is equivalent to coding the distance of a country to itself as infinite so that \( 1/dist_{ij} = 0 \). This implies that for a country such as the United States, included among the top wealthiest economies, \( 1/dist_{ij} = 0 \) captures the fact that the United States receives no FDI from itself.

28Supplementary Information D presents the results.
correcting for the standard errors as usual (Achen 1986, 141–44). We adopt this strategy here.\(^{29}\)

The results shown in Model 6 in Table 2 provide support for our nonlinear hypothesis. The coefficient on GDP per capita is still negative and statistically significant at the 1% level. The most important change is that the sign of instrumented FDI stock per capita becomes positive while the coefficient of the FDI-GDP interaction term is negative. Both coefficients are statistically significant beyond conventional levels.

These coefficients suggest that the relationship between FDI and corruption scales with development. At low levels of GDP per capita, more FDI results in higher levels of corruption, as predicted. When GDP per capita is above $20,671, the value that roughly corresponds to Spain’s in our sample, the net effect of FDI inflows on corruption turns negative. The marginal effect of FDI on corruption for the less developed countries is substantively significant as well. One standard deviation increase in FDI stock per capita results in approximately 1.95 units of change in corruption (0.86 standard deviations) for the median case among the less developed countries below the threshold. In contrast, for a median country above the threshold of GDP per capita, the results show that the coefficients of FDI, GDP per capita, and their interaction term all have expected signs and their coefficients are statistically significant at conventional levels. In Model 8, we add a set of dummy variables that measure different legal origins, and the addition of the interaction term does not greatly affect their signs or significance levels. Protestantism still has a negative and significant impact on corruption. The slope of natural resource endowments is also positive and significant.

Note that the estimates from Model 6 could also be biased, since GDP per capita is potentially endogenous to corruption. To address this problem, we use countries’ absolute latitudes as an instrumental variable for GDP per capita.\(^{30}\) Remoteness and absolute latitude are likely to correlate. However, the results of the first-stage regressions suggest that remoteness better captures the variation in FDI, as opposed to the variation in GDP per capita.\(^{31}\) When predicting FDI per capita in the first-stage regression, the coefficient of remoteness is highly significant at the 1% level, but the one of absolute latitude is not. In contrast, the coefficient of absolute latitude is statistically significant at the 1% level in predicting real GDP per capita, but the coefficient of remoteness is not significantly different from zero.\(^{32}\)

In Model 7, in which we instrument both FDI and GDP per capita, the results show that the coefficients of FDI, GDP per capita, and their interaction term all have expected signs and their coefficients are statistically significant at conventional levels. In Model 8, we add a set of dummy variables that measure different legal origins, and again obtain similar results as before.

\(^{29}\)The standard error of \(\hat{\beta}_j\) is the square root of the \(j\)th diagonal element in the matrix \(\hat{\Sigma}^{-1} = \hat{\Gamma} (X'X)^{-1}\), where \(\hat{\Sigma} = (n - k - 1)^{-1} \sum_{i=1}^n \hat{u}_i^2\), and \(\hat{u}_i = y_i - X\hat{\beta}\), \(i = 1, 2, \ldots, n\). The \(\hat{u}_i\) used to compute \(\hat{\Sigma}\) are not the residuals from the second-stage regression where the \(\hat{x}_i\) have been replaced by \(\hat{\xi}\), but those obtained when using the estimated coefficients \(\hat{\beta}\) and the endogenous \(\xi\). See Woodridge (2002, 93).

\(^{30}\)For a discussion of this instrumental variable, see Treisman (2000, 430).

\(^{31}\)See Models 3–6 in Table A in Supplementary Information B.

\(^{32}\)When we add countries’ legal origin as control variables, absolute latitude becomes a significant predictor of FDI (see Model 5 of Table A in the Supplementary Information). However, the F-statistic of its coefficient is only 7.06, suggesting that it is a weak instrument for FDI. By contrast, the F-statistic of remoteness’s coefficient is 33.47, suggesting it is a strong instrument for FDI.

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**Table 2. IV regression results: FDI stocks and corruption (CPI)**

<table>
<thead>
<tr>
<th>Model</th>
<th>FDI Stock per Capita</th>
<th>GDP per Capita (log)</th>
<th>FDI per Capita × GDP per Capita (log)</th>
<th>Democracy (Polity IV)</th>
<th>Fuel, Metal, &amp; Minerals Exports</th>
<th>Trade Openness (log)</th>
<th>Ethno. Fractionalization</th>
<th>Catholic</th>
<th>Muslim</th>
<th>Protestant</th>
<th>British Legal Origin</th>
<th>French Legal Origin</th>
<th>Constant</th>
<th>(^2)</th>
<th>(^2)</th>
<th>(^2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model 4</td>
<td>-0.13**</td>
<td>-1.09***</td>
<td>-0.25***</td>
<td>-0.06</td>
<td>1.04**</td>
<td>0.33</td>
<td>0.25</td>
<td>0.49</td>
<td>-0.47</td>
<td>-2.84***</td>
<td>-1.43</td>
<td>-0.14</td>
<td>4.83***</td>
<td>(0.05)</td>
<td>(0.05)</td>
<td>(0.19)</td>
</tr>
<tr>
<td>Model 5</td>
<td>-0.13***</td>
<td>-1.07***</td>
<td>0.13***</td>
<td>-0.05</td>
<td>1.04***</td>
<td>0.33</td>
<td>0.33</td>
<td>0.54</td>
<td>-0.41</td>
<td>-2.85***</td>
<td>-0.33</td>
<td>-0.14</td>
<td>4.89***</td>
<td>(0.05)</td>
<td>(0.05)</td>
<td>(0.19)</td>
</tr>
<tr>
<td>Model 6</td>
<td>0.35***</td>
<td>-1.23***</td>
<td>-0.13***</td>
<td>-0.05</td>
<td>0.79</td>
<td>-0.43</td>
<td>-0.04</td>
<td>0.05</td>
<td>-0.61</td>
<td>-2.76***</td>
<td>-0.71</td>
<td>-0.14</td>
<td>7.77***</td>
<td>(0.11)</td>
<td>(0.11)</td>
<td>(0.21)</td>
</tr>
<tr>
<td>Model 7</td>
<td>0.20***</td>
<td>-1.92***</td>
<td>-0.14***</td>
<td>-0.05</td>
<td>1.07**</td>
<td>-0.08</td>
<td>-0.04</td>
<td>0.05</td>
<td>-0.91</td>
<td>-2.72***</td>
<td>-0.66</td>
<td>-0.12</td>
<td>5.65***</td>
<td>(0.10)</td>
<td>(0.10)</td>
<td>(0.21)</td>
</tr>
<tr>
<td>Model 8</td>
<td>0.22**</td>
<td>-2.05***</td>
<td>-0.13***</td>
<td>-0.05</td>
<td>1.11*</td>
<td>-0.07</td>
<td>-0.04</td>
<td>0.17</td>
<td>-0.79</td>
<td>-2.73***</td>
<td>-0.66</td>
<td>-0.12</td>
<td>5.95***</td>
<td>(0.03)</td>
<td>(0.03)</td>
<td>(0.05)</td>
</tr>
</tbody>
</table>

Note: Standard errors in parentheses; * significant at 10%, ** significant at 5%, *** significant at 1%.
We calculate the net effect of FDI per capita on corruption and simulate the 95% confidence intervals by setting GDP per capita at the level of Papua New Guinea ($4,431, which corresponds to a value of –0.16 in the transformed variable) and Australia ($27,069, corresponding to 1.65 in the transformed variable). These two cases respectively represent the median GDP per capita for the group of countries below and above the threshold ($23,649, roughly corresponding to the level of Japan’s in our sample), at which point the estimated net effect flips signs. For a
country such as Papua New Guinea, the net effect of one-unit increase of FDI stock per capita ($1,000 PPP) is 0.24, with a 95% confidence interval of [0.06, 0.45]. For a country such as Australia, the net effect is almost 0 (–0.02), with a 95% confidence interval of [–0.18, 0.14].

Figure 1 graphs the marginal effects of FDI stock per capita on corruption and their 95% confidence intervals along different levels of economic development. The graph shows clearly that at the lowest levels of development, more FDI results in higher corruption, and the effect tapers off at higher levels of development.

So far, the results suggest that the effect of FDI on corruption is not linear. Increasing inward FDI correlates with higher levels of corruption in less developed countries. In advanced economies, increasing inward FDI has no substantial effect on corruption. The finding is consistent with our hypothesis that the presence of foreign investors in less developed countries can increase opportunities for rent extraction and, in turn, corrupt behavior. These results also suggest that corruption in less developed economies is more likely to be affected by external factors (like foreign investment) than in advanced economies. In the latter case, property rights and legal institutions are already well established; markets are highly competitive; corruption levels are already relatively low. Thus, the marginal effect of FDI on corruption resulting from increasing competition and efficiency is likely to be less consequential.

**FDI and Bribery Incidence**

One potential critique of the above results is that the CPI measure of corruption is subjective. Ideally, we should use objective measures of corruption. However, these so-called “objective” measures can be as subjective as experts’ opinions, and they are better proxies for petty corruption as opposed to grand corruption. One possible objection to these measures is how truthful responses are in less democratic and/or repressive settings. To check whether our results are driven by the subjective measure of corruption, we turn to the World Bank Enterprise Surveys (WBES) project. It has surveyed firms’ experiences with corruption in 144 countries.

We utilize two indices from the WBES as alternative measures of corruption: bribery incidence, which measures the percentage of firms experiencing at least one bribe payment request, and bribery depth, recording the

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33The marginal effect is doubled for countries in the bottom quartile of the per capita GDP distribution.

34See Jensen et al. (2010). They analyze the patterns of non-responses or non-truthful responses in the World Bank’s firm surveys.
percentage of public transactions in which a gift or informal payment was requested. We take log of these variables to deal with their skewed distributions. Since the World Bank conducts surveys in different years for different countries, we average all covariates over a 10-year span prior to the survey year in each country. Again, remoteness and absolute latitude are used as an instrumental variable for FDI and GDP per capita, respectively. We have also identified influential observations by calculating Cook’s distances (see more discussions in Supplementary Information B). The empirical analysis presented in Table 3 excludes these outliers.  

The dependent variable in Models 9 and 10 is bribery incidence and bribery depth in Models 11 and 12. We can see the results are consistent with those based on perception-based CPI. Figure 2 graphs the simulated marginal effects using coefficients from Models 10 and 12, respectively. The two panels show that more inward FDI strongly correlates with a higher incidence of bribery in developing countries, but the association disappears when the host country becomes developed. These results provide further support to our central argument that the effect of FDI on corruption is nonlinear.

**Additional Robustness Checks**

To further check the robustness of our findings, we experiment with different model specifications and explored alternative causal mechanisms. First, we use a dummy variable for those influential observations in first-stage regressions, rather than dropping them. Results are consistent with those presented in the paper. Second, we use the Export Concentration Index constructed by UNCTAD as a measure of market concentration and explore whether the effect of FDI on corruption varies with market concentration levels. The results show that inward FDI increases corruption in countries with concentrated markets, as proxied by their export portfolios, but the effect disappears in countries with more diversified economies. Third, to examine whether economic integration is the underlying driving force, we utilize a factor score of FDI and trade openness as a measure of economic integration. The results indicate that economic integration has a weaker effect on corruption. This suggests that the effect of integration on corruption is mainly through inward FDI, not trade.

Finally, we analyze the role of political development, which takes a prominent role in the existing literature on the determinants of corruption (Lerderman et al. 2005; Shleifer and Vishny 1993; Treisman 2000). We employ different measures of democracy, including Regime, Parcomp, and Polcomp from the Polity IV project, Freedom House’s political rights index, and Vanhanen’s (2003) measures of political participation. We also use a factor score of GDP per capita and democracy to capture a country’s joint level of economic and political development, since economic and political development go hand in hand. Our findings suggest that political and economic development play a different, albeit complementary, role: inward FDI correlates with high levels of corruption in countries with the lowest levels of economic and political development in our sample. We present the detailed discussions and results from these alternative specifications and robustness checks in the Supplementary Information.

**Conclusion**

Foreign direct investment has the potential to affect economic and political conditions in host countries. Yet, controversy surrounds the question of whether those effects are positive or negative: for every analysis describing FDI as a vehicle for the diffusion of good governance, another account vilifies multinationals and their alleged deleterious effects on host countries. Our own analysis focused on the relationship between inward foreign investment and corruption. We argued that whether FDI has positive (increasing corruption) or negative effects (reducing corruption) on corruption depends on the host country’s underlying economic environment. Our claim runs counter to the received wisdom that construes the effects of FDI as either always positive or always negative. Rent-sharing stands at the center of instances of grand corruption. FDI may alter the dynamics of market in host countries, resulting in rent creation or dissipation. The direction of its effect depends on the conditions of the host economy and the availability of local resources. FDI inflows are associated with high corruption levels in economic environments wherein FDI crowds out domestic investment and competition is restricted. Journalistic accounts and anecdotal evidence, mostly drawn from developing countries, provide partial support to our claim. MNCs do not necessarily demand higher standards of public governance, nor are they less likely than their domestic counterparts to engage in corruption (see Hellman, Jones, and Kaufman 2002; Søreide 2006).

Our argument builds on earlier work on the political economy of corruption by renowned scholars such as Alberto Ades and Rafael Di Tella (1999), Anne Krueger (1974), Susan Rose-Ackerman (1999), Andrei Shleifer and Robert Vishny (1993), Daniel Treisman (2000), and Gordon Tullock (1967), among others. This literature emphasizes the role of political and economic competition, or lack thereof, in the cost-and-benefit analysis faced by public officials and economic agents when deciding whether or not to engage in predatory behavior. Our main theoretical contribution lies in the emphasis that we place on the effect of foreign investment on the opportunities and costs of engaging in corruption.

Our findings underscore the importance of understanding the effects of global integration on domestic market dynamics, and consequently on political conditions in host countries. Future research should further explore the political consequences of endogenously determined investment flows. Political and economic conditions in the host country are likely to affect not only the location decision of foreign investors, but also their choice of entry mode. Investors’ location and entry-mode decisions, in turn, affect the political and economic parameters in host countries. While some investors are attracted to countries with favorable business climates and governance institutions, others are motivated by the opportunities for rent creation and extraction in countries whose leaders are institutionally unconstrained and politically unchallenged. Investors of the latter type may very well worsen political and economic conditions in host countries, and particularly in less developed ones.

Last, our study has significant policy implications. Addressing the consequences of globalization on rent creation could pay an important role in international efforts.
aimed at curbing corruption, as well as promoting good governance and international development. Efforts to ratchet up enforcement can be supplemented by initiatives that target rent creation by promoting competition, enforcing antitrust measures, and strengthening domestic business capacity. This would enable countries to be better able to enjoy the full benefits of engaging the global economy.

**Supplemental Information**

Additional Supplementary Information may be found in the online version of the article:
- **Appendix A.** Entry, Productivity, and Profits
- **Appendix B.** First-Stage Results
- **Appendix C.** FDI Inflows and Corruption
- **Appendix D.** Influen tal Observations and Alternative Model Specifications
- **Appendix E.** Sensitivity Analysis
- **Appendix F.** Political Development, FDI, and Corruption
- **Appendix G.** Robustness Checks: Alternative Measures of Corruption
- **Appendix H.** Robustness Checks: Economic Concentration
- **Appendix I.** Robustness Checks: Economic Integration
- **Appendix J.** Additional Supplementary Information

**References**


