

# Are Foreign Investors and Multinationals Engaging in Corrupt Practices in Transition Economies?

by Joel Hellman, Geraint Jones, and Daniel Kaufmann

*Foreign direct investment (FDI) plays an increasingly important role in emerging economies. Among transition economies, substantial investment has gone to a few countries in Eastern Europe and the former Soviet Union, while little investment has reached other countries in the region. Between 1994 and 1999 Poland received \$20 billion, the Czech Republic \$13 billion, and Hungary \$12 billion in cumulative FDI flows. In sharp contrast, Armenia, Belarus, Georgia, Tajikistan, and Uzbekistan received less than \$1 billion over the period, according to EBRD data. During that five-year period, annual average FDI in Belarus, Kyrgyzstan, Moldova, the Russian Federation, Ukraine, and Uzbekistan was less than \$20 per capita, while the Czech Republic and Hungary received about \$200 per capita a year, and Poland and Slovenia received about \$100.*

In countries rich in natural resources, such as Azerbaijan, Kazakhstan, the Russian Federation, and Turkmenistan, FDI was made, but flows were weaker than they would have been had better governance prevailed. In fact, for all 22 countries in transition for which data are available, after controlling for natural resource wealth, there is a significant negative association between per capita FDI and the extent of administrative and “grand” corruption—meaning kickbacks in large-scale government contracts. The assertion that corruption deters FDI is not new. In our research we concentrate on the converse question: compared with their domestic counterparts in the host country, do transnational firms (and local firms with substantial FDI or foreign ownership) exhibit higher standards of corporate responsibility? Do these firms engage in corrupt practices less often than other firms?

Conventional wisdom would answer in the affirmative. Most foreign firms are governed by additional legal constraints, the most recent being the OECD Convention on Combating Bribery of Public Officials in International Business Transactions, which went into force in early 1999. For more than 20 years U.S. firms have been subject to the Foreign Corrupt Practices Act, which prohibits U.S. firms from bribing foreign public officials to obtain international business. Foreign firms are also keen to enhance their reputations and re-

spond to stakeholder pressures for more responsible corporate practices. In fact, many firms have adopted voluntary codes of corporate conduct, which typically include anti-bribery commitments. It might thus be expected that relative to their domestic counterparts, firms with foreign capital would tend to avoid corrupt practices.

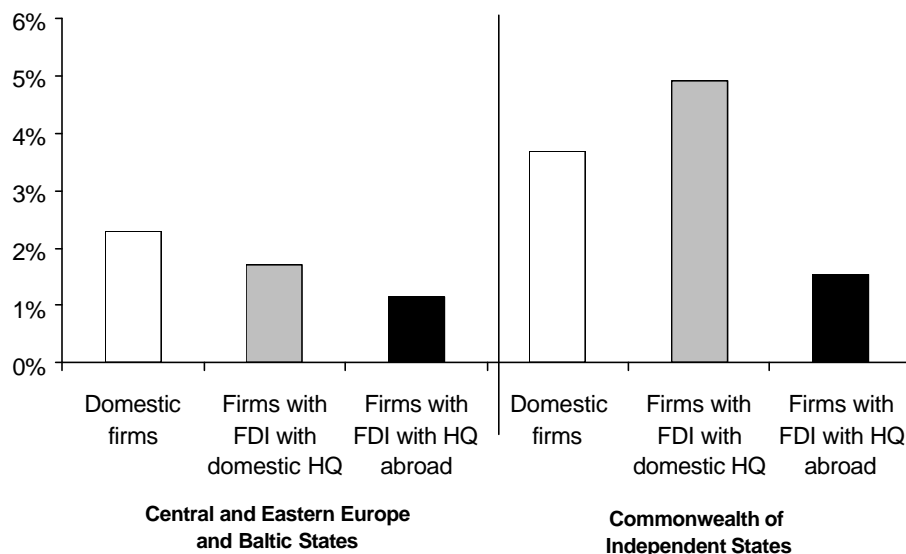
To study in depth the issues of governance and corruption in 22 transition countries, the World Bank and EBRD jointly carried out the Business Environment and Enterprise Performance Survey in mid-1999 (A.C. Nielsen administered the survey). Using the survey data, we analyzed the nature of the

relation between firms and government, focusing on various corrupt and noncorrupt means by which firms exert influence over the state. We took a multidimensional approach to corruption, governance, and influence, unbundling these concepts into specific subcomponents. Specifically, we analyzed the corporate behavior of foreign investors relating to legitimate influence (such as lobbying) as well as corrupt ways of exerting influence.

## Corrupting Influence

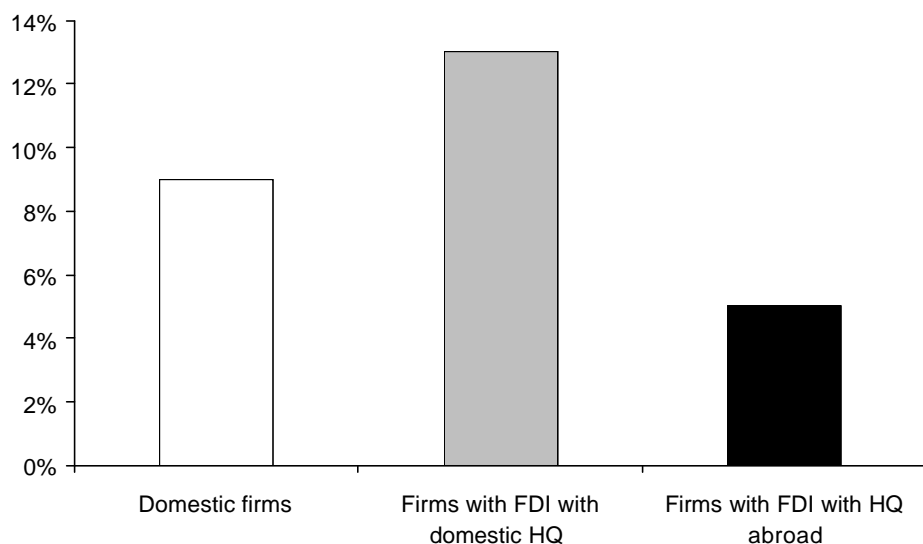
Our study examined three types of corruption: administrative corruption (bribes to

**Figure 1. Bribes as a Percentage of Firm Revenues in Transition Economies, by Subregion**



Source: the authors.

**Figure 2. Percentage of Firms in Transition Economies that Engage in State Capture**



Source: the authors.

bureaucrats to alter the implementation of rules and regulations), state capture (the “purchase” of laws and policies by corporations), and public procurement kickbacks (payments made to secure procurement contracts). We also examined legal methods of affecting policy (such as lobbying). We found that transnational firms are just as likely to pay administrative bribes and to try to capture the state as other firms and that transnational firms headquartered abroad are more likely than other firms to pay public procurement kickbacks.

**FDI and Administrative Corruption.** In a companion paper (“Seize the State, Seize the Day: An Empirical Analysis of State Capture and Corruption in Transition,” summarized in *Transition*, Vol.11, No. 2, April 2000, p. 8 ), we found that administrative corruption does not pay: on average all types of firms (with or without FDI) that engaged in administrative bribery experienced lower sales and investment growth than those that did not. The fact that the majority of firms in most countries still engage in such practices may reflect the fact that local bureaucrats exert extortionary pressure on them.

On average transnational firms pay just as high a percentage of their revenues in ad-

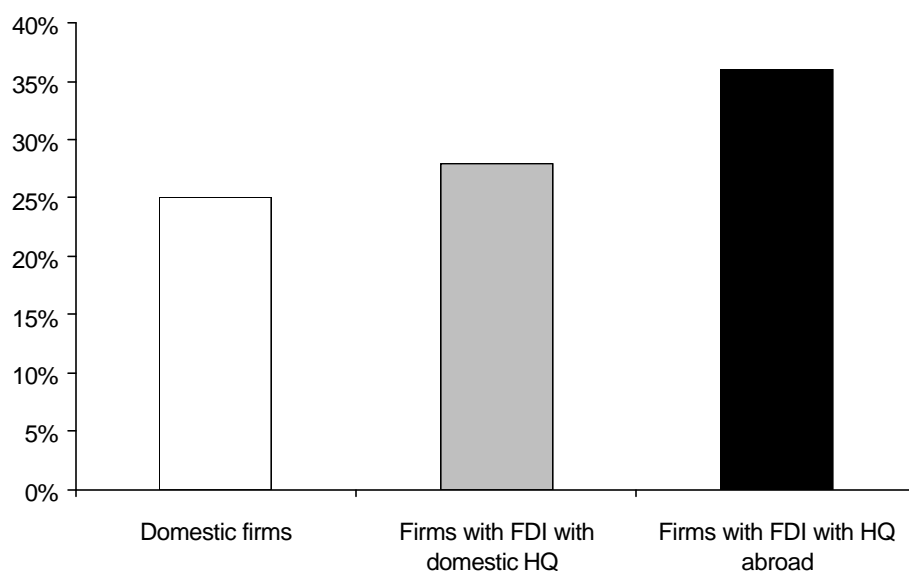
ministrative bribe payments as do domestic firms without FDI. There are, however, important differences across subregions (figure 1). Administrative bribery by FDI firms is less prevalent in Central and Eastern Europe and the Baltic than in the CIS. Bribery in the CIS is particularly prevalent in firms with foreign ownership headquarters are located in the host country rather than abroad.

**FDI and State Capture.** State capture, a pernicious form of corruption prevalent in many transition economies, refers to attempts to extract benefits from the state by corruptly influencing the formulation of policy (public laws, rules, and regulations). The evidence suggests that state capture is particularly prevalent when firms face insecure property rights, insufficient economic liberalization and competition, and only a partial liberalization in civil society and media activities, impairing their ability to effectively monitor the activities of the state.

Despite the more stringent regulations governing their behavior, firms with FDI are involved in state capture just as frequently as domestic firms without FDI. Transnational firms with headquarters in the host country are more likely to engaging in state capture than firms headquartered abroad (figure 2).

**FDI and Public Procurement Kickbacks.** Firms with FDI whose headquarters are located abroad are most likely to pay public procurement kickbacks (figure 3). Such firms are more likely to pay procurement kickbacks than domestic firms with no FDI or transnational firms headquartered in the host country.

**Figure 3. Percentage of Firms in Transition Economies that Pay Kickbacks for Public Procurement**



Source: the authors.

At least for transition economies, these results challenge the efficacy of transnational anti-bribery conventions and laws or self-imposed codes of conduct to reduce corruption by themselves. The data—admittedly based on a small sample for each country of FDI origin and thus subject to a high margin of statistical error—do not support the notion that transnational anti-bribery laws (such as those that have been in effect in the United States for decades) have led to higher standards of probity in overseas public procurement. True, the implementation of the OECD convention is just underway, and it is thus too early to evaluate its impact. Yet it is suggestive that FDI originating in the United States—which has been governed by the Foreign Corrupt Practices Act for more than 20 years—does not appear to be characterized by higher standards of corporate ethics than domestic firms or FDI originating in other countries (figure 4). The impact of coordinated multilateral action under the OECD convention may or may not end up being more potent if and when

countries fully implement, monitor, and enforce the recent agreement.

A positive benefit of transnational bribery laws concerns the behavior of potential investors. Transnational firms and foreign investors may avoid investing in countries with poor governance and high corruption. Reduced levels of FDI can thus indirectly exert pressure to improve governance within a country.

**FDI and Influence.** In contrast to the prevalence of corrupt practices by many firms with FDI in the CIS, exertion of influence is more prevalent in Central and Eastern Europe and the Baltics, particularly among foreign firms with local headquarters (figure 5). The evidence shows that firms that exert influence enjoy higher sales and greater investment growth than those that do not.

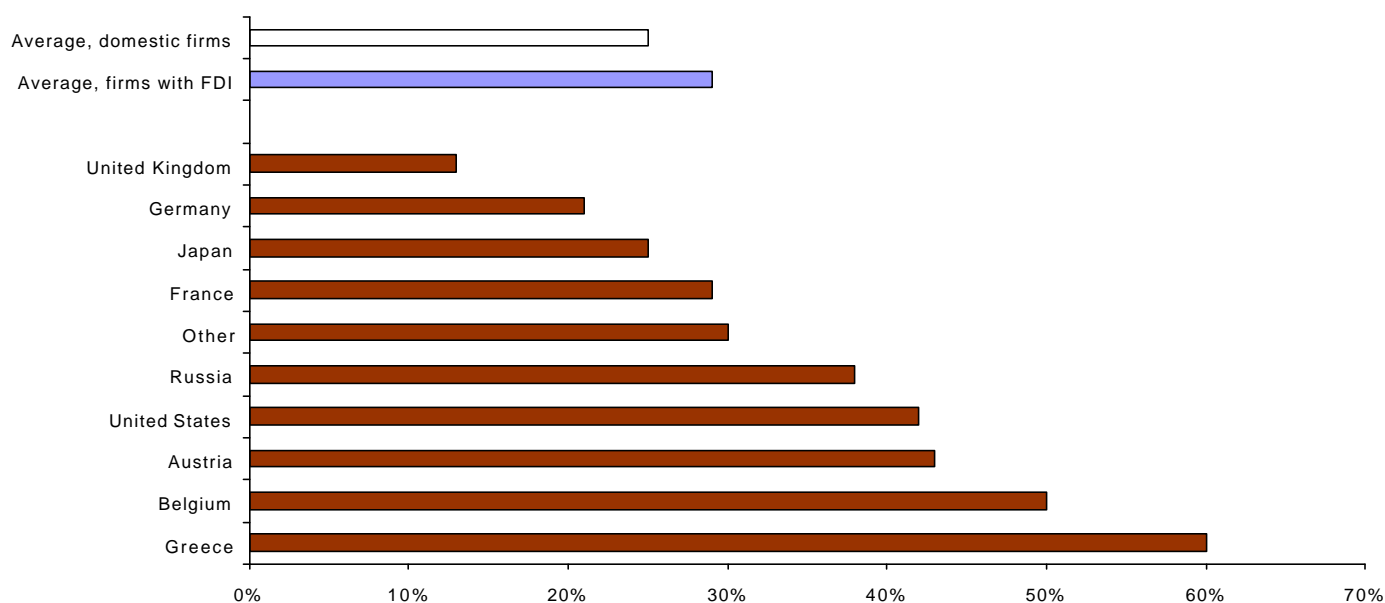
#### Reducing Grand Corruption

The causes and consequences of corruption are increasingly well understood; less

is known about the reasons for its persistence. The analysis of state capture and kickbacks points to powerful private incentives to engage in these activities. In capture economies, where there is a large market for capture of policies and laws, successful captor firms enjoy strong private gains in terms of performance and improved security of their property rights (from an admittedly very low level). Private gains also appear to accrue to public procurement corruption. The private benefits that domestic firms and firms with FDI derive from state capture and procurement kickbacks (in contrast with pettier forms of administrative corruption) suggest why addressing these pernicious forms of corruption is a particularly challenging task.

It is unrealistic to suppose that firms will not try to influence the policy and regulatory environment within which they operate. Indeed, firms in advanced market economies exercise influence over public policy through a variety of channels. Our research highlights the fact that these strong lobbies are present in transition

**Figure 4. Percentage of Firms that Pay Public Procurement Kickbacks, by Country of Origin of FDI**



*Note:* Survey question was "How often nowadays do firms like yours need to make extra, unofficial payments to public officials to gain government contracts?" Firms responding "sometimes" or "more frequently" were classified as paying kickbacks. These figures are subject to significant margins of error and should thus be regarded as approximate.

countries, too, but are directed into illicit channels with highly detrimental social and economic consequences.

Policymakers can adopt a variety of measures to reduce grand corruption, in other words, procurement kickbacks. **First, they can make the relation between the state and firms with FDI more transparent by:**

- Monitoring meetings between firms with FDI and elected officials on the Internet (to make lobbying more transparent).

- Striving for greater transparency in party financing.

- Supporting the establishment of foreign investment advisory councils and foreign business clubs and associations (to give transnational firms a meaningful alternative channel of influence and create interactive forums among competitors).

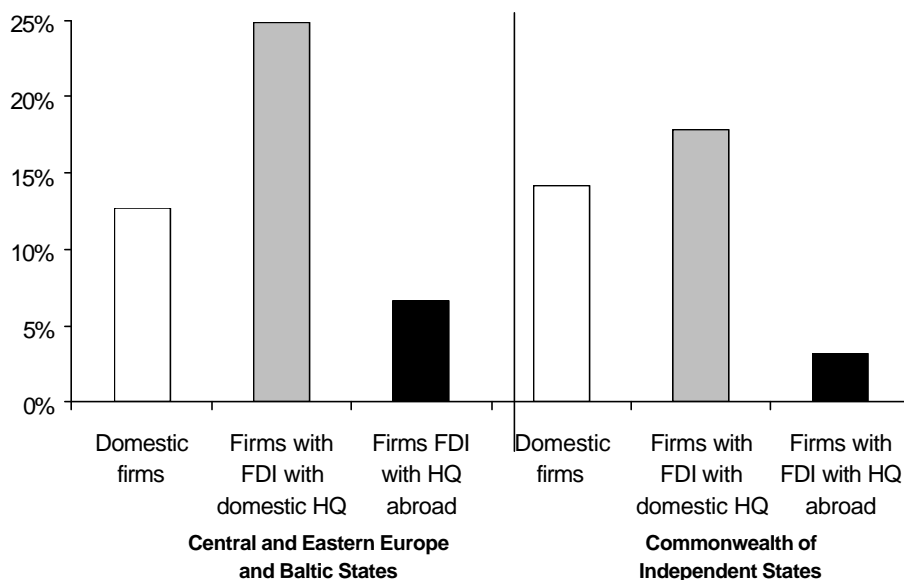
- Setting up monitoring groups with international business associations and other civil society groups to oversee tenders, privatization deals, and large-scale procurement with FDI participation.

- Regularly monitoring and disseminating survey-based data on corporate practices of firms with FDI and disseminating evidence on the socioeconomic costs of firms' illicit activities.

- Improving governance through coalition building and collective action by associations of entrepreneurs, reformist government officials, lawmakers, and the media. The World Bank Institute is already playing a facilitating role in building coalitions and deepening awareness through participatory workshops in which participants discuss the link between corporate responsibility and national governance.

**Second, policymakers can promote global transparency through collective international actions.** These actions include:

**Figure 5. Percentage of Firms in Transition Economies That Use Influence to Effect Policy, by Sub-region**



Source: the authors.

- Concerted monitoring and enforcement of global initiatives that mobilize national governments, legislative bodies, civil organizations, domestic firms, and the international investment and financial community to work in tandem.

- Expanding the World Bank's practice of publicly blacklisting firms found to engage in public procurement corruption (visit <http://www.worldbank.org/html/opr/procure/debarr.html>).

- Supporting the efforts of international NGOs, such as Transparency International and the International Chamber of Commerce, in advising firms on developing codes of corporate conduct that reject bribery.

- Widely disseminating information on transnational firms that have taken a proactive stance on corporate responsibility and ethics.

**Third, policymakers can design anti-corruption programs by:**

- Tailoring the national anticorruption strategy to the political and economic reality of state capture and other forms of grand corruption and putting particular

emphasis on demonopolization, competition, and protection of property rights, as well as complementary public sector reforms.

- Paying special attention to the needs of civil society, the competitive media, and legislative bodies.

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*This article is based on their article "Far from Home: Do Transnationals Import Better Governance in the Transition Economies?" It is part of a joint research project on governance and corruption by the European Bank for Reconstruction and Development and the World Bank Institute. This work is also an input into the ECA report "Anticorruption in Transition: Confronting the Challenge of State Capture," which will be published in September. For further details on the research papers, visit <http://worldbank.org/wbi/governance>.*