Linking In: Political Connections, Foreign Direct Investment and Corruption

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Abstract

How do firms react to the prospect of corruption in host countries? Although researchers argue that corruption is a deterrent to investment, considerable investment continues to flow to corrupt states. I argue that corruption does not deter investment when investors are able to form political connections with government officials. Due to the clandestine nature of corrupt activity, corrupt in foreign direct investment is difficult to directly study using traditional data. To examine the relationship between corruption and foreign investment, I conduct a field experiment using a sample of 36,662 US and Canadian firms. In the field experiment, I manipulate expectations of political connections and expected corruption in host countries. I find that firms respond more favorably to investment opportunities in high corruption host countries when the expectation of political connections is present. These findings have broad implications for political economy research on corruption, foreign investment and corporate global strategy.

Introduction

What is the relationship between corruption and foreign direct investment (FDI)? This question has not received a clear answer in the existing literature: while some argue that corruption is a deterrent for FDI, others argue that corruption serves to "grease the wheels" to bypass inefficient government policies and regulation (Cuervo-Cazurra, 2016; Dreher and Gassebner, 2013). While the overall scholarly consensus suggests that corruption deters FDI on average, significant amounts of investment continue to flow to host countries with high levels of corruption. Why are firms willing to overlook corruption in some cases but not in others? I attempt to answer this question in this paper by utilizing a novel field experiment.

Scholars generally agree that host country corruption generates higher costs and increased uncertainty for investors seeking to access foreign markets (Wei, 1997, 2000). Some investors, however, seem to ignore the downsides of corruption and choose to direct significant capital amounts to corrupt host countries. Countries like China, Mexico, Egypt, Russia and others continue to serve as destinations for foreign capital despite a lax rule of law, high occurrence of bribery and weak protections of property rights that characterize corrupt host countries. Existing research has overlooked this phenomenon, which raises a number of puzzles. How do firms perceive corruption risks and are firms able to manage and mitigate these risks? If firms are able to manage corruption risks in host countries, corruption may not deter investment to the extent suggested by the existing research.

In this paper, I argue that foreign firms cultivate and maintain political connections as a key strategy in mitigating corruption risk. Host country bureaucrats and political actors are more likely to engage in predatory behavior against firms that lack political connections and ties to key political actors. Firms lacking political connections are thus more likely to face a higher risk of expropriation, experience more frequent demands for bribes and experience a costly and unpredictable economic environment. Firms that are able to cultivate political

connections are less likely to face such risks. Foreign firms that develop connections to host country officials with political power are in effect purchasing "protection" from arbitrary predation. Given the necessary political connections, the investment environment becomes more predictable. While some additional costs are incurred, foreign investors may realize higher profits and face less competition if competing firms lack the necessary connections and experience in an uncertain and predator investment environment.

Given the clandestine and illegal nature of corruption, scholars have faced unique challenges in systematically studying these relationships. Understanding the nature of political connections is difficult when using aggregate data on investment flows since micro-level relationships involving political connections cannot be inferred from highly aggregated data. Survey research also involves difficulties since firms may have incentives to provide false or inaccurate information (Nederhof, 1985). If firms face the threat of criminal prosecution for bribery abroad in their home countries, as under the Foreign Corrupt Practices Act (FCPA), for example, firms have an incentive to hide the full extent of their activities in host countries abroad. To overcome these difficulties and study the relationship between corruption and political connections, I employ a novel field experiment to elicit attitudes towards corruption and foreign investment.

Fields experiments are increasingly employed by political scientists across subfields and provide several advantages that overcome the drawbacks of observational studies or traditional surveys (Gerber and Green, 2012; Findley, Nielson and Sharman, 2014; Chatterji et al., 2016). In particular, since participants are not aware that they are participating in a social science study, participants are more likely to reveal information regarding their preferences, while randomization of treatments ensures a high degree of internal validity. I utilize the field experimental approach and create a hypothetical investment consulting firm to evaluate how corruption and political connections affect how firms evaluate investment opportunities. Investment consulting firms are active in facilitating foreign direct investment

by acting as middlemen between firms seeking to expand internationally and host country governments, investment promotion and economic development agencies. I target a sample of 36,662 medium, large and very large firms located in the US and Canada and send advertisements for the hypothetical consulting firm to the firms' CEOs.[1] I manipulate the expectation of host country corruption and expected political connection to examine how these factors affect the response rate to the advertisement. I find that firms that receive a political connections treatment are more likely to respond with interest to the advertisement compared to firms that do not receive the political connections treatment. This effect occurs for both high and low corruption host countries This suggests that expectation of political connections override and dampen some of the risk and uncertainty involved in investing in corrupt host countries.

This paper makes a number of contributions to research on foreign direct investment, corruption and politically connected firms (Jensen, 2003, 2006, 2008; Büthe and Milner, 2008). I examine an overlooked aspect of the corruption-investment relationship and provide some explanations of firm behavior that diverge from expectations developed by existing theories. This paper is also the first to study firm-level preferences towards investment and corruption in a field-experimental context. To my knowledge, this is the first field experiment studying corruption conducted on firms. This work overcomes the drawbacks of observational and survey research, and contributes to research on the determinants of FDI by eliciting firms' true preferences towards investment host countries. Furthermore, this work also shows that political connections play an important role in determining the type of investment environment faced by firms. Thus, not all firms experience host country corruption equally: some may find the investment environment to be more predictable and stable than others. This suggests that is necessary to pay more attention to firm-level relationship and experiences in order to more fully understand the determinants of global

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[1]This draft presents preliminary results from a pilot study conducted with a smaller subsample of firms.

capital flows.

I proceed as follows. First, I examine existing research on corruption, foreign investment and political connections. Second, I develop a theory of political connections and host country investment environment. Third, I describe the field experiment and present results. I conclude with a discussion of implications and directions for future research.

Corruption and Political Connections

Corruption, defined as the pervasive and systemic abuse of public office for personal gain, is generally viewed as being detrimental for most factors associated with economic health: corruption has been found to have detrimental effects on economic growth, development and foreign investment (Mauro, 1995; Wei, 1997, 2000; Habib and Zurawicki, 2002; Cuervo-Cazurra, 2006; Javorcik and Wei, 2009; Fisman and Svensson, 2007; Harstad and Svensson, 2011). Bureaucrats, by demanding bribes and kickbacks, generate new costs for firms and create an unpredictable economic environment. While some firms may find it possible to adjust to "predictable" corruption and incorporate additional costs as the necessary requirement of doing business, not all corruption is predictable (Shleifer and Vishny, 1993). Multiple bureaucrats may act independently to demand separate bribes, without coordination and with no limits on bribe amounts. Similar to a tragedy of the commons, corrupt bureaucrats' bribe-seeking behavior results in a stifling of productive economic activity and deters FDI.

Despite the fact that corruption disincetivizes FDI, it appears that firms are willing to overlook many of the risks associated with corruption. Countries such as Indonesia, Nigeria and China in particular continue to receive considerable amounts of capital inflows. Large endowments of natural resource wealth are particularly associated with both high corruption and large amounts of FDI. Some research also suggests that foreign firms are

frequently willing participants in corruption. As Malesky et. al. show, foreign firms show little reluctance when giving bribes and may take an active role in engaging in corrupt practices to access restricted sectors and capture monopoly rents (Malesky, Gueorguiev and Jensen, 2015). Other research indicates that FDI may actually cause an increase in host country corruption (Pinto and Zhu, 2016).

Research thus increasingly suggests that firms exercise a considerable degree of agency when interacting with a high corruption investment environment. In this sense, firms are not passive "institution takers" but instead act strategically in cultivating relationships in host countries to maximize profits and minimize corruption risks. In Nigeria, domestic entrepreneurs take direct initiative in approaching members of the government bureaucracy to secure access to government contracts in exchange for bribes and kickbacks (Ufere et al., 2012). High-profile corruption scandals involving multinational firms also commonly implicate host country officials and bureaucrats. This behavior is observed in other countries and points to the importance of political connections and "non-market" components of firms' economic strategies.

The extensive literature on politically connected firms suggests that political connections are crucial for shielding firms from uncontrolled predation by government officials (Fisman, 2001; Murrell, 2008; Frye and Yakovlev, 2016). Evidence shows that politically connected firms are more likely to receive government bailouts, get access to lending and experience larger stock market valuations (Desbordes and Vauday, 2007; Malesky and Samphantharak, 2008). Political connections appear to have more importance in countries that lack strong institutions and have weak protections of property rights. These institutional environments operate on rules that are commonly non-transparent and less predictable compared to societies with a strong tradition of the rule of law and transparent institutions. Successful operation in an institutional environment marked by corruption thus requires some degree of political connectedness.

Why do political connections matter for firms' strategies to mitigate corruption risks? Firms that are able to play by the "rules of the game" and that can identify patrons that provide protection in exchange for a cut of the profits may minimize many of the risks associated with corrupt host countries (Campos, Lien and Pradhan, 1999; Hellman, 2000; Zhu and Zhang, 2017). A key risk associated with corruption involves concurrent bribe demands from multiple officials with no guarantees that services will be provided in exchange for a bribe (Wei, 1997). Identifying and building relationships with the appropriate government officials ensures that bribes demands are made more predictable and limited. By maintaining the necessary political connections, firms in effect conclude a kind of contract: bribes are paid to a specific individual or group that is able to provide services, access or goods in exchange for bribes, while shielding firms from outside bribe demands. While these "contracts" are not enforceable and operate outside the protections of the law, political connections are a second-best alternative.

Political connections may be sought not only for "defensive purposes," as outlined above, but may be sought out for more proactive reasons (Galang, 2012). Firms may receive other types of preferential treatment that may involve benefits above and beyond more limited bribe-seeking. Thus, political connections may be instrumental for firms seeking to receive access to contracts, favorable terms of market access, relaxed environmental, labor and other kinds of regulatory standards. Firms may also leverage political connections to create *unfavorable* conditions for competitors and to prevent market access by other firms. Provided that firms are able to establish and maintain connections with key decision makers and members of the bureaucracy, some firms may actually prefer investing in high corruption host countries rather than low corruption countries. In these cases, a firm may have a competitive advantage in leveraging its non-market expertise, rather than relying on market-based strategies of competition focused on increased productivity.

Investment in host countries with risky and unpredictable institutions may thus require

some degree of political connectedness. As a simplification, we may assume that firms have a simple utility function that determines the utility of investing in a given host country: $U(I) = I\alpha - b[1 - c(g)] - d[c(g)] - g$. Here, $I > 0$ is the investment capital amount, α is the expected rate of profit, b is the bribe demanded from unconnected firms, d is the bribe demanded from connected firms and c is the probability of obtaining political connections. Assume that $d < b$ and that seeking political connections is in itself a costly act. By building political connections, firms may have to spend time identifying the appropriate actors and spend resources to build and maintain the necessary connections. These costs are represented by g.

Given this utility function, firms face a simple decision-theoretic problem when selecting among investment destinations and setting I and g. Consider a case where c is high responsive to g (it is cheap to purchase political connections) and b is sufficiently large. In this case, purchasing political connections is an optimal strategy since doing so minimizes the expected bribe. This type of scenario may characterize investment in corrupt countries with ineffective legal, political and economic institutions. Alternatively, if c is not responsive to g (political connections are expensive) and b is sufficiently low or close to 0, firms may choose not to pursue political connections. This scenario may correspond to host countries with low corruption where political connections are not necessary for successful economic activity. If c is inelastic to g and d is very close to b (political connections are expensive and pay little dividends), firms may choose to stay out of the host country altogether.

This logic suggests some straight-forward implications. First, firms are able to manage and mitigate corruption risks by investing in political connections. Given the opportunity to invest in corrupt host states with a high potential for bribery, firms are more likely to do so if they are able to secure political connections. Second, firms are less likely to pursue political connections as the costs of doing so increase. These costs may involve the ease of locating and securing access to officials in host countries but may also involve the costs and

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risks of these activities at home. Since building political connections may in itself involve illegal activity, firms may face public backlash, be implicated in corruption scandals and be brought under criminal prosecution if such activity is uncovered in their home countries. This is particularly likely to be the case for firms headquartered in developed North American and Western European states due to the role of the laws and legally binding treaties such as the FCPA, the OECD Anti-Bribery Convention and the UN Convention Against Corruption. In sum, three testable hypotheses may be derived:

H1: Firms are more likely to invest in low corruption countries than high corruption countries.

H2: Firms are more likely to invest in high corruption countries when firms are politically connected.

H3: Firms are less likely to pursue political connections as the costs of political connections increase.

Experimental Design

These arguments have proven difficult to examine empirically, especially at the firm level. Firms have an incentive to hide information about potentially illegal activity abroad and are less likely to be truthful in survey responses. Corrupt activity is by its nature clandestine and secret, observable only when information becomes public through a corruption scandal or similar public event. These factors have made it difficult to effectively study corruption and political connections at the firm level. To overcome these issues, I use a field experiment

to examine the relationship between investment, corruption and political connections. Field experiments are more frequently used in political science and other fields to study behavior that may be difficult to observe otherwise. Field experiments have the advantage of both high internal and external validity: random assignment in field experiments ensures a high degree of confidence in the causal effect of experimental treatments. Because participants are unaware that they are taking part in an experiment, participants are more likely to provide honest and truthful information regarding motives, perceptions and behavior (Gerber and Green, 2012; Findley, Nielson and Sharman, 2014; Chatterji et al., 2016).

For the purpose of this experiment, I created a hypothetical investment consulting firm. Investment consulting firms commonly serve as middle-men between firms and host country government. Consulting firms generally perform services for governments seeking to attract investment and firms looking to expand internationally. On the government side, investment consulting firms generate leads for governments and help governments design investment attraction campaigns. For firms, investment consulting firms assist companies in selecting investment destination locations, locate access to finance in investment host countries and negotiate investment incentives. Mimicking these types of firms serves as a useful approach to evaluate how other firms think about corruption and foreign direct investment. In particular, mimicking an investment consulting firm allows me to evaluate how firms respond to investment opportunities and the role of corruption and political connections.

To examine firm responses to corruption and political connections, I use a sample of 36,662 US and Canadian firms. The sample of firms was identified using the Bureau Van Dijk's Orbis dataset and includes all US and Canadian firms with subsidiaries abroad. In this draft, I present results from a preliminary pilot experiment using smaller subsamples randomly drawn from the full sample. While Orbis provides contact information for a wide range of firms, the emails provided by Orbis are often generic emails. It is unclear how frequently these emails are checked and whether the advertisement email will be read by

the right contact person. I collected 3000 emails of firm CEOs to increase the likelihood that the emails are seen by key decision makers in a firm. Figures 1 below presents some descriptive information about the number of employees and the total assets of the firms in the sample. While most of the firms are fairly small, with less than 100 employees, the sample also includes some larger firms as well.

Figure 1: Sample Employees and Assets

(a) Employees

(b) Assets
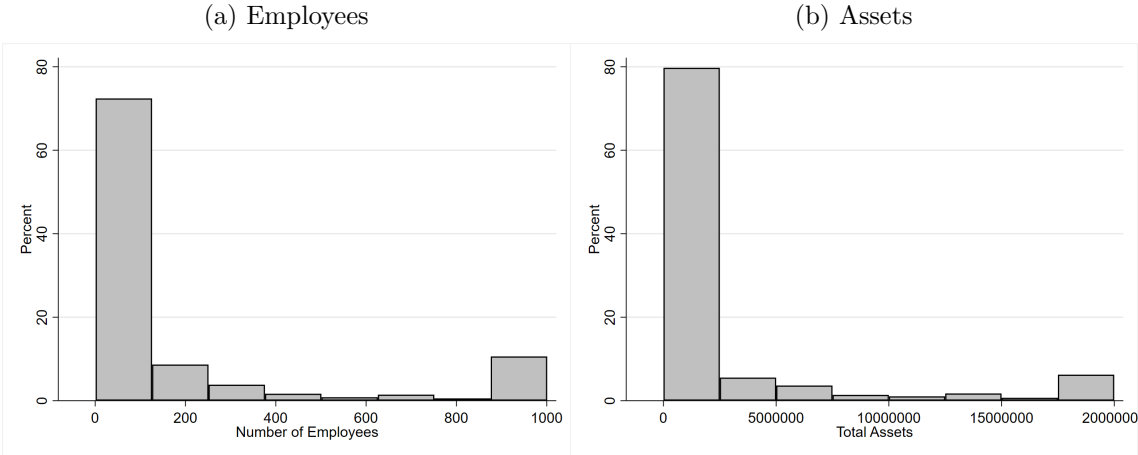
Using the hypothetical investment firm, I contact firms with an advertisement describing the firm's services. To evaluate how firms respond to the prospect of corruption, I randomly vary components of the advertisement that are designed to signal expected corruption and political connections. I use two key variables of interest. First, I examine the response rate. That is, I am interested in understanding how components of the advertisement affect the probability of a firm's response signaling further interest. I pursue no follow up with firms that respond since the goal is to study the response rate only. The variable of interest for each firm is a binary variable equal to 1 if a firm responds with interest to the advertisement, and 0 otherwise. Second, I created different versions of the company website corresponding to possible treatment combinations. The link provided in the advertisement email thus takes respondents to a website associated with a particular treatment condition. I tracked visitors

to the various webpages as an alternative behavioral response to treatments. While I am unable to match visitors to specific firms, I am nevertheless able to examine differences in webpage visits across the possible treatments. For this variable, I calculate the number of unique website visits as a percentage of all firms in a given treatment category.

The advertisement email reads as follows:

Hello,

I'm John at EOC Consulting and I am reaching out to tell you about our services.

EOC Consulting specializes in investment consulting on short-term and long-term projects. We assist companies in entering foreign markets, locate access to finance and customers, and perform benchmarking and location selection services.

Some of our clients include governments and investment promotion agencies in the [**Czech Republic, Taiwan, Chile and Qatar**] / [**Ukraine, Thailand, Bolivia and Algeria**] and corporate clients operating in small, medium and large markets.

[**We pride ourselves on our ability to provide timely access to key decision makers and influencers. We assist in building effective relationships between our clients and host country governments and provide our clients with the necessary connections to ensure the success of the investment project.**]

Our team of investment consulting professionals have many years of experience in

helping corporate clients successfully achieve their global investment strategies, assisting in location selection and providing profitable and sustainable solutions.

[We also consult companies on meeting Foreign Corrupt Practices Act (FCPA) standards. We assist our clients in achieving regulatory compliance, help to develop robust Codes of Conduct and conduct effective audits.]

We are looking to expand our network and would love to have you on board. Would you be interested in receiving a more detailed informational packet? Please reply to this email if you would like to get more information.

If this is an incorrect email for this type of inquiry, please forward this email to the appropriate contact person.

Looking forward to hearing from you!

John Baker http://www.eocconsult.com

Portions of the text presented in bold represent the three treatment categories used in this experiment. First, firms are randomly assigned to a given country basket (Czech Republic, Taiwan, Chile and Qatar or Ukraine, Thailand, Bolivia and Algeria). These country baskets represent potential investment destinations with diverging levels of corruption. Thus, the two baskets represent countries drawn from different points of the Transparency International Corruption Perceptions Index (CPI): the first basket corresponds to countries from the upper end of the index (less corrupt) while the second basket represents countries drawn from the

bottom of the scale (more corrupt). To ensure comparability across destinations, I selected countries at similar levels of development. Independently of other treatment conditions, I expect a higher response rate for the less corrupt treatment compared to the more corrupt treatment.

The second treatment condition randomly assigns firms to receive additional text referencing political connections. I expect a higher response rates for firms that receive this additional text, compared to firms that do not receive the text. The last treatment condition is the "compliance" treatment. This text is designed to prime firms to think about the possible costs of corruption, which may involve the risk of scandal, domestic prosecution, and broader issues related to potentially illegal conduct abroad. I expect this text to have no effect or a positive effect on the response rate of firms that also receive the less corrupt country treatment, and to have a positive effect on response rates of firms that receive the more corrupt country treatment.

The study emails were sent out in three waves during February 2019, June 2019 and March 2020. Table 1 below tabulates the response rates across the different treatments, with standard errors in parentheses. I report p-values for a difference-in-proportions test, with Low Corruption/No Political Connections/No Compliance category used as the baseline.

Although the response rates are quite low overall for all treatments, this table demonstrates some support for the hypotheses developed in this paper. Relative to the no political connections category, firms were more likely to respond to emails that contained the political connections treatment. This is the case for both the high corruption and low corruption categories. Furthermore, firms were also more likely to respond positively to the low corruption treatment compared to the high corruption treatment. This is consistent with patterns established in the literature and with the logic developed in this paper: all other factors held equal, firms express more interest in investment in low corruption countries compared to high corruption countries. However, it appears that the promise of political connections can

Table 1: Response Rates

Treatments	Direct Response	p-value	Website Visits	p-value
Low Corruption, No Pol. Con., No Comp.	1.1%	-	5%	-
High Corruption, No Pol. Con., No Comp.	.5%	.682	2.6%	.129
Low Corruption, No Pol Con., Comp.	2.4%	.263	6.4%	.529
High Corruption, No Pol Con., Comp.	0%	1	4%	.599
Low Corruption, Pol. Con., No Comp.	3.7%	.031	9.1%	.046
High Corruption, Pol. Con., No Comp.	2.9%	.118	7.2%	.287
Low Corruption, Pol. Con., Comp.	2.4%	.383	11.7%	.001
High Corruption, Pol. Con., Comp.	3.2%	.077	9.3%	.034
Overall Response Rate	2.1%		6.9%	

reduce this disparity. As the higher response rates indicate, firms appear to express more interest in investment opportunities in high corruption countries when presented with the prospect of political connections.

The compliance treatment does not generate the same results, however. While the compliance treatment increases response rates somewhat, these differences are generally not statistically significant. A similar pattern can be observed for website visit rates. Respondents are more likely to click the link in the email and visit the firm's website when the political connections treatment is included. This pattern persists for both low and high corruption treatments. Interestingly, individuals in firms that received the high corruption, political connections, and compliance treatment were more likely to visit the consulting firm's website compared to individuals that received the low corruption treatment only. This lends additional support to the notion that political connections can reduce and overcome some of the risks associated with FDI in high corruption countries. All other things equal, it is possible that firms may prefer investment in high corruption countries given political connections, compared to low corruption

Conclusion

Corruption is often a pervasive institutional feature for many developing countries. This has had a significant negative impact on foreign direct investment inflows, with important implications for the development trajectory of developing host countries. Corruption has not completely deterred investment, however, with many firms electing to direct investment capital despite the risks associated with corruption. Firms are often capable of mitigating and reducing the risks associated with corruption. For some firms, corruption is not a deterrent and may actually be an attractive factors. Firms may leverage their experience in navigating an institutional environment characterized by corruption into a source of competitive advantage and invest in markets where competition may be limited due the to the institutional barriers established by corruption risks.

In this paper, I have argued that political connections are an important component in firms' corruption-mitigation strategies. Firms seek political connections as an insurance against the risk and unpredictability associated with corruption. Corrupt systems are often characterized by a lack of stable formal institutional frameworks. Instead, economic actors must rely on informal connections to combat predation by government officials. Foreign firms are unlikely to commit investment capital to high corruption countries in the absence of political connections.

Using a field experiment, I find some support for this logic with a preliminary pilot study. Mimicking an investment consulting firm, I find that advertising emails that reference a potential for political connections are associated with higher response rates. While firms were more likely to express interest in low corruption countries, both high corruption and low corruption countries were associated with higher response rates when the political connections treatment was included. This provides some evidence for the notion that political connections alleviate the risks associated with high corruption.

This finding has implications for future research. In particular, it is important to understand other types of mitigation strategies used by firms when investing in high risk environments. While existing research has largely considered firms to be passive "institution-takers," it is apparent that firms take an active role in seeking to affect the investment environment. Firms may thus be viewed as political agents in their own right. Political connections may thus be only one potential item on the menu of strategies pursued by firms when investing in institutional environments that lack robust protections of the rule of law. Future research ought to explore in more detail how firms seek to adjust to high-risk investment environments.

A similar question also relates to the effect of firms' adjustment strategies on the host country. If firms are not passive and instead actively work to change the host country environment to ensure more favorable outcomes, what is the political and economic effect of these efforts in the home country? Although this question is receiving more attention, additional work is needed. In particular, it is unclear how firms' actions affect the level and extent of corruption in host countries. If firms cultivate political ties and seek to use the institutional environment to their benefit, these actions are unlikely to have a positive impact on host country corruption. Instead, corruption is likely to become more entrenched as domestic actors that benefit from corruption receive more capital from abroad. More systematic research is needed to more fully understand the impact of international investment on host country corruption.

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