Research in Economics (2002) **56**, 231–250
doi:10.1006/reec.2001.0277
Available online at http://www.idealibrary.com on IDEAL®

Manager honesty and foreign investment in developing countries*

DAMIEN BESANCENOT[†] AND RADU VRANCEANU[‡]

[†]*University of Paris 2 and ERMES, 92 rue d'Assas, 75006 Paris, France*
[‡]*ESSEC, Department of Economics, BP 105, 95021 Cergy Pontoise, France*

(*Received 8 September 1999, accepted 15 October 2001*)

Summary

The possibility of facing dishonest local managers is an important factor explaining foreigners' hesitations about investing in developing countries. The first part of the paper analyses the optimal decision rule of a manager who is able to transfer into his own hands a part of the output of the firm. It is shown that in a two-period framework with incomplete information about the nature of the manager, a rational expectations equilibrium exists where managers' behaviour and investors' expectations are mutually consistent. In particular, some young managers may aim at building a reputation of an honest person, then behave dishonestly when getting old. The global performance of an economy hosting a large number of managers is investigated in the second part of the paper, where analysis is cast in an overlapping generation framework. The frequency of dishonest managers, development prospects and global profitability appear to depend on the duration of the relationship between investors and managers.

J.E.L. Classification: O16,D82.
Keywords: developing countries, manager behaviour, rational expectations, corruption.

* The authors are grateful to participants to the ninth International Conference of the International Trade and Finance Association in Casablanca, Morocco, May 1999 as well as to Kim Huynh and Patrice Poncet for their comments on an early version of this text. They would also like to thank two anonymous referees for their helpful suggestions and critical remarks.

1090–9443/02/030231 + 20 $35.00/0

1. Introduction

Recent trends show that foreign direct investment, wherein a foreign company either builds from scratch or acquires a controlling stake in an existing facility, has become a major method of financing the developing world (UNCTAD, 1999). Many factors are considered as traditionally determining the foreign direct investment flow. All foreign investors have the same concerns: political stability, economic openness, ready access to inputs at reasonable prices and laws and regulations that are fairly and transparently enforced. Investors also look to the size and growth of domestic markets and closeness of major international markets; cheap raw materials and labour may also be important assets.†

Unfortunately, in many countries from Asia, Africa, Latin America and Eastern Europe, ambiguity in definition of property rights, widespread corruption of state officials‡ and inefficient legal systems pave the way of local managers to appropriate a share of the firm's wealth without being subject to legal sanctions. This paper develops a formal model on the lines of classical studies on policy credibility (e.g. Barro and Gordon, 1983; Backus and Driffill, 1985; Barro, 1986; Vickers, 1986) to analyse how the risk of facing dishonest managers influences foreign investment in a small developing country. It puts forward the incidence of reputation concerns on managers' individual and collective behaviour and highlights the impact of the length of the relationship between investors and managers on the global performance of such an economy.

In the first part of the text, we focus on the optimal decision of a representative manager with a two-period decision horizon (he is first young, then old). To introduce fraud risk in a simple way, we assume that each manager has the choice between diverting a positive share of the firm's income or preserving the firm's integrity. The representative manager wants to maximize his expected money income, made up of a statutory wage proportional to the firm's turnover and the diverted funds. Managers differ with respect to the subjective value they attach to $1 of diverted money; it may be nil for the "white knight" manager, or may be very large for the dishonest one. The foreign investor does not know the nature of the manager he faces, but knows the statistical distribution of this characteristic in the population of managers. It will be shown that a reputation effect occurs when investors agree to keep

† Substantial literature analyses the role of foreign direct investment in developing countries and its determining factors. See Donges and Wieners (1994), Dunning (1995) or the surveys of Agarwal (1980), Rayome and Backer (1995), Meyer (1998).

‡ Literature on the economic consequences of state officials' corruption is surveyed by Bardhan (1997) or Tanzi (1998).