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Bureaucratic corruption, environmental policy and inbound US FDI: theory and evidence

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Abstract

Previous studies have proposed that equilibrium capital flows are affected by environmental regulations—the commonly coined 'pollution haven' hypothesis. We revisit this issue by treating environmental policies as endogenous and allowing governmental corruption to influence foreign direct investment patterns. Via these two simple extensions, we are able to provide a much richer model of international capital flows. The theoretical model presumes that the effect of corruption on FDI operates via two channels: corruption affects capital flows through its impact on environmental policy stringency and due to greater theft of public funds earmarked for public spending. We empirically examine the implications of the model using US state-level panel data from four industrial sectors over the period 1977–1987. Empirical results suggest environmental policy and corruption both play a significant role in determining the spatial allocation of inbound US FDI. In addition, the estimated effect of environmental policy is found to depend critically on exogeneity assumptions.
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1. Introduction

Activities of multinational corporations have expanded considerably over the past 15 years. Data on worldwide nominal foreign direct investment (FDI) inflows show increases of nearly 18% per annum from 1985 to 1997. This growth rate is stark in light of the much smaller rates of growth observed in GDP and trade flows. Perhaps even more surprising, in light of the political rhetoric associated with capital flight, is that industrialized economies received a major share (71.5%) of these FDI inflows (Shatz and Venables, 2000). The asymmetric distribution of capital flows across countries has spurred a large literature examining the structural determinants of FDI flows (see, e.g. Froot, 1993). One insightful line of research includes studies that examine the effect of corruption on the cross-country pattern of FDI (Wheeler and Mody, 1992; Hines, 1995; Wei, 2000). A related line of work explores the impact of environmental regulation on US FDI, both inbound and outbound (see, e.g. Eskeland and Harrison, 1997; Keller and Levinson, 1999; List, 2001).

While the first set of studies suggests that corruption has a negative effect on FDI into developing countries, the latter group provides only weak evidence that lax environmental policies attract capital (i.e. that 'pollution havens' exist). This second set of studies, however, suffers from two potential deficiencies: (i) environmental policy is assumed exogenous, and (ii) governmental corruption is not explicitly modeled.[1] At first glance, one may conclude that corruption in the US is minimal, and therefore should play little role in the (inbound) FDI decision. However, anecdotal evidence suggests otherwise. For instance, an environmentally-related corruption ring, termed Operation Silver Shovel by the FBI, was uncovered in the mid-1990s. In the end, corruption convictions were handed out to 18 Chicago residents: six were current or former city aldermen. Herbert Collins, former Special-Agent-in-Charge of the Chicago Field Division quipped: 'This investigation was initiated because of the concerns about public officials who were misusing their offices by permitting illegal landfills and other environmental misuses to occur.'[2] The list of such distortions of environmental policy in the US is extensive, and highlights the need for a richer model of environmental policy determination.

In this paper, we attempt to remedy both potential deficiencies by investigating the impact of endogenous US state environmental regulations on FDI inflows, controlling for state level bureaucratic corruption. We therefore contribute to the literature on the pollution haven hypothesis as well as the relationship between corruption and FDI. To guide our empirical work, we first develop a simple theoretical model that endogenizes both environmental policy and the capital

[1] López and Mitra (2000) discuss the relationship between corruption, income, and pollution levels. They do not study environmental policy and capital flows, however.

[2] See http://www.fbi.gov/majcases/silvershovel/silvershovel.htm for further insights.

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