Corruption's impact on foreign portfolio investment

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\textbf{ABSTRACT}

Corruption has significant effects on a nation’s financial markets through its adverse impact on foreign portfolio investment (FPI). Yet, the effects of corruption on FPI are nonlinear and reverse J-shaped, with intermediate levels of corruption yielding the most negative effects. Highly transparent nations, where a “level playing field” exists between foreign and local investors due to lack of information asymmetries related to corruption, attract the most foreign investment. However, at the margin, very corrupt countries attract more investment than moderately corrupt countries because a “pervasive level playing field” in the former countries may put foreigners and locals on an even footing in terms of resolving asymmetric information problems. This nonlinear pattern is consistent with foreign investors’ desire to trade in markets where they are not at an informational disadvantage.

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1. Introduction

The Department of Justice (DOJ) and the SEC’s anti-bribery enforcement initiatives and penalties under the U.S. Foreign Corrupt Practices Act (FCPA) have made front page headlines in the popular press almost on a weekly basis in recent years.\textsuperscript{1} Many other countries around the world are also following suit. For example, the U.K. passed a major compliance regulation act (the Bribery Act) in April 2010. The prevalence of corruption cases and current regulatory and enforcement actions are due to several factors including the increased pressure on firms to compete for lucrative international business opportunities.

As Cheung, Rau, and Stouraitis (2011) show, the payoff to corrupt behavior can be quite tempting since they estimate that the average return is 10–11 times the original bribe amount for 166 high profile cases in 20 countries. In addition, Cuervo-Cazurra (2006, 2008) examines the impact of the OECD “Anti-Bribery Convention” of 1997 and finds that corruption has significant negative effects on foreign direct investment (FDI) but this effect can be ameliorated when anti-bribery laws are implemented and coordinated across many nations (rather than just the U.S.). The coordination of such laws effectively reduces the supply of bribes from OECD countries and therefore can reduce corruption around the world. In contrast to Cheung et al’s focus on the profitability of bribery and Cuervo-Cazurra’s analysis of changes in the supply of bribes, we provide the first country level empirical analysis of the effects of corruption on foreign portfolio investment (rather than FDI) in 49 countries.\textsuperscript{2} FPI is distinct from FDI in many respects such as investment tenure, taxation, and information asymmetries all of which can be directly affected by corruption.

Our main research question pertains to the investment activity of foreigners: are foreign equity and total portfolio investment adversely affected by the level of corruption?

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\textsuperscript{1} According to the Department of Justice, Congress enacted the FCPA in 1977 to bring a halt the bribery of foreign officials and to restore public confidence in the integrity of the American business system (e.g., see www.justice.gov/criminal\slash fraud/FCPA/docs/lay-persons-guide.pdf for more details). In particular, the FCPA was enacted for the purpose of making it unlawful for certain classes of persons and entities to make payments to foreign government officials to assist in obtaining or retaining business. Since its enactment, the FCPA has applied to all U.S. persons and certain foreign issuers of securities. With the addition of certain amendments in 1998, the FCPA now also applies to foreign firms and persons who cause, directly or indirectly, an act in furtherance of such a corrupt payment to take place within the territory of the United States.

\textsuperscript{2} Our focus is on the impact of corruption on financial investment and therefore differs from much of the literature which mainly examines FDI or firms’ entry strategies via acquisitions, joint ventures, or other investment vehicles (e.g., see Wei, 2000; Habib & Zarszick, 2002; Uhlenbruck, Rodriguez, Doh, & Eden, 2006; Cuervo-Cazurra, 2006, 2008; Malhotra, Zhu, & Locander, 2010). Also, we concentrate on corruption rather than the broader issue of political risk in prior literature.

http://dx.doi.org/10.1016/j.ibusrev.2016.05.004
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Please cite this article in press as: P.K. Jain, et al., Corruption’s impact on foreign portfolio investment, International Business Review (2016), http://dx.doi.org/10.1016/j.ibusrev.2016.05.004
The economic effect of corruption has as its theoretical underpinning recent research in asset pricing that focuses on the effects of market imperfections such as asymmetric information and investor uncertainty about a firm’s business fundamentals. Corruption’s effect works indirectly through its impact on asymmetric information and investor uncertainty which, in turn, lead to greater adverse selection costs that can affect FPI as well as trading activity related to FPI (see Fig. 1 for a graphical depiction of these relations). Both asymmetric information and investor uncertainty are likely to be influenced by the level of corruption in an economy because increased information about gains from corruption is typically not disclosed in the public markets and, similarly, losses from prosecutions and settlements are difficult to estimate before the enforcement cases are made public. Therefore, corruption deters investors from participating in a market, which would negatively affect foreign investment.

Asymmetric information is a well-known problem where some market participants have superior knowledge over other market participants in terms of the expected returns and riskiness of an asset. Easley and O’Hara (2004) show how public and private information affect asset returns and demonstrate that investors demand a higher return to hold stocks with greater private information (i.e., more severe information asymmetry). More recently, Brandao-Marques, Gelos, & Melgar (2013) show that a nation’s greater degree of “opacity” towards investors (including levels of financial and accounting disclosure) makes the country more susceptible to changes in global market conditions, which we infer can also affect foreign portfolio investment. In a theoretical model, Stenzel and Wagner (2014) demonstrate that opacity (possibly caused by corruption) in a financial market can impose significant adverse selection costs on investors which ultimately leads to higher trading costs and decreased portfolio investment (both domestically and internationally).

Shleifer and Vishny (1994) and La Porta, Lopez-de-Silanes, and Shleifer (2002) also suggest that higher levels of corruption lead to larger information asymmetries between investors and issuers, thus creating the classic Stiglitz and Weiss (1981) adverse selection, or “lemons,” problem associated with investing in risky firms. In addition, several macro-level studies have documented linear adverse effects of corruption on financing, valuation, and growth. For example, Lee and Ng (2009) show that firms from more corrupt countries trade at significantly lower market multiples by using firm level data from 44 countries. Using estimated bribe payments of Ugandan firms, Fisman and Svensson (2007) find that both the rate of taxation and bribery payments are negatively correlated with firm growth. Other studies with similar implications include Mauro (1997), Wei (2000), Kaufmann and Wei (1999), Cicchini, Durbin, and Ng (2003), Cuervo-Cazurra (2006), Butler, Fauver, and Mortal, 2009, Fisman (2001), and Johnson and Mitton (2003).

An important feature of the Stenzel and Wagner (2014) model is the possibility of non-linearity in the effects of opacity. We conjecture that the differential abilities of domestic and foreign institutional investors to deal with corruption and related opacity, can also create nonlinear relationships. Thus, as Coppier and Michetti (2006), Pagano (2002, 2008), Barreto (2000), Mauro (2004), Almeida, Dutta, and Sena (2008), Dutta and Traca (2010), and Ratek (2010) suggest, corruption can also have a nonlinear effect on an economy. Related to these issues of corruption and nonlinearity, Shleifer and Vishny (1993) show that the illegality of corruption and the need for secrecy makes it much more distortionary and costly than even taxation. They suggest that the demands of secrecy can shift a country’s investments away from more transparent high value projects into high risk opaque projects if the latter offer better opportunities for “secret” corruption. Naturally, these distortions from corruption serve to increase information asymmetries and hurt foreign investment. In our context, the focus on secrecy instead of shareholder wealth maximization also discourages equity investment into the corrupt country. In this regard, “pervasive and open” corruption without a need for secrecy is actually somewhat better than medium levels of “secret” corruption. This peculiarity further justifies the potential nonlinearity in our empirical models.

In addition, Meen and Sekkat (2005) propose an interesting test of the “greasing the wheels” versus “sand in the wheels” hypotheses related to corruption. This research suggests a possible nonlinear relation between corruption and the economy because, at some levels, corruption can be beneficial (i.e., it greases the wheels of commerce) and, at other levels, corruption might be harmful (thus, putting sand in the wheels of an economy).3

The nonlinear trade-off of the degrees of corruption on the ability of domestic and foreign institutional investors to deal with corruption, have not been previously explored. We investigate equity and total portfolio investments held by foreigners, which is particularly interesting because foreign investors have the choice to invest in many countries whereas domestic investors may not have the option to altogether avoid investment in their home country. Moreover, corruption also gives rise to varying degrees of asymmetric information between foreign and domestic investors that, in turn, affect investment decisions. For example, foreign equity investment is expected to be very high when corruption is extremely low. Such a transparent environment can create a “level playing field” where sophisticated foreign investors can thrive with high quality fundamental research.

In contrast, foreign equity investment can decrease sharply as

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3 A recent study by Quazi (2014) describes corruption as either a “helping” or “grabbing” hand and shows that the “helping” hand hypothesis dominates for 53 African nations due in part to the relatively weak regulatory/legal environment in this region. In addition, Brockman, Rui, & Zou, 2013 and Chen, Ding, & Kim, 2010 show that higher levels of corruption can help politically connected firms perform in terms of stock returns and earnings predictability. However, as Cuervo-Cazurra (2006, 2008) and others have observed, the negative consequences of corruption can be stronger in nations with somewhat stricter enforcement of regulations/laws.
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