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Foreign investment and bribery: A firm-level analysis of corruption in Vietnam

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ABSTRACT

Among the concerns faced by countries pondering the costs and benefits of greater economic openness to international capital flows is the worry that new and powerful external actors will exert a corrupting influence on the domestic economy. In this paper, we use a novel empirical strategy, drawn from research in experimental psychology, to test the linkage between foreign direct investment (FDI) and corruption. The prevailing literature has produced confused and contradictory results on this vital relationship due to errors in their measurement of corruption which are correlated with FDI inflows. When a less biased operationalization is employed, we find clear evidence of corruption during both registration and procurement procedures in Vietnam. The prevalence of corruption, however, is not associated with inflows of FDI. On the contrary, one measure of economic openness appears to be the most important driver of reductions in Vietnamese corruption: the wave of domestic legislation, which accompanied the country's bilateral trade liberalization agreement with the United States (US-BTA), significantly reduced bribery during business registration.

1. Introduction

In the summer before the 2011 Communist Party Congress, Ngo Vinh Long, a leading historian of Vietnam, wondered whether the large inflows of foreign capital that followed the country's 2006 entry into the World Trade Organization (WTO) was biasing national and local decision making: As he put it, "Huge concentrations of money, especially from foreign sources, have been at the roots of many arbitrary decisions of the Vietnamese state (Ngo, 2010, p. 6)." His speculations were echoed by Vu Quang Viet, a Vietnamese-American economist and close adviser to leading Vietnamese reform figures in the 1980s and 1990s. Surveying the policies of economic openness and decentralization, he concluded, "This has helped make Vietnam more dynamic, capable of attracting more foreign direct investment (FDI), opening up the economy outwardly and generating much more wealth, and thus offering more spoils for abuse and bribery which have reached an unprecedented scale under the current regime (Viet, 2010, p. 17)".

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The issues highlighted by these prominent analysts raise important questions, not just for Vietnam, but for all countries pondering the costs and benefits of greater economic openness to international capital flows. In this paper, we use a novel empirical strategy, drawn from research in experimental psychology, to test the linkage between FDI and corruption hypothesized above. In so doing, we make two interlinked arguments. The prevailing literature has produced confused and contradictory results on this vital relationship, because errors in their measurement of corruption are correlated with FDI inflows, leading to spurious findings. When a less biased operationalization is employed, we find clear evidence of corruption during both registration and procurement procedures in Vietnam.[1] In addition, the most important driver of reductions in Vietnamese bribe schedules appears to be the wave of legislation that accompanied the country's bilateral trade agreement with the United States (US-BTA), which significantly reduced corruption during business registration.

Beyond simply studying the direct relationship between openness and corruption, however, we also pay careful attention to conditioning variables. After all, policy-makers cannot simply reject the documented benefits of foreign capital flows (job growth, revenue, expertise, technology and production spillovers), because they fear increased bribe schedules. Rather policy-makers want to know what economic sectors are particularly vulnerable to corruption, what types of capital flows are prone to engaging in corruption, and what policy measures can facilitate investment while limiting the negative fallout. Because our empirical strategy allows for the analysis of firm-level determinants, we can move beyond aggregate relationships to answer these questions directly.

To accurately measure corruption and its association with international capital flows, we embedded two survey experiments in the most comprehensive annual assessment of the businessmen environment in Vietnam, known as the Provincial Competitiveness Index (PCI), which is jointly administered by the Vietnamese Chamber of Commerce and Industry and the US-AID funded Vietnam Competitiveness Initiative (VNCI) (see Malesky, 2009 for methodological details). As a result, the samples are highly representative of the national and provincial level business population in Vietnam, thereby providing extremely accurate conclusions about the extent of corruption affecting the Vietnamese business sector, both with respect to small-scale corruption during business registration and the large-scale corruption associated with procurement projects.

The rest of the paper is structured into eight sections. Section 2 situates the theoretical questions motivating this paper within the broader international political economy literature on corruption and lays out the core hypothesis to be explored. Section 3 discusses a number of common research design and measurement problems which have afflicted previous efforts at studying the relationship between corruption and foreign investment. Section 4 provides a description of the original data used in this paper. Section 5 describes the core empirical strategy used in the analysis and presents aggregate results related to trends in corruption among sampled domestic and foreign firms. Section 6 formally expresses the estimation technique for the main firm-level empirical analysis and lists all variables of interest. Section 7 presents and explains results from the firm-level analysis. Section 8 provides concluding remarks and caveats to the findings presented.

Anticipating our results, we find clear evidence of both small and large-scale corruption in Vietnam. In general, 22.9% of operations in Vietnam pay bribes during the registration period, and 34.6% pay bribes when trying to secure government procurement contracts. Not enough foreign firms compete for government procurement to obtain a clear estimate of their complicity in grand corruption, but it is clear that the proportion of foreign firms paying bribes at registration is slightly less than for domestic firms, although this result is not statistically significant. Delving further into the individual level analysis, we find that the US Bilateral Trade Agreement (US-BTA) led to a significant (28%) reduction in bribes paid at registration, but its impact was most prominently felt by foreign invested enterprises (FIEs).

2. The international political economy of corruption

Unfortunately, the international political economy (IPE) literature does not offer clear-cut findings on the relationship between economic openness and corruption to draw upon. This is particularly true when it comes to the role of FDI in facilitating corrupt behavior by government officials. The prevailing argument in the literature suggests that opening a country to FDI or trade flows should reduce corruption, as competition will lower monopoly rents and drive down bribe schedules (Ades & Di Tella, 1999; Larrain & Taveres, 2004; Rose-Ackerman, 1978). Treisman (2000) finds a relationship between openness and corruption (measured by imports/GDP), but concludes that the effect is substantively small. Other scholars concur with the competition hypothesis, but also argue that the adoption of Western business practices and international preferences for transparency has an equally positive effect on how governments do business (Gerring & Thacker, 2005; Kwok & Tadesse, 2006).

An alternative literature observes the same negative correlations between FDI and corruption in cross-national datasets but offers the opposite causal interpretation – that foreign investors are attracted to less corrupt business environments (Gatti, 2004; Lambsdorff, 1999; Wei, 2000). Rodriqguez, Uhlenbruck, and Eden (2005) find that corruption does not deter FDI so much as alter its entry strategy, finding that in highly corrupt environments, FIEs are far more likely to choose wholly owned subsidiaries over joint ventures.

Other scholars have disputed the notion that openness to foreign investment reduces corruption, arguing that FIEs can actually augment corruption in some environments. Hellman, Geraint, and Daniel (2002), using survey data drawn from transition economies in Eastern Europe and the Former Soviet Union, find that foreign firms are just as likely to engage in

[1] Survey instruments, firm-level, and provincial-level data are available at www.pcivietnam.org.