

# Foreign Direct Investment and Corruption in Brazil

Subjects: **Business**

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Foreign Direct Investment (FDI) is seen as a significant driver of economic growth and a potential ally in the struggle against poverty and inequality, making emerging countries focus on attracting this type of investment. Thus, understanding factors that impact the concentration of regional FDI is essential to verifying which characteristics encourage or deter foreign investment.

corruption

Foreign Direct Investment (FDI)

Brazil

## 1. Introduction

Recently, there has been a renewed interest in understanding how to achieve the Sustainable Development Goals (SDGs) established by the UN 2030 Agenda of Sustainable Development. In this context, Foreign Direct Investment (FDI) represents an essential ally for emerging economies, since it can help diminish poverty and hunger—SDG 1 and 2 <sup>[1]</sup>, enhance economic growth—SDG 8 <sup>[2][3]</sup>, control inequality—SDG 10 <sup>[4]</sup>, and strengthen local institutions—SDG 16 <sup>[5]</sup>.

However, several factors influence the presence of FDI in emerging economies. Among them, the institutional environment has been attracting increasing attention within the literature <sup>[6]</sup>, as both formal and informal practices (i.e., legislation and corruption) can either deter or facilitate Multinational Enterprises (MNEs)' activities <sup>[7]</sup>. In other words, evidence suggests that corruption may, along with other aspects, explain the regional concentration of foreign companies <sup>[7][8]</sup>.

The literature presents two opposing views on the role of corruption in the regional attraction and concentration of MNEs. The first, called “sand”, presents corruption as a constraining factor. Thus, according to Barassi and Zhou <sup>[6]</sup>, corruption can be viewed as “sand in the wheels of commerce”, as it creates costs, uncertainty, and distortion towards the activities of international enterprises. Wei <sup>[9]</sup> argues that corruption is costly for firms, as it is no different than an additional unofficial tax that directly reduces MNEs' profits. In addition, Kaufmann <sup>[10]</sup> states that the costs caused by corruption would not lie only in the bribe paid to the government in exchange for services, but also in the time and effort that MNEs have to spend dealing with corrupt public officials.

The second view is called “grease”. Within this idea, corruption can attract foreign investors since it may serve as a “helping hand” to foreign investors, as bribes could circumvent restrictions and regulations <sup>[11]</sup>. It holds especially for emerging economies (e.g., Brazil, Latin American countries), since they tend to present extremely complex and

inefficient legal, accounting, and taxes systems. Thus, corruption can be seen as an “efficient grease” that helps foreign firms to overcome rigid regulations and excessive government intervention within the host region [12].

Given the aforementioned literature, by employing regional Brazilian data, the study aims to challenge the dichotomous idea of “sand” or “grease” views within the scope of emerging economies. Researchers argue that MNEs may tolerate some levels of corruption to gain location-specific advantages such as access to a consumer market, cheap labor, or tax heavens [13]. Thus, the main issue to be investigated here goes beyond the “sand” or “grease” hypotheses, lying instead in the investigation of which level of corruption marks the change from the grease to the sand effect, which is equivalent to answering the following question: To what extent are MNEs willing to tolerate corruption?

Regional-level research on FDI in Brazil and other emerging economies is still limited. Regional investigations on the effects of FDI on the host are almost nonexistent in Brazil, with only a few exceptions [14][15]. These exceptions, however, do not address the relationship between FDI and corruption.

## 2. FDI and Corruption in Emerging Economies

Stimulating economic development in emerging countries is one of the goals set by the UN 2030 Agenda. In this context, several studies identify FDI as a significant driver of economic growth both in emerging [3][16][17] and transition economies [18][19]. Some authors assume that the positive effects of FDI on the economy come from the increase in the capital stock of the host region [20]. In contrast, others postulate that this growth derives from positive externalities, such as knowledge spillovers [21] and its associated productivity gains from domestic firms [22].

FDI assumes an even more critical role, as it is identified as a potential ally in the fight against poverty, hunger, and inequality [1][4][23][24], which is an essential target of the UN sustainable development goals. Nevertheless, recent studies point out that the benefits of FDI for emerging countries must be analyzed with caution, as other variables, such as environmental ones, must be taken into account [25]. Additionally, the method used to measure economic development must also be analyzed carefully, as econometric modeling is not always sufficient to capture the impact of a sector on economic growth [26]. Indeed, the country’s economic context and the proxy used to measure poverty are among them [16][27][28].

Likewise, it is widely accepted that creating and promoting an attractive environment for FDI is complex and varies from one country to another [19]. Some authors point out that one of the main attractions for FDI entry into an emerging country is the abundance of natural resources in the host region [29][30], while others focus on market openness [31], financial factors [32], and social variables [33] as determinants of FDI. However, the study highlights the importance of institutional and policy factors. Hoang et al. [34] argue that the level of social security and legal institutions plays an important role in attracting FDI. Moreover, according to Wan [35], institutions can affect the probability of success of foreign firms, since MNEs tend to adapt their strategies according to the host institutional environment [36][37].

Therefore, institutional factors affect not only the performance of MNEs in the country but also how the concentration and the inflow of foreign capital impact the local economy. In this sense, Chaudhry et al. [38] suggest that the efficiency of local institutions affects economic development and reduces the ecological footprint of MNEs in the host region. Slesman, Abubakar, and Mitra [39] argue that depending on hosts' level of institutional capacity, FDI can be harmful (in lower levels) or beneficial (in higher levels) to domestic firms. Further, Chih, Kishan, and Ojede [40] show that the impact of FDI on economic growth is non-linear, and it also depends on the democratic level of the country, indicating the complexity of the relation between FDI and its impact on (or how it is affected by) the characteristics of the host region, especially on emerging economies. Among the emerging economies, Latin America stands out. Indeed, since 1980, these countries have been undergoing a major industrial reform, with the opening of their markets to foreign investment and the privatization of large companies in critical sectors of the economy [41]. Nevertheless, despite the complexity of this relationship, it is essential to explore it due to its potential to bring both economic and social benefits (or harm) to the host region.

To light one of the factors that affect the complex relationship between FDI and its effect on emerging economies: corruption. The effects of corruption have been a topic of debate among economists and policymakers for at least 50 years [42], since it can impact the decision-making process, access to public resources, and information [43]. In this sense, understanding corruption in a deeper way is essential to exploring its regional economic impacts.

There are many definitions for the word "corruption". Tanzi and Davoodi [44] defined it as the acceptance or extortion of money for personal benefit by government officials; this perspective, although widely used, only addresses the public [45] or government corruption [46]. In the organizational sphere, other authors state that corruption occurs when someone misdirects resources or subverts organizational policies or routines to obtain personal gains [47][48]. Additionally, accepting a strong private-public dichotomy is essential to explaining the aforementioned concept of public and organizational corruption [49]. Here, researchers choose to use a broader definition: "corruption is any practice that violates important rules for personal or organizational gain" [50]. By choosing a broader definition of corruption, researchers accept that it happens whenever there is an abuse of power. This vision is aligned with Transparency International, a non-governmental organization responsible for estimating the Corruption Perception Index (CPI).

Although corruption may present different manifestations, bribery is the most common one according to Svensson [51]. Moreover, while scholars agree that the global monetary effects of bribes are significant [52], emerging markets such as Brazil are at the forefront of those bribing activities [53].

The literature has extensively investigated the problem of corruption in emerging countries. Kotabe, Jiang, and Murray [54] emphasize the political network's importance in reducing timing and uncertainty in highly bureaucratic and volatile emerging markets. Krammer's [42] findings corroborate these results by showing that corruption and bribery enhance innovation levels in emerging economies. Nevertheless, Habyaremye and Raymond [55] state that corruption has a contrary effect on innovation, since it undermines the foundations of institutional trust. Later, the same authors found that the relationship between corruption and innovation is not necessarily linear. The type of corruption (petty or grand) affects emerging markets firms' propensity to innovate [56].

Recently, Ojide and Agu [57] investigated the impact of corruption on the battle against the effects of COVID-19 in Nigeria, recommending measures to control corruption as an essential part of economic recovery policies in the country. On the other hand, Soh, Muhamad, and San [58] analyzed the relationship between corruption and public debt, noting that government efficiency can be an obstacle to reducing this debt in emerging countries. The authors state that a highly efficient country tends to have lesser levels of corruption. This reality was contrary to that found in developed economies, emphasizing the particularities of elaborating public policies in countries with different stages of economic development. Additionally, the results of Sadik-Zada, Gatto, and Niftiyev [59] point out that high levels of civil liberties and political rights have a positive relationship, with the decrease in petty corruption.

### 3. FDI and Corruption—The “Sand or Grease” Theory

Although the corruption impact on the economy is highly accepted in the literature [43][57][58][60][61], it remains a point of debate whether such illegal payments are harmful to economic activities [42] such as FDI inflows and their regional concentration [6][7][8][37][62][63].

According to Transparency International [60], corruption is not unusual in international business, especially in emerging economies. Meyer and Nguyen [7] show that formal and informal practices (i.e., legislation and corruption) may either deter or ease the investment incentives of foreign investors.

However, the literature on corruption is divided into two branches. The first one assumes that corruption acts as an agent that obstructs economic activities (“sand in the wheels”) by (i) imposing additional costs on firms [9][61][64][65][66], (ii) increasing uncertainty [67][68], (iii) decreasing foreign investments [69] by dissuading potential foreign participation in joint ventures [70], and (iv) hindering the innovation of processes and products [43].

Thus, Qian and Sandoval-Hernandez [71] asserted that corruption is harmful and therefore configures a deterrent factor of FDI. For instance, Hakimi and Hamdi [72] found that corruption is a serious hurdle for 15 Middle East and North African (MENA) countries, since it disturbs investment activities and FDI inflows. Recently, Chewaka [62] found that corruption can be a trap for the smooth growth of firms, even in promising potential markets. Additionally, Bouzahzah's [60] findings show that high levels of corruption get in the way of environmental regulations on multinationals.

The second and opposite branch of the literature on corruption believes that it acts as an enabling agent (“grease the wheels”) by (i) benefiting firms suffering from obstructive private monopolies and government practices [73][74], (ii) reducing the waiting time to obtain licenses [75], and (iii) increasing the speed of product innovation [76].

Urbina [11] states that corruption can act as a “helping hand” to foreign investors, as bribes could circumvent restrictions and regulations. Furthermore, Darendeli [77] found evidence that corruption can help MNEs circumvent political instabilities. Additionally, Helmy [78] did not find any evidence that corruption hinders FDI inflows and emphasizes that policies that aim to eradicate corruption should be cautious not to affect the economy's freedom

and openness. Accordingly, there is indeed a relationship between foreign investment and local corruption, although there are disagreements about whether this effect is positive or negative.

However, researchers challenge the idea that the corruption impact can be measured only as positive or negative ("sand OR grease") to FDI. Instead, researchers ask: To what extent are MNEs willing to tolerate corruption?

The literature shows that the impact of corruption on FDI changes according to its type and the response of firms to this process. Sartor [68] found that different types of corruption have different effects on MNE responses. Further, Galang's [79] findings show heterogeneous results in the firm's performance according to their responses to public corruption.

Using firm-level data, Ghosh [59] states that the illegality of corrupt practices hinders any way of measuring it at an individual level in companies; for this reason, many studies choose to analyze corruption at a regional level. Additionally, Ketteni and Kottaridi [37] suggest that the FDI effects on the economic development of host economies can vary significantly in the same country over time. The authors further suggest that this variation strongly depends on the status of regional regulations.

Moreover, the impact of corruption on FDI's regional concentration may vary depending on the sector analyzed [80], since MNEs inserted in highly corrupt sectors may be more indulgent to higher levels of regional corruption. One explanation for the variation in levels of corruption in different sectors is the type of regulation that each economic activity needs to function. Zhu and Wu [80] assume that the more a firm or sector needs government support or approval, the more likely it is to be involved in corrupt practices such as bribery.

The literature expands the field of economic sectors by analyzing foreign direct investment and corruption. For example, Phan and Nguyen [81] examined the effect of FDI and corruption on the development of public service in 10 ASEAN countries. They found that although FDI positively impacts the development of public sectors, this impact can be null in highly corrupt regions. Similarly, Rygh, Torgersen, and Benito [82] investigate the role of institutions in attracting FDI in agricultural and extractive activities, finding some evidence that corruption deters FDI in both primary subsectors. Additionally, some researchers argue that when anti-corruption policies are in place, foreign investors feel safer investing in highly corrupt sectors [83].

Corruption in different economic sectors can also hamper entrepreneurial activities. Berdiev and Saunoris [84] argue that corruption can harm or increase the propensity for entrepreneurial activities, and the determining factor for this is each sector's level of formality. They found that corruption deters formal sector entrepreneurship while boosting entrepreneurial activities in informal sectors. Even more, there is evidence that firms in corrupt sectors tend to mimic this behavior and naturalize corruption [85].

Kouneva-Loewenthal and Vojvodic [86] found that corruption can either deter or enhance FDI inflows depending on the economic sector. In other words, while corruption can damage ("sand") foreign investments in the manufacturing sector, it can also benefit ("grease") the energy sector. The authors also suggest that the analysis of

the relationship between FDI and corruption ought to be contextualized and complemented by sectoral-level research. However, studies that analyze the FDI disaggregated by sectors are still scarce. Based on the literature mentioned, researchers believe that analyzing different economic sectors is essential to deepening knowledge about the impacts of corruption on FDI. Finally, the sectoral analysis can capture different effects of corruption on the attraction of FDI due to the particularities (e.g., regulation, formality) and tolerance of corruption in each economic activity. Hence, the study also assesses aggregate FDI at the regional level by analyzing FDI disaggregated by economic sector and region.

## 4. Conclusions

This study adds to the existing literature by deepening the comprehension of corruption FDI intensity at the regional level of a developing region (especially the understudied region of Latin America). The first stage of the empirical results shows that corruption does have a statistically significant relationship with FDI and acts as a “grease” for FDI intensity at the regional level in Brazil. The results also show that regional corruption affects FDI intensity in different ways, considering that investors may be indifferent to very low levels of corruption. In the same way, investors may avoid regions with high levels of corruption. Despite some limitations, especially regarding the sample size, the results are in agreement with the previous literature, but researchers believe that caution in the database construction can yield robust results.

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