Chapter 46

Corruption’s Effect on Foreign Direct Investment: The Case of Bosnia and Herzegovina

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ABSTRACT

This study introduces a new perspective on the role of corruption in investment growth and provides quantitative estimates of the impact of corruption on the investment inflows. Motivated by these issues, the main objective of this article is to empirically reexamine the effects of corruption on foreign direct investment (FDI) inflows in Bosnia and Herzegovina, by incorporating a further link between corruption and investment inflows as new understanding investment concepts. Using data from Transparency International report, World Bank and National Banking Statistical data, it is manifested in a cross sectional setting that corruption has a negative and significant impact on the foreign direct investment inflows. The new model of eliminated unexpected risk involved managing corruption’s effect on investments. One has to immediately consider the linkage between corruption and investment inflows and to learn how to manage this phenomenon like old risk of a new model.

1. INTRODUCTION

A thorough understanding of the causes and consequences of corruption is an ever more pressing problem in the context of the challenges that supranational identities such as the European Union have to face in the forthcoming integration process of the transition countries. Only through this process will it be possible to find policy recommendations that target the problem precisely and discover viable solutions to the adverse effects of corruption such as the problem of income gap between the rich and poor regions of the world, which is for the most part due to the poor growth performance of the latter group. From a global perspective, it is extremely important to understand what role corruption plays in relation to growth, in order to come one step closer to the solution of the aforementioned problems.

Before proceeding further it is a good idea to define corruption for the purposes of this study. Corruption is commonly defined as the misuse...
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of public power for private benefit. The act often consists of paying bribes to public officials by private beneficiaries as compensation for the abuse. However, not all acts of corruption result in the payment of bribes. A powerful minister can locate a new investment project in his home town unsuitable for that particular activity or he could influence the sanctioning of big business loans to his relatives and friends and still not take any direct bribe. This is indirect cash and capital inflows.

Hence, corruption was claimed to have a beneficial face that made Pareto efficiency tenable. This is known as the greasing the wheel argument and was supported by Leff (1964) and Huntington (1968) among many others. Holding the line, on the other side of the argument was the Nobel laureate Gunnar Myrdal. For example, Myrdal (1968) argued that bribes were a source of inefficiency, and even the sheer possibility of collecting bribes was enough to induce the bureaucracy to create artificial bottlenecks. To put it differently, corruption provided the wrong incentives. As such, it would then be expected to sand the wheels. Papers that have been mentioned so far mainly included theoretical approach and did not offer much in the way of state of the art mathematical treatments of this subject. In the 1980s corruption started taking its due share from a more formal treatment. One relevant example is Lui (1985) where in the context of a queuing model it was shown that corruption induced efficient outcomes in that the ones with the highest willingness to pay bribes were exactly the ones who had the highest opportunity costs of waiting.

Corruption was also seen as a classical example of a phenomenon that is observable, but not measurable, Dogan and Kazancigil (1994). This picture changed drastically with the seminal work of Mauro (1995) that provided us with the first empirical treatment of the relationship between corruption and growth by using a cross-sectional analysis.

The presence of corruption causes substantial economic costs on an economy. Corruption is a double edged sword; it reduces both the volume and efficiency of investment and thus economic growth. This note identifies a simple concept of the macroeconomic efficiency of investment, establishes its linkage with corruption and estimates the relationship between them.

The aim of this paper is to highlight the relationship between corruption and the inflows of foreign direct investment in detail for the case of Bosnia and Herzegovina. However, to make motivation in this venture clear, it is necessary to say a few words on the relationship between corruption and growth, especially concerning the history of this topic. That corruption is one of the most ancient problems of mankind is well-known. However, how it affects economic growth has always been subject to debate. Under what can be termed as “greasing versus sanding the wheels debate,” scholars have forwarded ideas in either direction. In the first wave of the literature, it was not uncommon to argue that bribes act as speed money and help avoid bureaucratic efficiencies.

As mentioned above, first aim is to take a general look at this aforementioned relationship with using indicators of corruption. As expected, the regressions testify to a strong negative impact of corruption on FDI Inflows. Having done this, then decompose the corruption variable and test whether or not different perceptions of corruption have statistically different impact on the FDI Inflows. The answer to this question is also affirmative. The theoretical and empirical analysis suggests that the main fields through which the impact of corruption on FDI flows materializes are the crucial elements of business environment. In this case, granting of import/export permits, access to public utilities, annual tax payments and judicial decisions, are the most appropriate. The efficiency of investment variables computed by the authors and Transparency International’s Corruption Perception Indices are used as data. The note concludes that substantial gains in terms of economic growth could be achieved if corruption is combating.
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