



Corruption distance and FDI flows into Latin America



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ABSTRACT

Studies of corruption and its relationship with foreign direct investment (FDI) have yielded mixed results; some have found that corruption deters FDI but others have found the opposite. This paper replicates earlier studies within the OLI paradigm, but also seeks to advance our understanding of this relationship by introducing the concept of “corruption distance” between pairs of countries and applying it to the special context of Latin America.

After controlling for transaction costs and institutional variables, results show that corruption distance has an asymmetrical impact on FDI. Host countries with “positive” corruption distance compared to the corruption levels of home countries, experience no significant increases or reductions in levels of inward FDI. However, “negative” corruption distance suffered by host countries is associated with significantly lower levels of inward FDI. We argue that firms from a home country with relatively low levels of corruption are unfamiliar with the formal and informal institutions associated with corruption. Conversely, firms from home countries with high corruption are undeterred by high corruption in host countries. Thus, corruption distance can be seen as a key determinant of FDI when investing in a highly corrupt host location.

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1. Introduction

Corruption is usually defined narrowly as the abuse of *public* office for personal gain (Roy & Oliver, 2009). This definition is reflected in reported measures of the perceptions of national corruption levels (Transparency International, 2010). Such public corruption may have a corrosive effect on the integrity of a nation's entire system (Voyser & Beamish, 2004): it may reduce operational efficiency, distort public policy, slow the dissemination of information, negatively impact upon income distribution, and increase the poverty of an entire nation (Chen, Ding, & Kim, 2010). In the international business (IB) discipline, the study of corruption only recently gained prominence as firms from developed countries engaged in operations in emerging and transition economies (Rodriguez, Siegel, Hillman, & Eden, 2006). However, despite the popularity of the subject, the issue of how corruption affects the attraction of foreign direct investment (FDI) to a highly corrupt location is still not fully evaluated in the extant literature.

Multinational enterprises (MNEs) may use care when choosing host countries for their foreign subsidiaries because of their

concern for the additional uncertainty and operational costs associated with corruption (Kwok & Tadesse, 2006). Corruption has, consequently, been considered a deterrent to FDI (Judge, McNatt, & Xu, 2011). A contrary view, however, does exist and has seen corruption as a necessary evil; a lubricant for transactions (Meon & Weill, 2010), particularly when “institutional voids” are prevalent in developing economies (Khanna & Palepu, 2010). The “grease the wheels” hypothesis, for example, asserts that corruption may improve efficiency by alleviating the distortions caused by ill-functioning institutions and inefficient bureaucracy (Huntington, 1968; Leff, 1964). With more MNEs investing in developing countries (often with high levels of corruption) and with more MNEs from developing countries trading with each other, institutional differences must be acknowledged when analysing interactions between these groups (Peng, Wang, & Jiang, 2008). Moreover, the recent surge in FDI flows into and from developing countries, each accounting for 50 percent of total inflows and 30 percent outflows in 2010 (United Nations, 2011), calls for a reconsideration of corruption in the IB literature.

Corruption varies widely across different locations in its scope in an economy as well as in the level of uncertainty it creates. Also, not all MNEs perceive and respond to corruption in the same manner. Besides the direct impact of host country corruption on inward FDI, formal institutions in the host country may interact with institutions in the home country, which may themselves

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interact with informal institutions (Holmes, Miller, Hitt, & Salmador, 2012) and therefore affect the behaviour of foreign investors (Cuervo-Cazurra, 2008). In that sense, the degree of uncertainty and the costs associated with corruption may vary depending on the country of origin of the foreign investors (Cuervo-Cazurra, 2006). For this reason, recent studies have concluded that MNEs located in countries with low levels of corruption avoid investing in highly corrupt countries (Habib & Zurawicki, 2001). With little knowledge and skills for dealing with this phenomenon at home (Pajunen, 2008), they are more likely to be deterred by high levels of corruption as well as their unfamiliarity with it abroad (Driffield, Jones, & Crotty, 2013). On the other hand, firms which originated in highly corrupt environments may not be as sensitive to high corruption levels abroad; they may be attracted by the environment and even take advantage of corrupt activities (Cuervo-Cazurra, 2006; Suchman, 1995).

Based on the premise that the relative differences between corruption levels in home and host countries may influence FDI (Habib & Zurawicki, 2002), the understanding of corruption and its effects on FDI can be extended by replicating earlier studies within the unique context of Latin America, where corruption is prevalent. The concept and effects of corruption distance can also be furthered by taking into account the direction of such distance. In this sense, we extend to corruption the familiar notion of the “distance metaphor”, a staple tool of social science in general and of IB in particular (Shenkar, 2001): psychic distance (Johanson & Vahlne, 1977); cultural distance (Shenkar, 2001); and recently, institutional distance (Schwens, Eiche, & Kabst, 2011). With this new concept to hand, do positive and negative corruption distances (to be defined later) have a differential effect on inward FDI?

We argue that not all foreign investors are affected equally by corruption in the host country and specifically, that firms based in highly corrupt countries are not excessively affected by high levels of corruption abroad or by corruption distance. The next section addresses these research questions in relation to corruption and FDI, by reviewing the theoretical literature on corruption. Subsequent sections detail hypotheses, methodology, results, and conclusions.

2. Theoretical background

The study of FDI has generally focused on efficiency based on transaction cost analysis (Williamson, 1993). The transaction cost theory (TCT) utilises transactions as its basic unit of analysis. According to Williamson (1985, p. 1) a transaction “occurs when a good or service is transferred across a technologically separable interface.” Therefore, the organisation of economic activity is thus to be understood in transaction cost terms (Verbeke & Kano, 2012). In this sense, TCT is concerned with the costs of integrating an operation within the firm as apposed to the costs of using an external market to act for the firm in an overseas market (Williamson, 1985).

Building on TCT, Dunning developed his Ownership–Location–Internalisation paradigm (OLI) by subsuming the antecedent of transaction cost theory to analyse FDI activities. The OLI paradigm argues that a firm’s international activities are determined by three factors: ownership (O) advantages, location (L) advantages, and internalisation (I) advantages. The main premise of the paradigm is that MNEs develop competitive O advantages at their home country and then transfer them abroad to countries where they can be exploited (based on L advantages) through FDI, which allows the multinational enterprise (MNE) to internalise such O advantages (Rugman, 2010; Dunning, 1981).

The OLI paradigm embraces a wide variety of economic and social variables (Driffield et al., 2013; Dunning, 1993); specifically, the economic costs caused by geographic distance, including

transport and tariffs, and social costs arising from the unfamiliarity, relational and discriminatory hazards that foreign firms face in the host country (Eden & Miller, 2004; Zaheer, 2002). The economic-related costs have been reduced with the development of modern IT and globalization (Calhoun, 2002), and thus have been gradually downplayed in the IB literature. However, the social content of the costs have been highlighted in the liability-of-foreignness (LoF) stream of research (e.g. Zaheer, 1995). The hazards associated with LoF are viewed through the lens of institutional theory, employing the specific concept of institutional distance (Eden & Miller, 2004). This paper will use a synthesis of transaction cost theory within the OLI paradigm supplemented by institutional distance to analyse the impact of corruption on FDI attractiveness.

MNEs may use care when choosing host countries for their foreign subsidiaries due to greater uncertainty and difficulties, including the potential disadvantage of the cost of uncertainties (placing those MNEs at a financial disadvantage compared to local firms). Ownership advantages in certain host countries enable MNEs to overcome liability of foreignness and newness; in particular, asset specificity. Such asset specificity is a crucial part of ownership advantages in the paradigm (Rugman & Verbeke, 1992) that MNEs enjoy whilst local incumbents do not. This advantages, furthermore, can be exploited abroad to offset their disadvantages. Location-bound ownership advantages (OAs), defined as advantages that an MNE can exploit only in a particular location (Birkinshaw, Hood, & Jonsson, 1998) or set of locations (Anand & Delios, 1997) cannot be transferred with ease and significant adaptation is needed if an MNE would like to utilise them in a different location (Shan & Song, 1997). However, non-location-bound OA can be transferred globally at a low marginal cost and can be used in foreign operation without a significant adaptation (Harzing, 2002).

Analysed through the TCT lens, corruption in a host location can be seen in a cost/benefit manner that will deter foreign investors if the costs of the potential deal exceeds its benefits (Rose-Ackerman, 2008). This might suggest that while some firms with no experience in dealing with corruption at home might be at a disadvantage when operating in highly corrupt foreign countries, the same might not be true for those firms familiar with operating in highly corrupt home countries. MNEs with knowledge of dealing with corrupt environments at home may be encouraged by their location-bound-ownership advantages and willing to invest in similar locations. Thus, when analysing how corruption affects FDI, it is important to know if strategic knowledge of coping with corruption may be acquired at home by some firms and redeployed abroad without incurring high costs.

Another important factor in Dunning’s OLI paradigm is localisation ‘L’ advantages in the host country. MNEs locate foreign operations where operating costs can be minimised while firms internalise activities in overseas locations in order to lower costs derived from risk and uncertainty (Wang, Hong, Kafourous, & Boateng, 2012a, 2012b). However, critics of Dunning argued that the L part of the paradigm was too focused on a foreign locations physical attributes and not on such location’s institutional arrangement. Acknowledging the lack of institutional content in the paradigm, Dunning (1998) enhanced the location dimension by including political risk, policies, regulations, cultural differences and exchange rates. MNEs contemplating FDI have to take the host country institutional characteristics into account, especially when analysing developing economies (Peng et al., 2008), including the quality of institutions and the existence of corruption.

Corruption is an important part of a country’s institutions (Wei, 2000a, 2000b). Therefore, corruption (or its absence) lies at the core of any national environment. Institutions are seen as consciously designed, man-made and tangible features, including

“...structures of codified and explicit rules and standards” (Holmes et al., 2012, p. 3). One compelling perspective, according to North (1990), on the entire national environment proposes the co-evolution of informal and formal institutions, whereby customs, habits and social norms become codified and institutionalised. This co-evolutionary view is echoed by Holmes et al. (2012, p. 4), who note that “...formal institutions reflect, embody and reinforce the country’s culture across the population.” Likewise, Dunning and Lundan (2008, p. 579) following North (1990) insist that “...anything that is likely to influence individual decision making, such as education, social mores and belief systems, is also likely to affect the choice of institutions” of any location.

Considering corruption as one of the most important institutions of a given location (Peng et al., 2008), scholars have argued that corruption can be seen as an outcome that reflects a country’s legal, economic, cultural, and political institutions (Svensson, 2005). Murphy, Shleifer, and Vishny (1993) argue that corrupt behaviour can be institutionalised and thus becoming a normal practice in certain locations. Local levels of corruption are not only determined by the formal institution of the law and its enforcement, but also by informal social norms on what is acceptable. Research by Ufere, Perelli, Boland, and Carlsson (2012) found bribe-generating behaviour by entrepreneurs in Nigeria, a country governed by a well-embedded set of social norms, rules, routine, and power relations. Giving and taking a bribe may seem like a simple unskilled task, but a foreigner with limited knowledge of local laws and norms may risk exposure. The costs involved in establishing and maintaining legitimacy places MNEs at a competitive disadvantage (Eden & Miller, 2004). For example, local firms are most likely to successfully reach corrupt deals with public officials, as well as have access to legislators; therefore, they have an advantage over those without such access (Anechiarico & Jacobs, 1996).

Even though until recently the TCT within the OLI paradigm had not considered the institutional environment of a foreign location and the impact that institutional uncertainty has on the attraction of FDI (Hosseini, 1994), institutions matter. Institutions have an effect in the capacity of firms to perform in the host country and hence, they affect the transaction and coordination costs of operating abroad (Mudambi & Navarra, 2002). By including institutional variables to the OLI paradigm, researchers have extended transaction cost theory by examining the ability of a firm to expand or enhance its competitive advantage in a particular market (Brouthers, 2013).

Therefore, in order to achieve institutional legitimacy in a host country (taking into account the entire institutional environment), MNEs must comply with the host state’s pressures to pay bribes and is likely to do so unless the home country prohibits such practices. In addition to costs created by business transactions, MNEs also face higher administrative costs for managing the relationships between parties involved in doing business abroad (Anderson & Gatignon, 1986; Buckley & Casson, 1998); such cost being associated with liability of foreignness, where institutional distance and its three pillars between the home and host countries are the key drivers (Eden & Miller, 2004).

While host country institutions present these hazards for foreign investors, recently researchers have argued that it is not only the institutional environment of the host country what might increase the costs of operating abroad, but the institutional distance between the host and home countries. Institutional distance, defined as the degree of difference/similarity between the regulatory, cognitive and normative institutions of two countries has been used to explain MNE behaviour in terms of organisational legitimacy in host countries (Kostova, 1996; Kostova & Zaheer, 1999), location decisions, and mode of entry

strategies (Xu & Shenkar, 2002) and so on. The larger the institutional distance between home and host countries, the more difficulty the MNE has building external legitimacy (Kostova & Zaheer, 1999), and the greater pressure on investors to tailor their strategies to local institutions (Kostova & Roth, 2002). In this context, ‘corruption distance’ (defined later), as a LoF can be seen as a unique subset of institutional distance that involves both formal and informal institutions in the form of both regulative and normative constraints.

2.1. Empirical studies of corruption and FDI

With the expansion of international business activities, corruption gained prominence by IB scholars and managers as firms from developed countries engaged in operations in emerging and transition economies (Habib & Zurawicki, 2002; Rodriguez et al., 2006). Also, thanks for the publication of corruption indices, empirical studies have been conducted to show how a host country’s corruption significantly reduces its inflows of foreign direct investment (Habib & Zurawicki, 2002; Mauro, 1995; Voyer & Beamish, 2004; Wei, 2000a, 2000b; Woo & Heo, 2009).

Habib and Zurawicki (2002) assess corruption in two manners – the level of corruption of the host country and the difference between levels of corruption of the home and host countries, pointing out that high levels corruption in the host country deters FDI. Habib and Zurawicki (2002, p. 303) state that countries with different levels of corruption avoid trading with each other and that “foreign firms are unwilling to deal with the planning and operational pitfalls related to an environment with a different corruption level.” Nevertheless, empirical studies have mainly focused on the relationship between corruption of the host country and FDI. Thus, the question of whether or not corruption distance affects different host countries differently depending on their corruption levels as compared to the home countries has remained unanswered. Although the literature regarding corruption and FDI is relatively large, empirical studies are limited on the possibility that firms being exposed to high levels of corruption at home can internalise that knowledge and recognise that it may represent an L-advantage in host countries (Egger & Winner, 2005).

Despite these studies showing corruption as a deterrent of FDI, some empirical studies have found no relationship between the two variables (Henisz, 2000; Wheeler & Mody, 1992). Furthermore, other authors have actually found that corruption can be positive as it facilitates transactions in countries with too many regulations (Egger & Winner, 2005; Huntington, 1968; Leff, 1964). For example, when studying location decisions for US MNEs, Wheeler and Mody (1992) used a combination of transaction costs and institutional variables including corruption. They found that corruption, political risk, and short-term incentives have little effect on the attraction of US FDI in developing economies; investors preferred good infrastructure development, specialised suppliers, and a growing market. Henisz (2000) studied FDI activities of US multinationals in countries with high political risk and concluded that corruption did not have a significant effect on the location decision. One obvious drawback of this study, however, is that Henisz (2000) only examined US MNEs that were not interested in the local market of the foreign location, which might have influenced the results.

3. Corruption distance and FDI

Even though it seems logical that foreign firms would design strategies to deal with corruption in a host country and that corruption might not affect all firms equally, this has not been easy to establish (Rodriguez et al., 2006). The aim in this section is to achieve a successful analysis of this issue by developing a simple

terminology that allows for effective differentiation of corruption levels of a country. In doing so, we simplify this complex environment for corruption by adopting a fairly narrow definition of corruption and developing a concept of corruption distance to capture the different direction of corruption between host and home countries. While corruption may be a feature of transactions between private and/or public parties (Habib & Zurawicki, 2002), it is usually identified (e.g. Cuervo-Cazurra, 2006, p. 807) as merely the abuse of *public* power for private gain. Measures of national levels of corruption also reflect this narrow definition, capturing business people and country experts' perceptions of the extent of corruption in the public sector (Transparency International, 2010).

There can be substantial variation across countries with respect to institutional distance between home and host countries. Both differences between home and host countries can have a significant effect on an MNE when conducting operations abroad since it raises the transaction costs and risks associated with operating in an 'unknown' business environment (Brouthers & Brouthers, 2001). Such unknown business environment increases the difficulties for a foreign manager to understand the values and norms of the foreign market (Tihanyi, Griffith, & Russell, 2005), as well as the organisational legitimacy. In this context, "corruption distance" as a LoF can be seen as a unique subset of institutional distance that involves both formal and informal institutions in the form of both regulative and normative constraints. We develop the conceptual framework of Eden and Miller (2004) and use the same definition of corruption distance, i.e. the difference in the pervasiveness and arbitrariness of public sector corruption between the home and host countries (Eden & Miller, 2004). A situation favouring a host country (i.e. with lower corruption relative to home countries) is referred to as "positive" corruption distance, and vice versa.

In their paper, Eden and Miller (2004) have focused on institutional distance in an absolute value sense, ignoring whether the home or host country has stronger institutions and how this might affect liability of foreignness and the MNE's ownership strategy. In the case of corruption, current literature has explained that the greater the difference in corruption levels between a home and host country, the more FDI will be deterred (Habib & Zurawicki, 2002). However, we argue that it is not only the distance in corruption levels what might deter FDI, but the direction of such distance. In other words, we argue that corruption distance might have a negative effect on FDI when the home country has lower levels of corruption than a highly corrupt host country. Simultaneously, corruption distance might not have a negative effect on home countries that are considered more corrupt than a highly corrupt host country. This can be explained by the smaller liability of foreignness between highly corrupt home and host countries familiar with operating in these conditions.

An illustrative exercise is to consider the movement between two different corrupt countries, shown in Fig. 1. We use the upper half of the diagram in Fig. 1 to represent the new phenomenon of FDI flow between developing countries (South–South FDI) indicating FDI from countries with high levels of corruption (e.g. Mexico) to less corrupt host countries (e.g. Chile). In this sense, MNEs are expected to feel less pressured by legitimacy threats, as they have engaged in the lengthy and expensive process of developing knowledge of how to deal with corruption at home (Cuervo-Cazurra, 2006) and can make use of benefits they learn from engaging corrupt officials at home. The lower part of the diagram presented in Fig. 1, on the other hand, represents the situation envisaged in the extant IB literature on corruption and FDI, where home (usually developed) countries with relatively low levels of corruption are deterred from investing in more corrupt (and usually developing) host countries. Therefore, MNEs are expected to experience difficulties due to the uncertainty

and costs of engaging in local corruption and to acquire and maintain legitimacy. The cost of isolating themselves from government intervention is high.

In this paper we argue that host country corruption has different effects on investors depending on their home country corruption level. This means that home countries with lower levels of corruption than a highly corrupt host country will be affected by corruption in the host country, while home countries with higher corruption levels than the host location will not. For MNEs headquartered in countries with lower levels of corruption than the host region, host country corruption represents more risk and uncertainty (and thus higher costs). We contend that the host country corruption may have a negative association with inward FDI. Therefore we put forward the following research hypothesis:

Hypothesis 1. Host country corruption will have a negative association with inward FDI.

However, the degree of risk and uncertainty associated with corruption varies by different firms. It is possible that foreign investors from highly corrupt countries use their knowledge of how to deal with corruption as a competitive advantage (Cuervo-Cazurra & Genc, 2008) against those without such knowledge. Studies analysing MNEs from developing countries have found that the experience of operating in less than ideal institutional conditions can be considered to be a location-bound O-advantage (Buckley, Clegg, Liu, Voss, & Zheng, 2007). Furthermore, these O-advantages enable firms from developing countries to operate more efficiently in other developing countries (Cuervo-Cazurra & Genc, 2008). Therefore, drawing on their O-advantages certain firms might prefer to invest in foreign locations that resemble their home environment. Building on this premise, corruption can be seen as influencing L-advantages as either a deterrent or encouragement to inward FDI. Acquiring skills in managing corruption may help to develop a certain competitive advantage (Habib & Zurawicki, 2002) and thus, when they internationalise, these firms may not be deterred by host-country corruption. They may take advantages of their knowledge gained from working with a corruption government at home and be attracted by such host countries for three reasons.

First, they may face lower costs of dealing with host country corruption than firms from developed countries. Second, they may even deliberately select countries with high levels of corruption (but lower than their own) due to the similarities in conditions with their country of origin (Cuervo-Cazurra, 2006). Third, equipped with advanced knowledge in international business and a vast international network, MNEs may have developed sophisticated skills of bribery (Kwok & Tadesse, 2006). Those firms that have developed knowledge of how to cope with corruption at home might be able to minimise the risks and costs produced by corruption abroad. We therefore propose:

Hypothesis 2a. As positive corruption distance exists between the home and host countries, FDI inflows to the host country is more likely to decrease.

Hypothesis 2b. As negative corruption distance exists between the home and host countries, FDI inflows to the host country is more likely to increase.

4. Methods

Corruption is now well rooted in Latin America and it has a deep effect on the region. This makes it an ideal location to analyse how corruption affects FDI to an entire region. To do so, home countries will be divided into countries with higher or lower

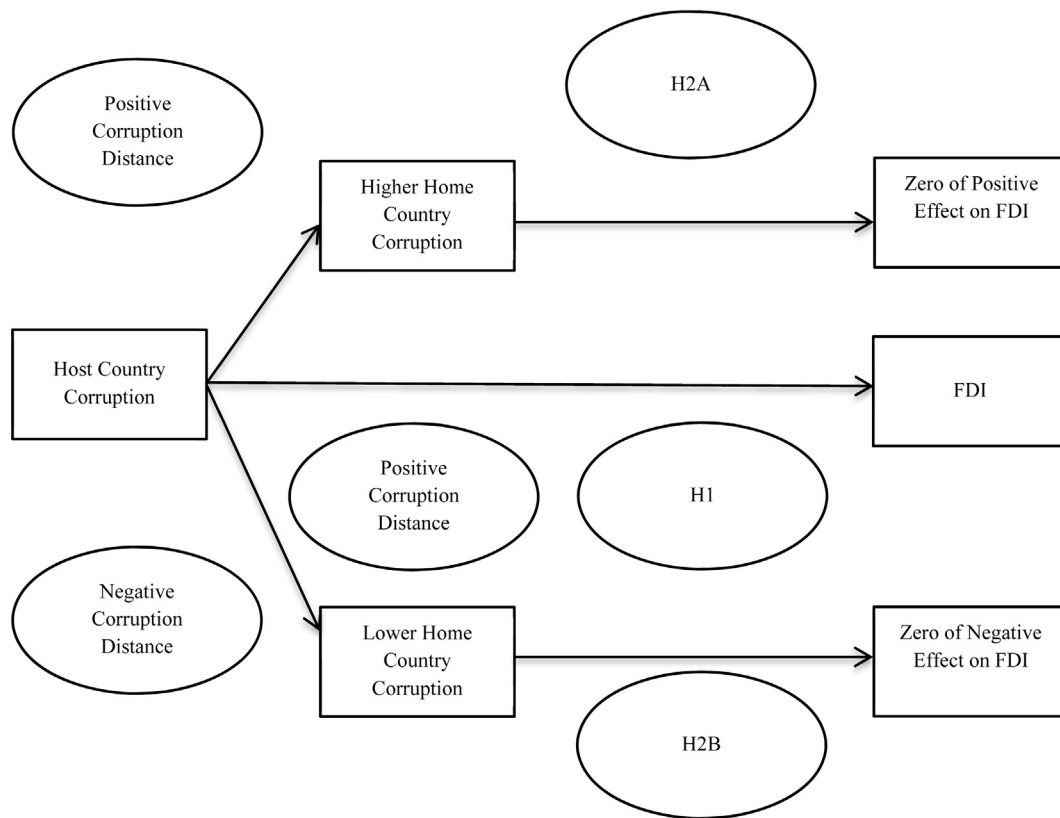


Fig. 1. Corruption distance and its effect on FDI.

corruption levels than the host countries. Also, in order to obtain a better picture of corruption and its effects on FDI the distance in the levels of corruption of host and home countries will be considered.

To test our hypotheses, FDI inflows to 12 Latin American countries will be analysed from 2006 to 2009¹: Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, Guatemala, Honduras, Mexico, Nicaragua, Panama, and Peru. Although the number of host countries is limited, the number of observations in the given period adds to a total of 308. From those 308 observations, 212 are FDI flows from countries with lower corruption levels than the host countries, while the remaining 96 observations are from countries with higher levels of corruption than the host countries.

The corruption distance analysed was taken by subtracting the corruption level of the home country from the corruption level of the host country. Therefore, a negative corruption distance denotes an investment from a less corrupt home country to a more corrupt home country. On the other hand, a positive corruption distance represents an investment from a more corrupt home country than an already highly corrupt host country.

We analyse home countries as either more or less corrupt than host countries. By doing so, we can also observe how FDI is affected by a region that comprises only developing countries characterised by high levels of corruption, according to Transparency International (Transparency International, 2010). The effects of corruption can be studied according to whether or not foreign investors are familiar with dealing with corruption in their home countries. Also, we can test if the distance between corruption levels affects

countries with high corruption levels as well as those with lower corruption levels at home.

5. Variables and measurements

To test our hypotheses, FDI inflows to Latin America from 2006 to 2009 were used as the dependent variable. These flows were obtained from the Economic Commission for Latin America and the Caribbean (ECLAC) publication in 2010 (ECLAC, 2012). To measure corruption we use the Corruption Perception Index (CPI) from Transparency International, which has been widely used by scholars studying corruption and its effects (Judge et al., 2011). The CPI rates countries from around the world from 0 (highly corrupt) to 10 (clean).

Although there is an ongoing debate regarding which institutions matter in relation to the attraction of FDI (Buckley et al., 2007), there are various institutional and macro-economic variables that have been used in several studies to analyse similar issues. These variables are constructs of several measures and sources, and hence, provide a more comprehensive measurement than individual indicators. However, they present the disadvantage of being estimates and thus could introduce measurement errors (Globerman & Shapiro, 2003). Such variables encompass both institutional and transaction cost variables and are integrated in our model to observe their interaction with the corruption level of the host country. A concise description of these variables is presented next.

Firstly we begin with corruption distance when home countries are either more or less corrupt than the host countries. We use the distance between the host country and the home country according to the Corruption Perception Index from Transparency International. By analysing corruption distance, we control to a large extent for cultural distance, since such distance can be

¹ These countries have been selected due to the availability of data in the years mentioned.

Table 1

List of the variables, their measurements, and date sources.

	Variable	Measure	Source
Dependent variable	Ln FDI flows	Inward FDI Flows in the Country in US\$, measured as natural logarithm	ECLAC 2012
Independent variables	Corruption	From 10 = highly corrupt to 0 = clean	Transparency International 2011
	Corruption Distance 1	Value of the average corruption level between the home and host country for host countries with lower levels of corruption than home countries	Transparency International 2011
	Corruption Distance 2	Value of the average corruption level between the home and host country for host countries with higher levels of corruption than home countries	Transparency International 2011
	Human development index	Combination of three measurements, GDP per capita, education, and life expectancy. From 0 (not existent) to 100 (excellent)	United Nations Development Programme 2012
Control variables	Rule of law index	Measures quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. From 0 (not existent) to 100 (excellent)	World Bank Governance Datasets 2012
	Bureaucracy	Rank of countries based on the average time to start a business	World Bank Governance Datasets 2012
	Infrastructure quality	Urban Development Index Based on the percentage of people using the internet	World Bank Governance Datasets 2012
	Economic freedom index	Includes fiscal, trade, and monetary policy. From 0 (not existent) to 100 (excellent)	Heritage Foundation 2012
	Educational attainment	Total college-age students enrolled in tertiary education	ECLAC 2012
	Host country inflation	Annual percentage change in the consumer price index	IMF's annual Balance of Payments 2012
	Host country GDP	Natural logarithm of a country's GDP	United Nations Statistical Yearbook 2012
	Unemployment rate	Percentage of working-age population without employment	United Nations Statistical Yearbook 2012

treated as institutional distance (Demirbag, Tatoglu, & Glaister, 2007). Furthermore, this measurement is more appropriate for our research since we are using a fairly homogeneous host region in terms of national culture as our unit of analysis (Zhao, Luo, & Suh, 2004).

As control variables we use the human development index published by the United Nations (UNDP, 2012) which is a construct made up of GDP per capita, education, and life expectancy at birth, as proposed by Globerman and Shapiro (2003). The rule of law index retrieved from the World Bank Dataset (World Bank, 2011) measures law enforcement, property rights, crime, etc. (Globerman & Shapiro, 2003). Bureaucracy level ranks countries on how easy it is to start a business there (World Bank, 2011). The infrastructure index was taken from the percentage of internet users of the host country (World Bank, 2011). The educational attainment index was measured by the total number of college students enrolled in tertiary education (ECLAC, 2012). The economic freedom index was used to measure trade, fiscal, and monetary policy (Heritage Foundation, 2013). The inflation rate was measured as the annual percentage rate in the consumer price index from the International Monetary Fund (IMF, 2011).

The natural logarithm of the total GDP (World Bank, 2011) of the host country was used to measure purchasing power of the host country, as used by Globerman and Shapiro (2003) and Buckley et al. (2007). Finally, the unemployment rate of the host country was used to indicate the attractiveness of the country since investors are aware that employees will be loyal due to the lack of other opportunities of employment. The unemployment rate was taken from The United Nations (2011).

6. The model

We employed random effects logistic regressions to control for the possible correlations between variables and since no individual effects (fixed) in the data. We also chose the model by performing a Hausman test for random effects with a $\chi^2(01) = 1.000$. In addition, the model allows for a comprehensive inclusion of all the variables to reduce omitted variable bias. It also has the advantage of being replicable with little or no changes to test different geographic areas to see if corruption affects the attraction of FDI differently in different locations.

Based on the above method the following model will be used:

$$\begin{aligned} \text{Ln FDI} = & \alpha_i + \beta_1 \text{CPI}_{it} + \beta_2 \text{CorrDummy}_{it} + \beta_3 \text{CorrDis1}_{it} \\ & + \beta_4 \text{CorrDis2}_{it} + \beta_5 \text{Human}_{it} \\ & + \beta_6 \text{Law}_{it} + \beta_7 \text{Bureaucracy}_{it} + \beta_8 \text{EcFreedom}_{it} + \beta_9 \text{Education}_{it} \\ & + \beta_{10} \text{Inflation}_{it} \\ & + \beta_{11} \text{Infrastructure}_{it} + \beta_{12} \text{GDP}_{it} + \beta_{13} \text{Unemployment}_{it} + \mu_{it} + \epsilon_{it} \end{aligned}$$

In this model as presented in Table 1, i is the country subscript, t is the time subscript, β s are unknown parameters to be estimated, α is the average natural logarithm of FDI for the entire region, μ is the between-entity error, and ϵ is the within-entity error. Even though some variables suggested somewhat high correlations with each other, a multicollinearity test did not suggest any serious problem. In order to test for multicollinearity, we ran a Durbin–Watson test for autocorrelation to see if the linear relationships among the variables can affect our results. The results of the test Durbin–Watson tests are $\text{prob} > \chi^2 = 0.000$. This indicates no autocorrelation problems since this test argues that with such value there is not autocorrelation in the sample (Savin & White, 1977). Also, the variance inflation factors (VIFs) did not suggest multicollinearity between variables (mean VIF = 4.395), since it is significantly lower than the threshold of 10 used by most scholars (O'Brien, 2007).

7. Results

Table 2 shows how FDI and corruption correlate in the Latin American region. The results of the correlation matrix show statistical significant negative relationship between FDI and the corruption level in the host countries at a $p < 0.10$, which means that FDI might be negatively affected by corruption in the host country. Corruption distance presents a strong negative correlation at the $p < 0.001$ level with FDI flows when the host countries have a lower corruption level than home countries. On the other hand, corruption distance shows a significant positive correlation at the $p < 0.10$ level with FDI when the home countries experience higher levels of corruption than the host countries. These results suggest that corruption distance might negatively affect the attraction of FDI to a highly corrupt host region when the home country has

Table 2
Pearson's correlation matrix.

Variable	Mean	St. deviation	FDI	CPI	CorrDis1	CorrDis2	Human	Law	Bureaucracy	EcFreedom	Education	Inflation	Infrastructure	GDP	Unemployment
1 FDI	9.71	2.62	1												
2 CPI	5.31	1.94	-0.89**	1											
3 CorrDis1	4.39	1.16	0.71	-0.38***	1										
4 CorrDis2	6.33	1.24	-0.34	-0.4***	0.45*	1									
5 Human	0.69	0.07	0.74**	-0.43**	-0.33*	0.51	1								
6 Law	36.31	21.28	0.46**	-0.51**	-0.19**	0.69*	0.63***	1							
7 Bureaucracy	32.92	17.36	-0.14	0.25*	0.28**	-0.24	-0.03**	0.21**	1						
8 EcFreedom	55.33	10.98	0.13*	-0.15*	-0.05	0.32	-0.15	-0.38	-0.08**	1					
9 Education	16.77	4.22	0.15	0.09*	0.01**	0.11	-0.23	-0.08*	-0.35	0.15	1				
10 Inflation	6.13	3.59	0.55	0.46	0.46	-0.64	0.79	0.72	0.06**	-0.25*	-0.22	1			
11 Infrastructure	21	10.81	0.71**	0.63**	0.56**	-0.23	0.57***	0.25***	-0.22*	0.02	-0.29*	0.56	1		
12 GDP	24.34	1.58	0.37***	0.13	0.62	-0.24	0.47**	0.34*	-0.05	0.25	-0.21	-0.46*	0.39**	1	
13 Unemployment	6.31	2.52	0.22	-0.23*	-0.02	-0.29	0.48**	0.34*	-0.28*	-0.05	0.24*	-0.21	0.45***	0.39*	1

* Significance of 10%.
** Significance of 5%.
*** Significance of 1%.

lower levels of corruption than the host country. However, when the home country has higher levels of corruption than the host country, corruption distance might not have an effect on the attraction of FDI; it may even have a positive effect.

The random effects regression results for the full sample are presented in Table 3. In this table three models are run. Model 1 analyses how corruption affects the total FDI flows to Latin America and excludes the corruption distance variables. This was done to understand how corruption affects FDI flows to Latin America. The result from Model 1 is that the total amount of FDI received in Latin America is negatively affected by high levels of corruption of the host countries moderately supporting Hypothesis 1, which argues that the total amount of FDI to Latin America is deterred by corruption. This result is statistically significant at a level of $p < 0.10$.

Model 2 tests what effect corruption distance has on the attraction of FDI to a highly corrupt region when the home countries are more corrupt than the host countries. In this model the corruption distance from home countries with lower levels of corruption than the host countries are excluded. The result shows that corruption distance is negatively associated ($p < 0.10$) with FDI flows when home countries have a lower level of corruption than host countries experiencing high levels of corruption, which

moderately supports Hypothesis 2a, which says that negative corruption distance will have a negative association with FDI inflows.

Finally, Model 3 analyses how corruption distance affects home countries with lower corruption levels than the host countries. The results testing Hypothesis 2b are not significant. This could mean that corruption distance does not have an effect on FDI flows from countries with higher corrupt levels than an already highly corrupt host region. Thus, these results suggest that FDI from home countries with high levels of corruption might not be deterred by high corruption levels in the host country.

8. Discussion

This paper argues that when investing abroad, foreign investors might be influenced not only by corruption in the host country, but also by corruption distance and its direction. To explore this issue, we proposed two hypotheses. Our first hypothesis stated that, in general, corruption would have a negative effect on FDI flows to Latin America. Our second hypothesis was divided in two parts. The first part proposed that positive corruption distance will have a positive association with FDI inflows when the home country has a higher corruption level than the host country. While the second part argued that negative corruption distance will have a negative association with FDI inflows.

Our results moderately support Hypotheses 1 and 2a based on the premise that corruption distance would negatively affect investors located in countries with low levels of corruption when investing in countries with high levels of corruption. These statements are based in the low transaction costs and ownership advantages that firms might have acquired at home and were able to redeploy abroad when investing in other countries with similar institutional environments. While the results do not show a strong statistical significance, they still shed light into the study of corruption and how it affects FDI. These results suggest that it is not the corruption level itself what might deter FDI but instead, the corruption distance and its direction might be what has an effect on FDI. Furthermore, our results are not statistically significant for Hypothesis 2b. Nonetheless, this could imply that firms established in countries with high levels of corruption are not affected by high corruption levels in the host countries when investing in them.

Most studies in this subject conclude that corruption deters FDI (Judge et al., 2011). However, our research indicates that corruption and corruption distance have a different effect depending on origin of home country. Moreover, when the corruption distance between home countries with low levels of

Table 3
Results random effects regression.

Dependent variable: FDI			
	Model 1	Model 2	Model 3
CPI	-30.92*		
CorrDis1		-27.88*	
CorrDis2			3.04
Human	1.12*	0.92*	0.20*
Law	11.94**	5.87***	6.07**
Bureaucracy	0.11	0.11	0.01
EcFreedom	0.02	0.02	0.001
Education	0.01	0.07	-0.06
Inflation	0.18	0.11	0.07
Infrastructure	0.02*	0.03*	0.04*
GDP	1.40	1.07	0.32
Unemployment	0.02	0.26	0.28
Model summary			
No. observations	308	212	96
Adj. R	0.68	0.67	0.61
Wald Chi2	56.74	61.51	0.61
Prob > chi2	***	***	***

* Significance of 10%.
** Significance of 5%.
*** Significance of 1%.

corruption and host countries with high corruption is higher, the levels of FDI are lower. However, when both home and host countries are considered corrupt, the corruption distance does not have a significant effect on FDI. This is because firms familiar with operating in highly corrupt countries have internalised the knowledge of dealing with corruption abroad and use it as a firm-specific O-advantage (Cuervo-Cazurra & Genc, 2008). On the other hand, those firms based in countries where corruption is not as prominent may face higher costs to learn how to cope with it in a foreign location.

This study also integrated institutional variables to the L section of the OLI paradigm to analyse how corruption affects FDI. A higher liability of foreignness may increase cost in the search, negotiation and enforcement of contracts abroad, and hence, these conditions may deter FDI to certain locations (Meyer, 2001). Therefore, companies prefer to invest in those environments that are similar to their home countries (Johanson & Vahlne, 1977), which may include the levels of corruption. Hence, we furthered the L part of the OLI paradigm by adding corruption distance, as a measurement for institutional distance, between the home and host countries to the concept of LoF.

By analysing FDI flows based on their source country, either highly corrupt or less corrupt, important issues arise. Consistent with IB literature, this study confirms that corruption deters the attraction of FDI. However, this statement could be valid if the home country has lower levels of corruption than a highly corrupt host country. This result suggests that firms based in countries with low corruption see corruption as a high and costly risk, and hence, avoid it abroad (Habib & Zurawicki, 2001). However, if the source of FDI is divided into countries with high or low levels of corruption, we can see that corruption has different effects on foreign investors.

Firms based in developed countries are generally not familiar with dealing with corruption in their home market and have signed the OECD anti-corruption in international business transactions (OECD, 1997). Therefore, they face greater pressures to obtain legitimacy from their home governments and from their headquarters than firms from highly corrupt countries (Rose-Ackerman, 1999). Glynn and Abzug (2002) argue that in order to gain legitimacy, firms adapt to the institutional context on which they operate. This means that for firms based in less corrupt countries, corruption might not be tolerated, and hence, they may avoid engaging in corrupt deals abroad. On the other hand, MNEs based in highly corrupt countries are used to performing in countries with underdeveloped institutions (Dawar & Frost, 1999), and have not subscribed to such laws. Therefore, when facing similar conditions abroad they already have the expertise to cope with such conditions with little pressures from their stakeholders; additionally, they do not have a legal impediment to engage in corrupt acts. These might be the reasons why corruption does not appear to have a negative effect on FDI from highly corrupt countries to Latin America.

9. Conclusion

In this study we analysed how corruption distance affects FDI according to the source country, either more or less corrupt than the host country. We made this distinction in order to analyse whether or not firms from each set of countries react differently to corruption in the host country. We also included the concept of 'corruption distance' in order to evaluate how the difference in levels of corruption between host and home countries affected FDI. Our results suggest that corruption distance has a negative effect on FDI from when the home countries experience lower levels of corruption than the host countries. On the other hand, firms from

highly corrupt countries were not affected by corruption distance when investing in the area.

Despite its popularity, the OLI paradigm based on TCT has not fully researched how location advantages can contribute to the long-run development of the new ownership advantage (OA) through their usage within the MNEs (Kedia & Mukherjeeb, 2009). Therefore, an inclusion of an institutional distance approach as well as an in-depth analysis of transaction costs to analyse how corruption affects FDI a promising avenue on the IB field. In this sense, understanding how corruption might enhance or undermine the development of OA will be analysed in the work to deepen the knowledge of the location advantages.

Grounded on the transaction cost and institutional theories, we argue that firms based on corrupt countries have internalised knowledge of how to deal with corruption. This location-bound specific advantage helps these firms to lower the costs associated with coping with corruption abroad. We also explain this phenomenon by arguing that firms based on highly corrupt countries choose to operate in locations that are psychically close to them, which include high levels of corruption. Thus, we furthered the L part of the OLI paradigm by including institutional variables like corruption distance between the home and host countries.

This paper contributes to the international IB two main aspects. Firstly, we make special emphasis on acquiring and internalising knowledge of how to deal with weak institutional environments abroad. IB literature argues that firms from countries with low levels of corruption (generally developed countries) have an upper hand due to their ownership-specific advantages; however, firms based in less developed countries (generally with high levels of corruption) have acquired advantages by learning to operate in challenging locations.

Secondly, we provide empirical evidence to complement studies suggesting that firms based on countries with high levels of corruption are not affected by this issue when investing abroad. By doing so, we were able to contribute to the study of how corruption affects FDI. Future studies should take into account not only the host country corruption levels, but also how well equipped the home country is to cope with this problem. Due to the availability of data this study did not take into account how corruption affects FDI at the industry level. Nevertheless, new studies should analyse how corruption and corruption distance affect FDI to the region at the industry and firm levels.

This study also has its limitations that result from the nature of the data presented. Due to the availability of data the macroeconomic approach only analysed FDI flows to 12 Latin American countries from 2006 to 2009. Also, the FDI flows were not disaggregated at the industry or firm levels, which could show differences on how FDI is affected by corruption based on the industry on which foreign investors operate. Future studies should focus to analysing how corruption distance affects the attraction of FDI at the industry or firm levels in order to better understand the issue.

Finally, this study is also important for managers and policy makers. For managers this study means that they should evaluate foreign locations not only based on their corruption levels, but also on the difference and direction in corruption levels between their country of origin and the possible host location. Even though this research argues that corruption does not have a significant effect on the attraction of FDI when both the home and host countries are considered highly corrupt, it is necessary to point out that the majority of FDI to Latin America is carried out by MNEs based in countries with low levels of corruption. Therefore, authorities should work to improve the institutional environment of the host countries in order to attract more FDI to the region.

Appendix A

Home Countries:

Argentina, Bahamas, Bermuda, Brazil, Canada, Chile, China, Colombia, Costa Rica, Ecuador, El Salvador, France, Guatemala, Germany, Honduras, Italy, Japan, Luxembourg, Mexico, Netherlands, Nicaragua, Norway, Panama, Peru, Republic of Korea, Spain, South Africa, Switzerland, United States, United Kingdom, Uruguay, Venezuela.

Host Countries:

Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, Guatemala, Honduras, Mexico, Nicaragua, Panama, and Peru.

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