The Impact of Corruption on Foreign Direct Investment

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INTRODUCTION

This article examines the relationship between corruption and foreign direct investment (FDI). Most recent development and economic theories argue that FDI is beneficial for economic growth and that corruption damages economic growth. Yet, it is only recently that research started looking at the effects of corruption on FDI. This article identifies the need to formulate a definition of corruption that encompasses all forms of corruption as they appear in the context of FDI. Earlier findings as well as the corruption indices used in research shall serve as the backbone for this article's findings. The article concludes that corruption only has a mild impact on the decision to participate in FDI. However, further research is required to ascertain the exact magnitude of such an impact. Furthermore, this article suggests the utility of engaging in future research, on topics such as a) investigating the impact that prosecutions of foreign investors on grounds of corruption has on FDI flows and b) the distinction between the influence that corruption may have on a foreign direct investor's decision to enter the host country on one hand, and to continue its activities in the host country on the other.

A. IDENTIFYING THE FORMS OF CORRUPTION THAT ARE RELEVANT TO THE FDI CONTEXT

It is fundamental that research on the relationship between corruption and FDI first identifies the purposes or forms of corruption that are commonplace in the FDI context. This will be the starting point. Such an identification exercise will list the various forms of corruption that could bear a significant influence on a foreign direct investor's investment decision. The forms of corruption that are less relevant to the FDI context are left out of the definition. For instance, the more political forms of corruption such as graft are less relevant to the business activities of a foreign direct investor than the economic forms of corruption such as bribery. However, political forms of corruption may influence a foreign direct investor's perception of corruption. The debate to identify the characteristics of corruption relevant to the FDI context is important. A clear view on the

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kinds of corruption that matter to a foreign direct investor would help policy-makers as well as further research. A definition of corruption that encompasses the kinds of corruption that affect FDI would lead to more accurate research results, which, in turn, would allow us to come to a better understanding of the true impact of corruption on FDI.

**DEFINING CORRUPTION IN CONNECTION WITH FDI**

Corruption is not easy to define. Many experts have come up with different and sometimes overlapping definitions of corruption. Although they concur that the central element of corruption involves the use of public office for private gain, the exact forms of corruption that fall under this category is hardly an objective matter.

A definition of corruption that fits the FDI context and, thus, only covers the forms of corruption that matter in the FDI context is currently non-existent. Other definitions of corruption, e.g. the OECD and UN definition are not fully satisfactory for the purpose of measuring the effect of corruption on FDI. The definition of corruption used by the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions – also referred to as the OECD Anti-Bribery Convention (OECD Convention), which was drafted in 1997 and, by March 2008, ratified by thirty-seven countries – fails to cover all forms of bribery.

Actually, the OECD Convention has a few important weaknesses. The first, most important weakness of the OECD Convention is that it only covers the offering of bribes, which is called “active corruption”. It does not deal with the problem of “passive corruption”, the offence committed by accepting a bribe. Furthermore, the OECD definition of corruption does not cover bribes given to foreign officials of political parties or candidates for public office. A third weakness is that the OECD Convention fails to criminalize small facilitation payments.

The United Nations Convention against Corruption (UNCAC), which came into force in December 2005 as the yet most comprehensive anti-corruption Convention yet in both scope of signatory countries and provisions, prohibits facilitation payments, but, nonetheless, fails to adequately solve the problem of facilitation payments. The problem with regard to UNCAC is that it only recommends governments to consider legislation. Its provisions leave enough space for each government to interpret them in their own desired manner.

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2 OECD companies that pay bribes to foreign officials in order to win or retain business can be subject to prosecution in their home country if found guilty of the wrongdoing stipulated in Article 1(1) of the OECD Convention: "To offer, promise or give any undue pecuniary or other advantage, whether directly or through intermediaries, to a foreign public official, for that official or for a third party in order that the official act or refrain from acting in relation to the performance of official duties, in order to obtain or retain business or other improper advantage in the conduct of international business".

3 OECD, *Commentaries on the OECD Convention on Combating Bribery* (accessed April 8, 2008); available from [http://www.oecd.org/document/1/0,2340,en_2649_37447_2048129_1_1_1_37447,00.html](http://www.oecd.org/document/1/0,2340,en_2649_37447_2048129_1_1_1_37447,00.html), 1997.