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INFLUENCE OF THE CORRUPTION ON THE FDI LEVEL, CASE OF SERBIA

Damien Bazin[1], Marko Danon[2]

Abstract

In this text we will show a connection between the level of corruption and the level of the FDI entering an economy. We are focusing the institutional efficiency and institutions as regulating organisms. After presenting the theoretic approach, we will to approach our theoretic conclusions on the case study of Serbia. Principal results of the study are deeper understanding of the process by which the corruption transmits its effects thru the economy, in this case, on the FDI.

Key words: Corruption, FDI, Institutions, Transition, Institutional Efficiency

1. Introduction

During the past decades, the corruption has become one of the major problems of the transition economies. Not only that the corruption widens the gap between the social classes, but it also raises suspicions of the foreign investors. Importance of the studying the relation between the foreign direct investments (FDI) and the corruption comes from the crucial role of the FDI for the transition countries. This role is crucial for the FDI speed up the development, technology transfer, commerce, etc.

There are numerous definitions of the corruption. According to the Transparency International (www.transparency.org), we can define the corruption as: ''Corruption is commonly considered as the misuse of public power for private benefit, thus affecting all the society, in special the less well-off stratus, and, in a well-known way, hampers business activity and economic development.''. We can always state that the corruption has a hazard of decomposing the social tissue, its institutions, its economic efficiency, even its moral codes. It is also possible to perceive that the corruption is a game of three players – bribe offering agent, bribe receiving agent and the victim. A company makes an IDE when it takes hold of at least 10% of the actions in a foreign company. An IDE can take several forms: acquisitions, privatizations, Greenfield investments. The latter are crucial for the transition economies, for they imply creating new enterprises ex nihilo. Companies choose the destination of their investment according to a multitude of criterion. Generally, we can state that the size of the receptive country (with the size of its national market), salary level, natural resources level, macroeconomic and political stability are one of the most important causes. The investors are motivated by the augmentation of the profit, either by penetrating the market of the receptive country or a market of a third country (by exporting the goods or services from the receptive country). Governments attract the investors by different stimulus – fiscal and monetary politics or by other politics and regulations. Their interests are even more numerous than they are in case of companies – stabilizing the current account, technology transfer, unemployment reduction, limiting the regional disparities, enhancing the political

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relations with the investor's home country. Apart from the stimulus, the country disposes with certain advantages, such as the general literacy, productivity, stability or overall attraction. It is important to concentrate on the corruption as a dominant constant, the one that diminishes the total efficiency of the all factors by reducing the power of the country's institutions. Corruption is thus a corrosive element which reduces the certitude and deprives the agents of information; with the rise of the incertitude, the transaction costs rise as well; as the transaction costs rise, the profits fall. It is a very simple calculus, but these are only superficial costs. Corruption is not always directly connected with the FDI, but by three mechanisms – thru dissemination of asymmetric information, thru rise of the transactions costs and thru tarnishing the attraction perception. In our paper, we shall try to show that the high corruption countries have in general a low attraction for the investors. A different question we will try to open is that whether the rise of the FDI provokes a decline of the corruption level, or does the fall of the corruption leads to the rise of the FDI. We shall also try to answer how it is possible that some countries managed to attract notable investments with having a high level of corruption.

2. Consequence of the institutional imperfections on the level of the FDI, the case of Serbia

There are many schools of thought relating to this problem, but two are particularly important for the issue. These two schools differ on the question whether the corruption is a ''sand or grease'', that is, whether the corruption up to a certain point may be favorable for the investments. Two theories agree that the corruption is generally unfavorable, but the latter school claims that the corruption up to some point can be favorable if the institutional system is too rigid[3]. Wei (1997) has empirically shown, on a range of data, that the rise of the corruption level in a host country has a negative effect on the influx of the FDI. Egger and Winner (2005), show that the corruption is hurting the foreign investors by raising the transaction costs and bribery. Before we start studying the consequences of the institutional imperfections on the level of the FDI, we should first imagine of the perfect system properties, or, the system with perfect institutions. According to Cartier - Bresson[4], roots of the corruption are to be found in five categories:
1. Information asymmetry
2. Monopoly vested to the functionaries
3. Absence of the sense for the responsibilities
4. Powerless system of sanctions
5. Size of the public rents.

This means that a perfect system should dispose with totally perfect information symmetry, combined with the absence of the monopoly vested to the functionaries, with a rigorous moral code, an omnipotent judiciary system. Of course, such system has never existed; however, the distance of one society from this state is a reflection of its corruption level. If we follow this logic, it is easy to perceive the connection between the corruption and the FDI. We can imagine that in a perfect system, all the companies, be it foreign or domestic, do not have any barriers for doing business. Once that any of these conditions disappear, system becomes vulnerable to the corruption. It is so, the health of the institutions that possesses a dominant force of attraction for the foreign investors; as the institutions can emit the information in a substantial quantity and quality in order to augment the transparency. Institutional health also means that the institutional size should not be too large. The more one state wants to regulate, the more it exposes itself to the menace of the corruption, as more regulations demands more procedures and more functionaries, which can create a situation wholly opposed to the desired one.

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[3] Al Alvaro Cuervo-Cazurra (2008), "Better the devil you don't know: Types of corruption and FDI in transition economies", *Journal of International Management*, vol.14, pp.12–27

[4] Jean Cartier Bresson, (2008), *Economie politique de la corruption et de la gouvernance*, L'Harmattan, Paris, 246 p.

After the fall of the former regime and its institutions, east European transition countries had to create new institutions, based on the new rules of the market economy. In most of these countries the role of the state became to shift to a citizen service, rather than to an omnipotent regulatory body. As these countries had no experience, and as the state apparatus was brand new, the new institutions were inefficient. Serbia is not usual, as unlike the other countries in the region, it has not fully finished with its old institutions during the 90's, and it hasn't really started producing the new ones. It is why Serbia had an institutional vacuum, a crisis harder than in the most of comparable countries. Only in the year 2000, Serbia actually started a reformation. The same year, the first significant FDI came flowing in the country. After 2000, the FDI level has risen significantly, but on the negative side the FDI structure is not favorable for the development. This means that the investments are almost exclusively related to the privatizations, much less in the form of Greenfield investments. Even within the Greenfield investments, the most of them are focused to the non industrial sector. Industrial Greenfield investments, as the east European experience shows, demand a highly stable political and macroeconomic situation. For us it is important to cite a part of the study of the CMI (Chr. Michelsen Institute, Norway)[5] on the corruption in Serbia: Corruption as a perceived problem for doing business was worse in Serbia than in the rest of the region... (Judiciary) 27% of respondents named the judiciary as the biggest problem... (Imports and exports) 20% of 2005 respondents stated that bribery to customs was frequent... (Legal framework) The 2005 survey found that regulatory uncertainty was a problem for 80% of businesses in 2005.... (Taxation) 60% having a problem with the tax administration. Over 20% of respondents reported having to pay bribes to tax inspectors... (Privatization) ... allegations of corruption surrounding a number of privatization deals, in particular when they involved companies that were competitive, and therefore attractive to investors. The allegations involved deliberately undervaluing state property for the benefit of potential buyers, the leaking of information to select competitors, and the intimidation of potential bidders. A recurring concern is that the privatization process is used to legitimize illicitly obtained money. Managers are known to strip off assets of the socially-owned companies they are in charge of, by selling parts to private buyers, despite being aware that such sales will be annulled by the Privatization Agency. The character of the reforms in Serbia is also well shown in the study of the UNCTAD (UN conference on Trade and Development): In the western Balkans, political insecurity, the fragmentation of markets and hesitant market reforms hindered economic development and kept away foreign investors during most of the 1990s... Consumption increased while production stagnated; the current account gap was financed by foreign aid. FDI came in the form of smaller ventures mainly supporting the import and distribution of consumer goods.

Chart 1. FDI in Serbia and in the SEE, millions of USD[6]
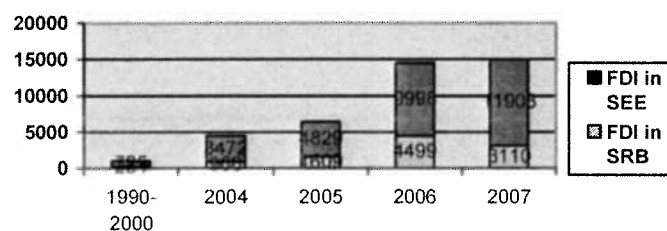
It is interesting to compare these results with the information concerning the ease of doing business and the perception of the corruption by the foreign investors. Here we have used the information of the World Bank[7]. The information is collected from the enterprises active in the region.

[5] CMI, (2007), "Corruption and doing business in Serbia", number 11, September
[6] Source:UNCTAD, www.unctad.org
[7] International bank for reconstruction and development (2009), "Doing business 2010 - Serbia".

Table 2. The Doing business grades for 2010[8]

Factor	Rank	Factor	Rank
Ease of Doing Business	88	Trading Across Borders	69
Starting a Business	73	Enforcing Contracts	97
Dealing with Construction Permits	174	Closing a Business	102
Protecting Investors	73	Registering Property	105
Paying Taxes	137	Getting credit	4

Each of the countries in the world is associated with a grade which is a combination of several other particular grades, concerning a specific field of interest for the foreign investors. According to the table, Serbia is evaluated with a very low overall grade, and even lower in some particular notes. Serbia has a particularly low grade with dealing with construction permits and paying taxes domains, one of the lowest grades in the world. This data correspond with the research of the Chr. Michelsen Institute. All the other notes are low, except for the getting credit, where Serbia is one of the most advanced in the world. Despite an absolute rise in the global ranking, Serbia is still situated very low – at ranking of 88, Serbia is far behind the regional competitors – Slovakia, Bulgaria, Hungary and Romania have the ranks of 42, 44, 47, 55 respectively. This difference may be a result of the fact that Serbia has started its transition in the year 2000, whereas all the others have started around 1989.

## Table 2. Important factors for doing business[9]

Factor	Procedures	Time days	Cost
Starting a business	7	13	7,1 (%income per capita)
Construction permits	20	279	1907
Registering property	6	111	2,8 (% of property value)
Enforcing contracts	36	635	28,9 (% of claim)
Factor	**Extent of disclosure (1-10)**	**Extent of director liability index (1-10)**	**Strength of investor protection index (1- 10)**
Protecting investors	7	6	5,3
Factor	**Documents to export/import**	**Time to export/import (days)**	**Cost to export/import (USD/container)**
Trading across borders	6/6	12/14	1398/1559

At this table we show the complexity of the problem for the foreign investors in Serbia. All the costs here imply the size of the transaction costs. For instance, in order to obtain a construction permit, it takes 279 days in Serbia, whereas the OECD average is only 157 days. In order to register property it takes 111 days in Serbia, and the OECD average is 25 days. In Serbia, companies pay different taxes 66 times a year, whereas the OECD average is 12, 8. Transaction costs lower the overall attraction of the country, but it also raises the corruption level. In a situation where the transaction costs are so high, a number of bribe offering and receiving agents is also on the rise.

We are going to present the dynamics of the selected number of factors that we find important, in a two year horizon.

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[8] Ibid.
[9] Ibid.

Chart 2. Doing business, dynamic perspective[10]
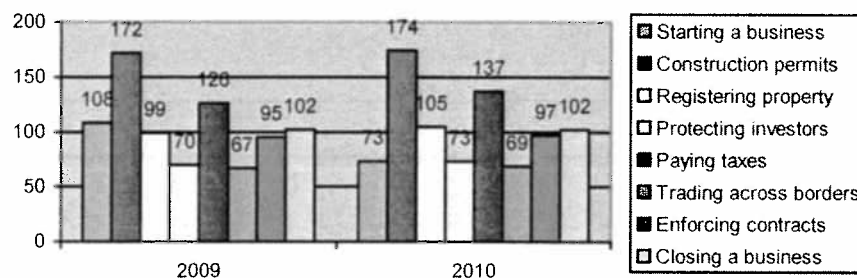
These factors are the source of the institutional corruption. Multiplication of the procedures and prolongation of their processing generate a possibility for the bribe offering and bribe demanding agents to do business. At the diagram it is possible to see the advance that Serbia has had at the domain of starting business, but stagnation at all the other fields. Again it is important to compare Serbian results to the results of the competing economies. At the following chart, we present these factors for a number of selected comparative economies.

Chart 3. Doing business, comparison with the comparative economies[11]
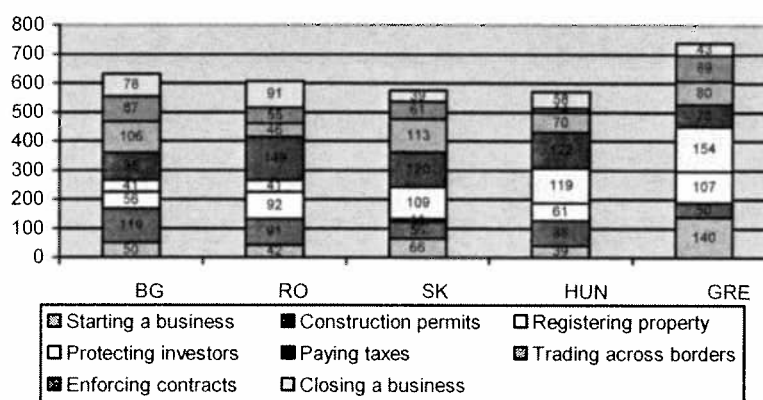
The presented data are an excellent example of the consequence of the institutional imperfection in Serbia. Institutional structure in Serbia is not solid, which provokes unfavorable business climate and a very fertile ground for the corruption. For instance, a "long queue" for getting a construction permit may be avoided by bribing an official who may have such power to exempt certain companies from the rule. So, not only that the bad system creates bad climate, but it also raises chances of the apparition of corruption.

The second group of data we use, however, is directly connected with the corruption. We used the research of Transparency International (TI), concerning the level of the perceived corruption. The TI used the information collected from different agencies and economic agents, be it residents or non residents. We present the data concerning Serbia and its comparative economies, but also the benchmark economies (the worst and the best one).

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[10] Ibid.

[11] Ibid.

Table 3. Perceived level of corruption in 2008[12]

Rank	Country	2008 CPI Score	Surveys Used	Standard Deviation	High-Low Range	Confidence range
1	Denmark	9.3	6	0,2	8.9 - 9.6	9.1 - 9.4
47	Hungary	5,1	8	0,6	4.2 - 5.9	4.8 - 5.4
52	Slovakia	5,0	8	0,7	3.5 - 5.9	4.5 - 5.3
57	Greece	4.7	6	0,6	3.5 - 5.3	4.2 - 5.0
62	Croatia	4,4	8	0,7	3.5 - 5.3	4.0 - 4.8
70	Romania	3.8	8	0,8	2.7 - 4.9	3.4 - 4.2
72	Bulgaria	3,6	8	1,1	2.4 - 5.6	3.0 - 4.3
85	Albania	3,4	5	0,1	3.2 - 3.5	3.3 - 3.4
85	**Serbia**	**3,4**	**6**	**0,8**	**2.7 - 4.9**	**3.0 - 4.0**
92	Bosnia and Herzegovina	3,2	7	0,6	2.6 - 3.9	2.9 - 3.5
180	Somalia	1,0	4	0,6	0.3 - 1.8	0.5 - 1.4

Once again we see that Serbia is not efficient in cutting down the corruption. In despite to a standard deviation almost equal to zero, and to a wide gap between the results, Serbian result is not favorable. Even if we take the most optimistic mark, 4,9, this is still a bad note (that would correspond to a global ranking of 54). Hi – low range from 2,7 to 4,9 signifies a difference between the best and the worst note. Standard deviation signifies the difference between the sources. Standard deviation of 0,5 signifies the general agreement, interval 0,51 – 0,9 signifies the more or less agreement, and values above 0,91 signify disagreement. Confidence range provides a range of possible values of the CPI score. This reflects how a country's score may vary, depending on measurement precision. In case of Serbia, some 80% of the notes vary from 3 to 4, which is a very low grade. High level of agreement implies that the vision of the institution efficiency and corruption is shared; low level implies the lack of that vision. If there is a strong disagreement on whether the corruption is low or not, than we can suppose that the quality of institutions is very erratic, which is exactly the case of Serbia. Unreliable institutions provoke possibility for corruption within the system. For instance, 90% of answers for Slovakia vary from 4,5 to 5,3; in the same country, economic agents have a strong agreement on perception of corruption.
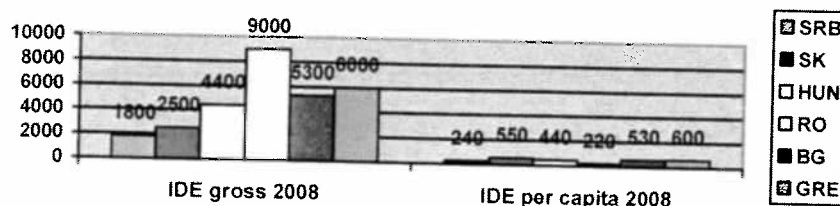
If we put two previous groups of data and again take six selected economies as example, their combination would look like this:

Charts 4 and 5. Six selected economies, according to the TI and World Bank data, and their FDI level, gross and per capita[13]
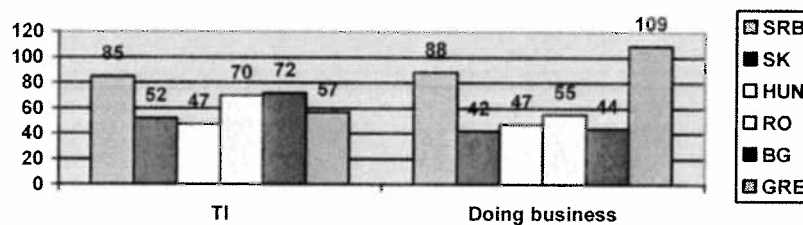
We can see here the connection between the corruption perception and institution quality on one side and the actual level of FDI on the other side. As the Serbian institutions are rated worse from its competitors (the World Bank – doing business study) and as its corruption perception level is the highest, Serbia is lagging behind in the level of the FDI. This is expected, because the causes – low transparency and low quality institutions – provoke high transaction costs, high uncertainty and a bad image. These three consequences directly reduce the FDI.

3. Conclusion

We have shown on the case of Serbia the dangerous role of the corruption. In absence of econometric methodology, it is not easy to find an evident connection between the corruption and the FDI. In our paper, we have opted for a methodology based on the interpretation of the information collected by various international credible organizations, such as the World Bank or the Transparency International.

We think that the mechanism by which the corruption transmits its consequences is based on three pillars: transparence (information asymmetry), high transaction costs and unfavorable perception of corruption. As the institutional system is weakened by the corruption, the institutions can no longer provide transparency or the regulation; it is why some agents are in an *institutional fog*, where the rules of the game are either not clear or even inexistent. Second group of conclusions is concentrated on the Serbian case study. We can state that, in Serbian case, the corruption is the highest obstacle for the foreign investments.

When it comes to solutions, there are several tools at disposal. We think that the authorities should concentrate on three points: low transparency, unfavorable business climate and a very bad corruption perception. There exists already an agency – SIEPA, which stimulates the investments and exports by various lobbying, marketing, consulting activities. Apart from the SIEPA, there are numerous state agencies that have for objective either to reduce corruption or to improve the FDI. However there is no central system that would have the exclusive role of managing the investment policies. We think that only one ministry or government organization should assume full responsibility for managing the investment attraction. On the other side, root of the problem still survives within the institutional inefficiency. So it is the institutional efficiency that should be elevated, in order to achieve a better business climate and a higher transparency.

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