29 Firm responses to corruption in foreign markets

Klaus Uhlenbruck, Peter Rodriguez, Jonathan Doh and Lorraine Eden[1]

Government corruption has a widespread but insufficiently studied influence on international business and managerial decision-making. We employed a model that incorporates two fundamental features of corruption – its pervasiveness and arbitrariness – to evaluate how corruption affects international market entry decisions by telecommunications firms.

The experience of corruption can vary widely across countries that rank similarly on one-dimensional indices of corruption. In our two-dimensional measure of corruption, one dimension, 'pervasiveness', reflects the average firm's likelihood of confronting corrupt transactions in a given country. The second dimension, 'arbitrariness', captures the inherent degree of ambiguity surrounding corrupt transactions. Where arbitrariness is high, firms are unsure whether bribes are necessary, whom to pay, what to pay, or whether the payments will have an effect. Taken together, measures of pervasiveness and arbitrariness allow for a richer and more useful depiction of the variance in the nature of government corruption.[2] Research has shown that both the level and the arbitrariness of corruption independently reduce foreign direct investment (FDI).[3]

We derived measures of pervasiveness and arbitrariness from the 1998 World Business Environment Survey (WBES), which was based on the perceptions of company managers. The WBES provided information on both the extent and nature of expectations surrounding corrupt transactions and was drawn from a broad sample of 8,000 firms across 80 emerging countries. The questions used to extract 'pervasiveness' enquired about the frequency of bribery and breadth of government officials and agencies requesting or requiring bribe payments. The questions used to extract 'arbitrariness' enquired about the extent to which the terms of corrupt transactions were predictable and the objects of bribery were usually delivered as agreed once a bribe was paid. Figure 29.1 presents a representative distribution across the two dimensions showing the substantial variation in the nature of corruption.[4]

We combined these data with a database of 400 telecommunications projects started largely between 1996 and 1998 in 96 emerging countries, drawn from the World Bank's Private Participation in Infrastructure (PPI) database. There are several advantages to a focus on infrastructure investments, including the increased likelihood of identifying effects and the fact that the services created cannot subsequently be exported to other countries, thus providing a clear linkage to host country conditions. Because these projects involve more interaction with government agencies, however, there is a higher potential for encountering corruption than for firms in some other industries.

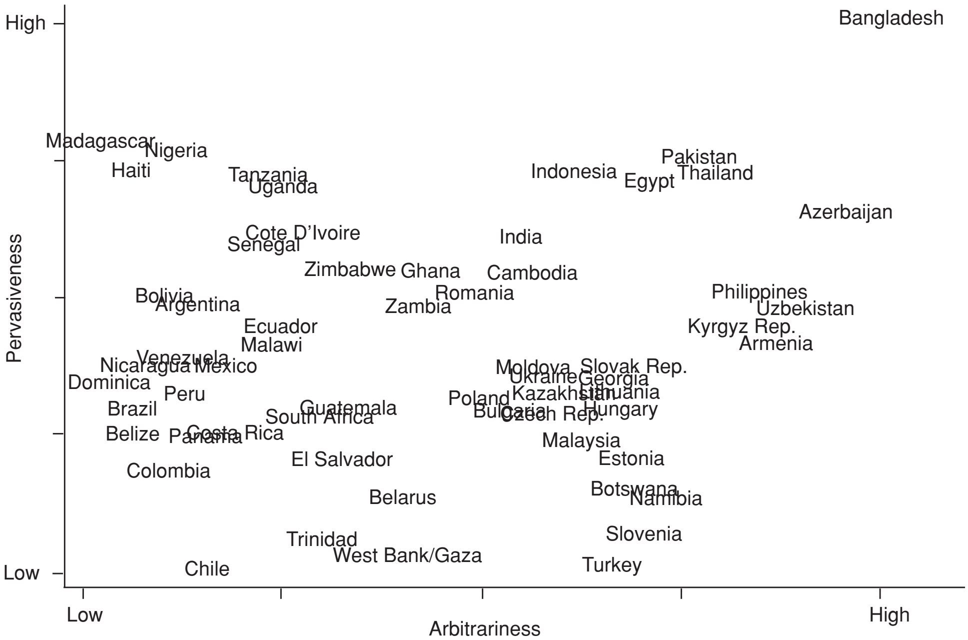

Figure 29.1: Two dimensions of corruption

Our two dependent variables indicate the characteristics of the entry modes of foreign firms. The first indicates whether firms engage in short-term turnkey projects that involve exporting technological know-how, or whether they commit to long-term FDI in the host country by maintaining ownership in the newly created facilities. The second indicates whether a multinational enterprise that pursues FDI engages in a wholly-owned subsidiary or a joint venture with a local partner. The data were analysed with logistic regression.

We found that some firms simply avoid investment in countries plagued by corruption. Other firms adapt their organisation forms and entry strategies in order to buffer their operations from the deleterious effects of corruption. After controlling for restrictions on FDI and country-specific legal and developmental characteristics, we observed that:

- as pervasiveness of corruption increases, entry modes are more likely to take the form of short-term turnkey projects rather than long-term FDI. Firms are more inclined to transfer ownership to local firms or the government, and less willing to remain in countries where pervasiveness is high. Additionally, where both pervasiveness and arbitrariness are high, virtually all projects are sold or transferred after completion
- as arbitrariness of corruption increases, entry modes are more likely to take the form of joint ventures and include local partners. We conclude that investors

ally with local partners to navigate environments characterised by ambiguous or highly unpredictable systems of corruption. In addition, the interaction between arbitrariness and pervasiveness increases the likelihood of joint venture entry.

Firms' adaptations to the nature of corruption ultimately generate additional costs to companies, host governments and society. By creating conditions where firms feel forced to divest and exit once projects are completed, or take on local partners solely to protect against corruption, host governments limit the potential benefits of FDI even when they do not completely deter it. However, policy-makers should consider the versatility of multinational firms when formulating investment policies. Rather than forgoing economic opportunities because of highly corrupt environments, firms look for alternative modes to participate in such markets, for instance via short-term engagements such as turnkey projects. While international firms find ways to adapt to difficult conditions, local firms with strong ties to the domestic economy are more constrained and probably suffer the most from government corruption.

Notes

1. Klaus Uhlenbruck is in the Department of Management and Marketing at the University of Montana, United States (contact: klaus.uhlenbruck@business.umt.edu). Peter Rodriguez is at the Darden Graduate School of Business Administration at the University of Virginia, United States (contact: rodriguezp@darden.virginia.edu). Jonathan Doh is in the Department of Management at Villanova University, United States (contact: jonathan.doh@villanova.edu). Lorraine Eden is in the Department of Management at Texas A&M University, United States (contact: leden@tamu.edu).
2. For a detailed discussion of this view of the nature of corruption, see P. Rodriguez, K. Uhlenbruck and L. Eden, 'Government Corruption and Entry Strategies of Multinationals', *Academy of Management Review* (forthcoming, 2005). Also see A. Shleifer and R. Vishny, 'Corruption', *Quarterly Journal of Economics* 108 (1993).
3. See J. E. Campos, D. Lien and S. Pradhan, 'The Impact of Corruption on Investment: Predictability Matters', *World Development* 27 (1999); S.-J. Wei, Why is Corruption So Much More Taxing than Tax? Arbitrariness Kills, NBER Working Paper No. 6255 (1997).
4. The two dimensions are nearly orthogonal. Factor loadings were highly significant and reliabilities (Cronbach's alphas) were all above 0.70.