The Impact of Corruption on Foreign Investments in Eastern Europe and Central

Eleni A. Kaditi\textsuperscript{1,2}
University of Leuven & CEPS

The problem of corruption and its impact on foreign direct investments are analyzed in this paper. Corruption affects not only the level of foreign direct investments, but also its composition and the level of firms’ growth. If corruption is widespread, then foreign investors will avoid the host country altogether. If corruption is not widespread but still present, foreign investors will prefer to associate with local partners because of the importance of their knowledge about how to deal with immoral bureaucrats. If corruption is absent, then foreign investors, especially when keen to protect intangible assets, will prefer wholly-owned affiliates. Assuming this impact of corruption on the magnitude and pattern of foreign investments, corruption further affects the economic outcome of the firms, reducing innovation and increasing operating costs. These hypotheses are tested in this paper for all transition economies in Eastern Europe and Central Asia, using various measures of corruption from the Business Environment and Enterprise Performance Surveys. We find that corruption deters foreign investments, shifts ownership structure towards joint ventures and that the higher the level of corruption the less firms grow. Yet, different forms of corruption have different effects on foreign investments.

\textbf{JEL number:} D73, F2, P3.
\textbf{Keywords:} corruption, foreign investments, transition economies.

\textsuperscript{1} Corresponding author:
E. Kaditi, LICOS - Centre for Institutions and Economic Performance, K.U. Leuven, Deberiotstraat 34, B-3000 Leuven, BELGIUM; Tel: 32-16-326598, Fax: 32-16-326599; Email: Eleni.Kaditi@econ.kuleuven.be.
\textsuperscript{2} All the analysis, interpretations, and conclusions drawn from the data of BEEPS Surveys are entirely and solely those of the author.