

EFFECT OF CORRUPTION ON FDI INFLOWS AND ECONOMIC GROWTH: AN INDIAN PERSPECTIVE

Arti Yadav*, Dipika Sahu**, Abhishek Singh***

Abstract *The aim of the study is to find out the impact of corruption on Foreign Direct Investment (FDI) inflows and economic growth of India. Economic growth and FDI are two of the important factors showing the development scenario in developing economies like India. At the same time, corruption continues to be one of the greatest impediments to economic and social development in these economies. The present paper examines the effects of corruption on FDI inflows and economic growth by using secondary data over the period of 1995 to 2017. Ordinary Least Squares regression has been applied as the main technique for the study. The present study contributes to the existing literature by defining the relationship between corruption, FDI inflows and economic growth in Indian aspect. Further, an endeavor has been made to comprehend that how corruption influences FDI decision and economic growth of Indian economy.*

Keywords: *Corruption, Foreign Direct Investment, India, Economic Growth*

INTRODUCTION

According to the Global Corruption Barometer 2017, the Asia-Pacific region exhibits that out of 22,000 people surveyed, 38 percent of the poorest said that they had to pay a bribe to get access to public services. The cost of corruption to society is huge. Further, the World Economic Forum estimates that the cost of corruption today equals more than 5 percent of global GDP USD 2.6 trillion (Keuleers, 2017). Global economic environment is changing rapidly during the last two decades. Economies around the world differ extensively in the occurrence and intensity of corruption. Within individual economies some industries and departments may be very corrupt while others are not. Corruption can considerably affect the efficiency, equality, and legitimacy of activities. Corruption generally distorts allocation of economic benefits, favoring the not to do things, leads to a less reasonable income distribution and effects political stability (Ackerman, 1997). Foreign investors may prefer not to invest because of extra costs involved, as the cost of corruption is considered incorrect and it also leads to operational inefficiencies (Habib & Zurawicki, 2002).

Foreign direct investment (FDI) globally drops by 23 per cent in 2017, showing that cross-border investment in developed countries dropped sharply, whereas growth was near zero in developing economies. This became a long-term concern for policymakers globally, particularly for developing economies, where international investment is crucial for sustainable industrial development (World Investment Report, 2018). The effects of FDI depend upon the domestic policy, the internal environment and strengths of domestic organizations for a country like India. The level of corruption in the internal environment of an economy also plays a significant role in attracting FDI. In various studies it has been found that corruption also distorts the allocation of resources, indirectly leading to price rise and discourages FDI. As economic growth and FDI are two of the important factors showing the development scenario in developing economies like India, also at the same time, corruption continues to be one of the greatest impediments to economic and social development in India. Therefore, the aim of the present study is to find out the impact of corruption on FDI inflows and economic growth of India.

* Post Doctoral Fellow, Indian Council of Social Science Research, Department of Commerce, Aligarh Muslim University, Uttar Pradesh, India. Email: artiyadavdse@gmail.com

** Guest Assistant Professor, Dr. Bhim Rao Ambedkar College, University of Delhi, Delhi, India. Email: dipikasahudse@gmail.com

*** Pursuing MBA from ABV-IIITM, Gwalior, Madhya Pradesh, India. Email: abhisheksinghskb@gmail.com

LITERATURE REVIEW

Previously various studies have been carried out to see the impact and determinants of FDI flows focusing on the macroeconomic and institutional determinants such as market size, population, growth prospects, financial development, inflation, real exchange rate, openness, trade openness, human capital, institutional quality, infrastructure, political stability and taxes (Bayar & Ozel, 2014).

Gasanova, Medvedev and Komotskiy (2017), tried to study the impact of corruption on the inflow of foreign direct investment (FDI). The study showed that the flow of FDI is high in countries which have a transparent, attractive and open economy with low level of corruption.

Hasan, Rahman and Iqbal (2017), attempted to understand how corruption influence FDI decision in India and China. The result of the study proved that there is a significant relation between corruption and FDI but the impact is opposite for India and China. For India, there is an inverse relation between corruption and FDI, whereas it is positively related for China. The relationship between corruption and FDI is different for different economies.

Bayar and Alakbarav (2016), tried to study the interaction among corruption, rule of law and FDI inflows in 23 emerging market economies during the period of 2002-2014 through the method of Westerlund-Durbin-Hausman cointegration test. The result exhibited that there is no significant impact on FDI inflows in overall panel by controlling both corruption and rule of law.

Yuan (2016), sampled four developed European countries as source countries and 12 new EU member states as target countries for the period of 2007-2012 to determine the relationship between FDI and corruption. The result proved that corruption has a negative impact on FDI, while GDP being a positive factor.

Rahman, Romli, Ismail, Romaiha and Roseli (2015), attempted to investigate the impact of corruption on FDI mainly in ASEAN-5 economies. The result exhibited a positive significant relationship between corruption and FDI in boosting the economic growth of ASEAN-5 countries.

Ravi (2015), in his paper tried to make a comparative study of the effect of corruption on FDI in India and China. The result revealed that corruption does affect the level of FDI inflows, but the effect is dependent not only on the size of corruption, but also on the nature of corruption.

Tokunova (2015), examined the interrelation between corruption perception index (CPI) level and amount of FDI inflows and different effects of CPI on developed and developing countries. The result showed that corruption

does affect the FDI, but it is different for developed and developing countries.

Quazi (2014), tried to study the role of corruption on FDI in South Asia and East Asia with a panel regression model using 1995-2011 data. The result revealed that the prevalence of corruption hinders the flow of FDI. The result also revealed that due to regional differences East Asia enjoys a favorable advantage in the flow of FDI over South Asia.

Tosun, Yurkadul and Iyidogan (2014), tried to study the causality relationship among corruption, political risk, industrial production index and FDI for Turkey through the Pesaran, Shin and Smith bounds test of cointegration and error correction methods. The result showed that causality runs from corruption to FDI in Turkey and hence, control of corruption improves the flow of FDI. As regard the relationship between political risk and FDI is concerned, the result revealed that increase in political risk develops FDI inflows.

Udenze (2014), tested the relationship between the levels of corruption and the FDI inflows as a fraction of GDP in low and middle income countries and Sub-Saharan African and in the rest of the world over a period of seven years. The findings proved that there was a negative correlation between net FDI inflows and corruption, whereas the relationship was positive in Sub-Saharan Africa.

Khan (2013), tried to investigate the effect of corruption on FDI for 33 less developed Countries (LDCs) over a period of 1985-2011. The result showed an adverse affect of corruption on FDI for 33 LDCs during the period under study.

Sadig (2009), examined the effects of corruption on FDI inflows by incorporating an econometric method. The result of the study revealed that the institution's quality of a country is more relevant in determining the FDI inflows into the country rather than the level of corruption.

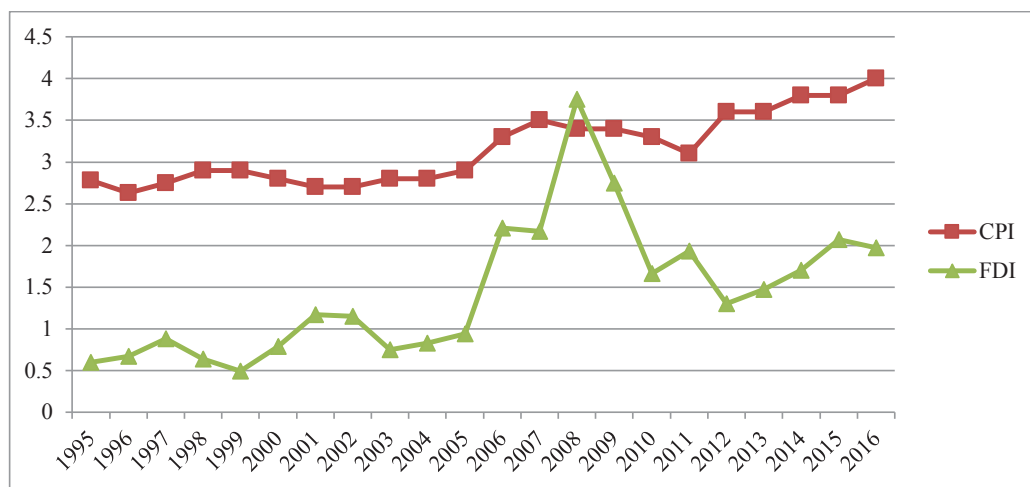
Ohlsson (2007), tried to analyze how corruption in host countries impacts its FDI inflows. The result showed that there is a negative relationship between corruption and FDI.

FDI AND CORRUPTION IN INDIA: AN OVERVIEW

According to International Monetary Fund (IMF), direct investment is the category of international investment that reflects the objective of a resident entity in one economy obtaining a lasting interest in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise. On the other hand, according to Transparency International, Corruption is the abuse of

entrusted power for private gain. It can be classified as grand, petty and political, depending on the amounts of money lost and the sector where it occurs. It can be a threat to economic constancy, democracy and development. Due to increase in corruption cases in industrialized countries, high increase of corruption cost, changes in political scenario around the world, Corruption has made an impact on external finance flow in economies (Lawal, 2007).

FDI inflows have turn out to be a vital external financing source for rising economies and developing nations and based on that these economies has applied various institutional reforms to magnetize additional inflow of FDI for their economic growth and development. Various studies have claimed that Corruption is also one of the main determinants of FDI inflows in host economy (Wei, 1997; Ohlsson, 2007).

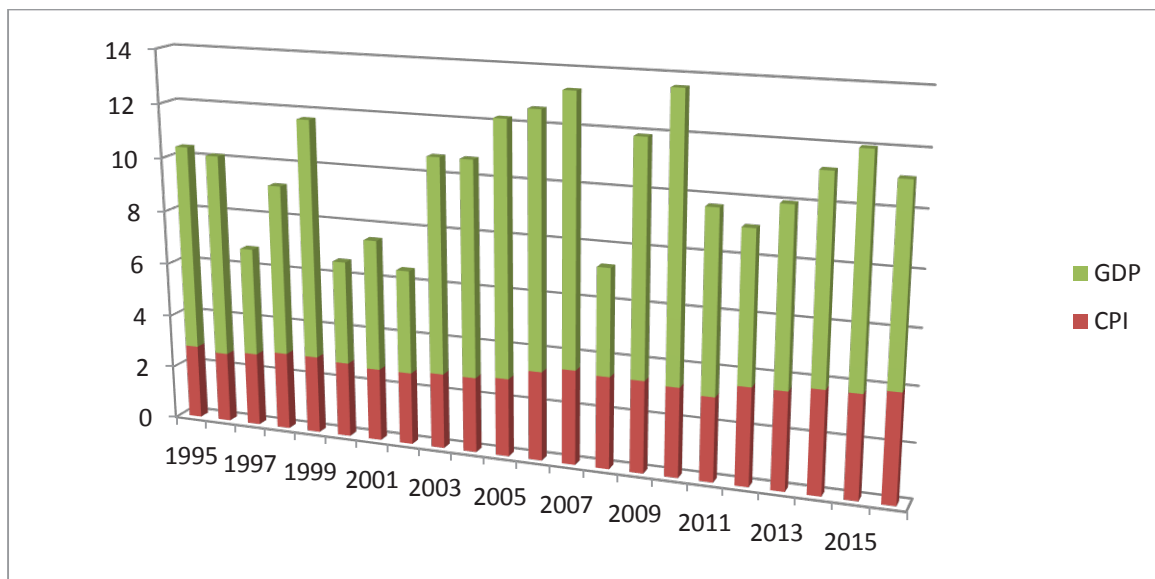


Source: World Bank Database, UNCTAD Database and Transparency International

Fig. 1: Trend and Pattern of CPI and FDI (% of GDP) in India

Fig. 1 shows the trend and pattern of Corruption Perception Index (CPI) and FDI. With the liberalization of Indian economy, FDI has turn into a vital medium for the development of the economy. Though, the amount of FDI

is not evenly distributed. One of the reasons for the low level of FDI flow in some economies has the high level of corruption.



Source: World Bank Database, UNCTAD Database and Transparency International

Fig. 2: Level of GDP and CPI in India

Fig. 2 shows the level of Gross Domestic Product (GDP) and CPI in India. Corruption also affects the growth in an economy. Corruption affects every sector and level of an economy leading to reduction in its efficiency. It signifies a probable threat to all sectors and institutions within an economy.

Table 1: Ranking of India as per Corruption Perception Index

Year	Ranking	Score
1995	46	27.4
1996	45	26.3
1997	66	27.5
1998	72	29.0
1999	69	29.0
2000	71	28.0
2001	71	27.0
2002	83	27.0
2003	90	28.0
2004	88	28.0
2005	70	29.0
2006	72	33.0
2007	85	35.0
2008	84	34.0
2009	97	34.0
2010	95	33.0
2011	94	31.0
2012	94	36.0
2013	85	36.0
2014	76	38.0
2015	76	38.0
2016	79	40.0
2017	81	40.0

Source: Transparency International, 2018

Table 1 shows the ranking and score of CPI of India from the year 1995 to 2017. The corruption index of India is considered high since 2000 as their ranks never reach below 70 after that. The index represents a scale of 0 to 100, where 0 shows highly corrupt and hundred shows not at all corrupt. Also, India remains a difficult place for organizations to do business as to obtain a single permit for construction, there are around twenty seven dealings leading to 162 days, and

costs 46 percent of the total cost according to a World Bank survey (Sukhtankar and Milan, 2015).

HYPOTHESES OF THE STUDY

H₀₁: There is no significant impact of corruption on the level of FDI in India.

H₀₂: There is no significant impact of corruption on the economic growth (GDP) of India.

METHODOLOGY, DATA ANALYSIS AND INTERPRETATION

The relationship between FDI, economic growth and corruption has been formulated based on the various literature works in different economies, as well as various issues raised around corruption and impact on economic growth. Also it has been found in different classical and modern theories of FDI that FDI also plays an important role in defining the economic growth of an economy. So, the study tries to evaluate that if corruption can influence economic growth, will the effect is same in terms of FDI or not using regression model.

In order to estimate the relationship between Corruption, FDI inflows and GDP, data for the variables has been obtained from the World Bank Development Indicators database from. CPI data has been obtained from Transparency International. This index data is derived by using surveys to determine the perceived levels of corruption in different countries around the world. Data has been taken over a period from 1995 to 2016. A negative sign of the parameter indicates a positive impact of corruption on FDI. On the other hand, a positive sign indicates a negative impact of corruption on FDI. Microsoft Excel was used to accumulate the data and Eviews was used for the regression analysis. Ordinary least squares regression is used to estimate the relationship between corruption and FDI/GDP as shown by the general regression equation:

Model I:

$$Y(\text{FDI}) = \alpha + \beta_1 (\text{CPI}) + \varepsilon$$

Where,

Y= Foreign Direct Investment

CPI= Corruption Perception Index

Model II:

$$Y(\text{GDP}) = \alpha + \beta_1 (\text{CPI}) + \varepsilon$$

Where,

Y= Gross Domestic Product

CPI= Corruption Perception Index

Table 2: Regression Result of Model I

Variable	Dependent Variable: FDI			
	Coefficient	Std. Error	t-Statistic	Prob.
CPI	-2.457619	1.050265	-2.340000	0.0298
C	1.237513	0.329809	3.752210	0.0013
R-squared	0.413130	Mean dependent var		1.449545
F-statistic	14.07908	Prob (F-statistic)		0.001255

Source: Eviews Output

As per the result, the Model I (Table 2), there is significant and positive impact of corruption on FDI inflows in India as the parameter value is negative and probability value is less than 0.05 (0.0298). The probability value of intercept and coefficient also suggest that null hypothesis of “no significant impact” is rejected. As a result, H_0 is rejected.

Table 3: Regression Result of Model II

Variable	Dependent Variable: GDP			
	Coefficient	Std. Error	t-Statistic	Prob.
CPI	23.76428	0.481468	49.35796	0.0000
C	0.766727	0.151193	5.071187	0.0001
R-squared	0.562525	Mean dependent var		26.18505
F-statistic	25.71694	Prob (F-statistic)		0.000058

Source: Eviews Output

On the other hand, the Model I (Table 2) shows that there is significant and negative impact of corruption on FDI inflows in India as the parameter value is positive and probability value is less than 0.05 (0.0298). The probability value of intercept and coefficient also suggest that null hypothesis of “no significant impact” is rejected. As a result, H_0 is rejected.

CONCLUSION

The findings of the study reveal that there is a statistically significant positive relationship between net FDI inflows and perceived corruption in India. A one point increase in corruption perception in India would lead to a 0.41% increase in the FDI inflows. Further, there is statistically significant negative relationship between GDP growth and perceived corruption in India signifying that one point increase in corruption perception will lead to 0.56% decrease in the level of GDP in India.

Therefore, corruption in terms of economic growth has proved to be a hindrance. However, the effect of corruption specifically on FDI in India has been subject to different views. Also, some studies squabble that, bribes help in avoiding bureaucratic inefficiencies and speeding up process (Teksoz, 2006). Further, in economies where governments are incompetent, corruption may be one of the ways to push investment through contributing different aspects to carry out business. However, various studies have also shown the empirical evidence of the negative effects of corruption that has gradually increased. So, corruption can affect FDI and economic growth through tarnishing the image of solidity and quality of an investment in an economy.

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