Governance Quality as a Determinant of FDI: the Case of Russian Regions

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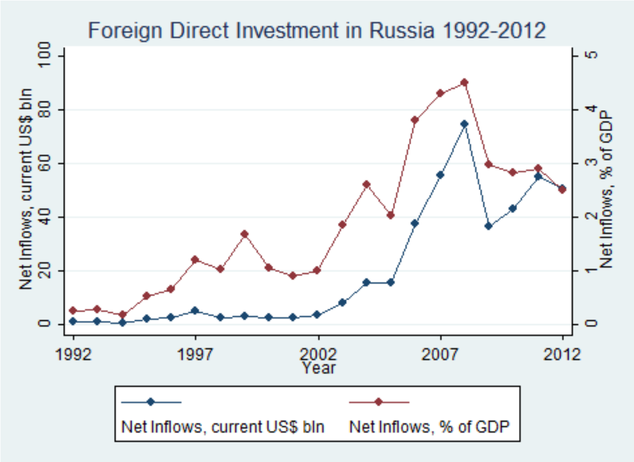
This brief highlights the results of a study of the effect of poor governance quality on foreign direct investment in Russia. Using a survey of businesses across forty administrative districts, we find that a higher frequency of using illegal payments and a higher pressure from regulatory agencies, enforcement authorities, and criminals, negatively affect foreign direct investment (FDI). We find that moving from average to top governance quality across Russian regions more than doubles the FDI stock.

What are the reasons for the large heterogeneity in investment across cities, regions, and countries? Why do some of them prosper while others struggle in attracting investors and developing in the long term? This brief summarizes a study (Kuzmina et al, 2014) where we explore how quality of governance affects a specific type of investment – foreign direct investment (FDI). FDI is a very important source of economic growth, especially for developing countries. It allows them to overcome the local deficiencies in capital, technologies, and expertise, and has strong and long-lasting effects on growth – through both direct and spillover channels. Analysis of the determinants of FDI is popular among academic researchers, however, the existing empirical research, especially the one based on cross-country variation in governance quality, is not entirely convincing.

FDI Inflows in Russian Regions

During the first decade of transition in 1990s, the inflow of FDI to Russia was low compared to the Eastern European countries and other emerging economies. However, this changed dramatically around 2003. As oil prices surged FDI flows into Russia increased ten-fold within just a few years. As Figure 1 shows, a maximum of $74.8 billion was achieved in 2008 (corresponding to 4.5% of the country's GDP), and Russia became one of the top countries in the world for inward FDI. By 2006, FDI inflows to Russia in per capita terms had surpassed FDI into China.

Figure 1. Foreign Direct Investment in Russia 1992-2012



Notes: This figure plots the evolution of FDI in Russia in 1992-2012. The blue line measures net inflows in current US$ billions (the scale corresponds to the left axis), and the red line measures net inflows as the percentage of GDP (the scale corresponds to the right axis). The data come from the World Bank(http://databank.worldbank.org/).

Nevertheless, the stock of FDI in Russia has remained substantially lower than in some comparable middle-income countries. The accumulated stock of FDI as a share of GDP (PPP) in Russia was 21% in 2013. This is only slightly more than in Ukraine (18%), and significantly less than the 28% in Brazil and the 30% in Poland. The stock of FDI in 2012 was distributed mainly between manufacturing (32%), real estate (15%), mining and quarrying (15%), and financial services (13%). Given the diversity of Russian regions in terms of natural, economic and institutional conditions, we also observe a substantial heterogeneity of FDI across Russian regions. The accumulated stock of FDI per capita is only $0.32 in the Republic of Karachaevo-Cherkessia, while it reaches a substantial $30,371 in the Sakhalin region. The average regional accumulated stock is just above $1,000 per capita. In terms of total stock, Moscow City is the leader with more than $39 billion of accumulated FDI.

An important feature of FDI in Russia is a significant share of so-called round-tripping investments. In 2012, $7.5 billion out of $18.5 billion of inward FDI in Russia came from offshore financial centers, with the most important OFC being Cyprus that delivered around 80% of total offshore investments. On overall, about half of total inward FDI stock in Russia comes from offshore countries.

There are several reasons behind the significant role of offshores in external Russian transactions. The traditional cause for using offshore financial centers (OFC) in developed countries is tax avoidance. While profit concerns are relevant for Russian law-abiding entrepreneurs, there are also other important reasons that force them to use offshore shells for their Russian-based enterprises. The possibility to get cheaper international financing and some other financial services for large Russian companies is important for large companies. On the other hand, underdeveloped institutions and poor property right protection are often referred to as the main driving forces for small and medium sized companies to go offshore (Ledyaeva et al., 2013; Kheyfets, 2013).

Given the importance of round-tripping investments in the Russian economy and the differences in incentives behind regular FDI and the one from offshores, we need to distinguish between these two types of investments when studying their determinants. On the one hand, poor regulatory governance might be a reason for the higher volumes of round tripping investments, but on the other hand, they might be a reason for the low attractiveness for true foreign investments.

Diversity of Quality of Governance across Russian Regions

The stable macroeconomic environment in Russia over the last decade has benefited Russian regions in attracting FDI. The diversity of Russian regions in various institutional aspects is, however, recognized in many studies. Yakovlev and Zhuravskaya (2007) report substantial differences in the speed of regulatory reform in twenty Russian regions over 2002-2005. A recent subnational survey of firms in 37 Russian regions by the World Bank indicates significant differences in the list of the most severe obstacles for firms' performance across regions (World Bank, 2013).

The governance quality data in our study come from the Index of Support ("Index Opory") survey conducted in 2011. This is a survey of directors of small and medium Russian firms that was collected by the Eurasia Competitiveness Institute (a not-for-profit think tank) and Opora Rossii (a non-for-profit organization that supports small business). It includes about 6000 firms and is designed to be a random sample of small businesses, stratified by size, location (urban or rural), and industry (with about two thirds from agriculture and manufacturing industries, and the rest from infrastructure and services).

Our data cover 40 regions. The surveyed regions are the most developed ones and their economic weight corresponds to 84% of total FDI stock and 83% of GDP in 2011.

All respondents of the survey were asked to answer a set of questions related to regional infrastructure, availability of labor, capital, and intermediate goods, and the absence of administrative pressures. Their answers were then aggregated within regions and all regions were ranked according to each criterion. We use the data coming from the administrative pressure section of the survey. The surveyed regions are ranked according to the average answers on questions reagrding the frequency of firms in the region using illegal payments to officials (Bribes to Officials), the frequency of firms facing abuse on the side of inspection authorities (Inspection Agencies Pressure), the side of enforcement authorities (Police Pressure), and the criminal community (Criminal Pressure).

To give a few examples, the top regions in terms of governance quality are Belgorod and Astrakhan Regions, as well as Stavropol and Krasnodar Territories. For example, the Belgorod region is ranked first in terms of police pressure, second in terms of bribes to officials and criminal pressure, and sixth in terms of inspection agencies pressure. This makes it the top region overall. The Kaluga region, which is commonly viewed as one of the best regions to invest in, in Russia, is ranked fifth overall, achieving some of the best positions in all indicators except for bribes to officials where it is somewhere in the middle (ranked 16th). To give a comparison, Moscow City ranks 27th overall. Leningrad, Irkutsk, Voronezh, Ryazan, and Rostov Regions take the bottom five places.

Worker Strikes in 1895-1914 and Why They Matter for Today

The common problem in this type of research is the reverse causality between the main variable of interest – quality of governance – and FDI. The effect of foreign investors might go through the better practices they bring to the host country or through the legal restrictions imposed on their business by the domestic jurisdiction in any country in which they decide to invest. To deal with the reversed causality problem in our study, we rely on an instrumental variable approach. As an instrument for governance quality in Russian regions, we choose the intensity of worker strikes in Russian provinces 1895-1914. We assume that the intensity of strikes in this period can be used as a proxy for the trust between the local businesses and the political elites, on the one hand, and ordinary people, on the other.

The choice of this period is not accidental. First, this was a period of unprecedentedly high growth of Russian industries. In 1887-1900, the production of many industrial goods and fuels in Russia increased by factor 3 to 5 in real terms; around five thousand kilometers of railroads were put in operations annually. Not surprisingly, the conflicts between workers, on the one hand, and management and owners, on the other, intensified in the 1890s. The police was an important instrument that managers and owners relied upon to keep control over the workers. The important link between local authorities and industrialists was formed to ensure the alignment between the interests of police and business owners. The formation of enforcement agencies was strongly influenced by this alignment, and this alignment in turn defines the level of trust between the elites and enforcement agencies, and the population.

Second, before 1897 no law regulated the duration of working hours in Russia. It was in discretion of the factory owners to establish the norms. On June 2, 1897 the first law governing working hours at a level well below the pre-existing level in Russian factories was signed into force. This law was an important first step towards improving the living conditions of Russian workers. With this law, workers could now claim their rights against the factory management. The factory inspections that were launched earlier, around 1882, were supposed to control the enforcement of labor regulation in general and the new labor law in particular. However, as conflicts between workers and capital owners and management dramatically intensified, these regulatory agencies were used to control workers and their organizations (Kupriyanova, 2000).

We interpret the intensity of strikes at the regional level as a measure of the revealed conflict between the state and the owners of existing businesses, or the local elite, on one hand, and the population on the other. In these conflicts, the enforcement and first regulatory agencies were used to secure the interests of small groups of local elites against interests of the broad population. In this way, we may rely on the intensity of strikes as an inverse proxy for the trust between population and local elites.

Modern research recognizes the importance of history for economic development. Nunn (2009) indicates several mechanisms that justify the projection of history onto modern life. For our study, two of these mechanisms are especially relevant. One is the historical root of modern formal institutions. The second is the effect of history on social and cultural norms. Aghion et al. (2010) suggest a mechanism of possible coevolution of trust and regulation: people in low-trust environments want more government interventions even though they are aware of the low quality of governance. For our study, the prediction of the study by Ahgion et al. (2010) – about the link between the trust and the quality of governance and their coevolution – is especially relevant.

One important issue about using our instrument is whether we can reasonably assume the preservation of some institutions or social norms through the two later dramatic changes in the Russian political regime. While there is evidence of institutional persistency, some aspects of institutions do change often. Acemoglu and Robinson (2006) address this question of whether changes in certain dimensions of institutions are consistent with overall institutional persistence. One of the results of their study is the possible persistence of the institutions that are essential for the allocation of resources in the economy despite the changes in the political regime. The essential condition for institutional persistence is the persistence of the incentives of those in power to distort the economic system for their own benefit. Therefore, as long as the incentives are preserved, the institutions may survive changes in the regime.

A number of empirical studies support this conclusion. To cite just one relevant study in the Russian context, Dower and Markevich (2014) show that the measure of conflict brought by the Stolypin land reform in Russian farmer's communities about a hundred years ago explains current attitudes toward the privatization outcomes of the 1990s.

Results: Good Governance Matters for Non-Offshore FDI

Putting together data on the FDI stock in Russian regions, the level of governance quality in regions as of 2011, and some other controls, our results indicate that a higher administrative burden, a higher pressure of enforcement and regulatory agencies, a poor criminal situation and a higher level of corruption reported by the businesses in Russian regions contribute to a lower level of investments of foreign residents. Using the instrumental variable, which proxies the conflict between elites and people at the time when the regulatory agencies were formed a century ago, we can find the causal effect of governance quality on foreign investment. As an additional test, we study the effect of governance on offshore-related direct investments. We show that the sensitivity of offshore investments on governance quality is positive and non-significant. These results confirm our assumption that poor quality of governance decreases the reward of investments and is an important determinant of economic activity.

There is a straightforward policy application of our result. The improvement of governance quality alone, better compliance of regulatory agencies with existing legislation, is an important source of increases in the attractiveness of the regions for foreign investors. In particular, moving from average governance quality to the top increases FDI by 158%. This suggests that there are large returns to improving the quality of governance at the regional level, and this policy does not require a lot of budget spending which is especially important in modern Russia.

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