Chapter 3
Foreign Direct Investment, Corruption, and Crime:
A Theoretical Analysis of Drug Trafficking

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ABSTRACT

Drug trafficking could be associated with the corrupt structures of governments and any anti-drug enforcement policy would be compromised. At the same time, it is perceived that the flow of foreign direct investment, which is inversely related with drug trafficking, drives the economy and the host government faces a dilemma between encouraging foreign direct investment or allowing drug trafficking. In this chapter, a theoretical model of this stylized fact is made. It is found that the host government sets a strict enforcement policy if the corruption level is low; otherwise, a lax policy would be set. Once the enforcement policy has been set, an increase in the corruption level reduces the enforcement level. Additionally, an increase in the demand for drugs may reduce or increase the enforcement level depending of the size of corruption level compared with the market size for foreign investors. However, with an international specific policy, an increase in demand of drugs reduces unequivocally the optimal enforcement level.

INTRODUCTION

The need to explain the location of multinationals and the flow of investment all over the world is given by the increasing globalization process and the inherent integration among the economies. International trade is not the only reason to integrate economies, but several positive externalities derived from the attraction of foreign capital such as employment, transfer of technology, and clustering with local firms. All these externalities are believed to promote growth and development (Cortez Yactayo & Espinosa Ramirez, 2011). Foreign Direct Investment (FDI) is one of the most desired foreign investments. FDI is understood as long-term capital in which foreign firms and multinationals assume risk to locate in foreign markets to obtain a higher rate of return and to enter foreign and local markets. It is a strategy

game between foreign investors and receiving developing countries in order to determine the location of foreign investment.

On one hand, foreign investors evaluate the conditions and treaties to locate in developing countries (Salacuse, 2017). On the other hand, it is crucial for host countries to identify the determinant factors in order to attract foreign direct investment. Even when it is quite important to know the reasons for FDI location for emerging economies, there is not a consensus about the patter of localization of foreign investment (Singh & Jun, 1995). In the report on World Investment 2018 made by UNCTAD, between 2016 and 2017 FDI flows to developed economies fell by one-third to US\$712 billion, while FDI in-flows to developing economies remained close to their 2016 level at US\$671 billion (UNCTAD, 2018, p. 2). Despite the last year general decline in FDI worldwide, emphasis is given to the growing flow of investment addressed to developing economies after 2015.

However, despite the stable scenario for developing economies, UNCTAD warns to keep healthy institutional policies as the investment law and institutional reforms (UNCTAD, 2018, p. 106). International investors seem to be sensitive to the institutional health of a country to invest; in particular, the investment made in emerging economies. Hernandez and Guillen (2018) reviewed the classic theory of Multinational Enterprises (MNE) and past attempts to use it to understand the internationalization of firms from emerging markets. They found that emerging markets offer the opportunity to observe the origin of the capabilities of MNEs in general and the development of the institutional ecosystem that supports internationalization.

Jude and Levieuge (2017) investigated the effect of FDI on economic growth conditions on the institutional quality of host countries. They show that FDI has a positive effect on growth only beyond a certain threshold of institutional quality. Smith and Thomas (2017) argue the importance of institutional change and FDI, and specifically, the social impact of this relationship in Russia. Shi, Sun, Yan, and Zhu (2017) develop the concept of institutional fragility to investigate the outward foreign direct investment behavior of firms from emerging economies, and specifically in China.

Corruption is one of the most important concerns for foreign investors with regards to institutional factors. Corruption in many developing economies is a well-established institution as it is supported socially and individuals engage in the practice to reduce transaction costs. Corruption in developing economies guarantees stability in the social order (Della Porta & Vannucci, 2016). With this argument, Huang (2017), using a sample of 13 Asia-Pacific countries, does not support the common perception that corruption is bad for economic growth. In this work, corruption may encourage growth as in the case of Korea and China.

However, it is believed that corruption undermines the social structures and inhibits economic growth. For instance, Aghion, Akcigit, Cage, and Kerr (2016) analyze the relationships between taxation, corruption, and economic growth. They found that reducing corruption provides the largest potential impact for welfare gain through its impact on the uses of tax revenues. D'Agostino, Dunne, and Pieroni (2016) show the negative effect of corruption and military spending in Africa, but also show that corruption interacts with the military burden through indirect and complementary effects to further increase its negative effect. In summary, even when corruption is morally condemned, there is no consensus on the impact of corruption on economic growth (Farrag & Ezzat, 2016).

There is no robust evidence of political interest to eradicate due to its social place (Dzhumashev, 2014). On the other hand, it seems foreign investors have an ambiguous perception about corruption (Belasen & Toma, 2016). Therefore, the impact of corruption on foreign investment flows is contradictory (Cuervo-

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