

# THE IMPACT OF CORRUPTION ON INVESTMENT AND FINANCING IN THE EUROPEAN UNION: NEW INSIGHTS

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## ABSTRACT

Corruption is a phenomenon that is not just restricted to less developed nations, but also touches developed countries like those in the European Union, often seen as one of the least corrupt economic areas in the world. Corruption practices and perceptions can seriously hinder economic growth and innovation, This can be due to lower access to corporate funding, greater cost of capital, its effects on competition, misallocation of resources, and distortions in the composition of public spending and the effectiveness of government policies. This paper first provides a short discussion and an overview of some academic literature for the link between corruption, financing decisions and economic growth. It then summarizes the findings of the five papers in this special issue on the topic of Corruption in a European context, discusses some insights from their results and finally points out at some avenues for future research in related topics.

Keywords: corruption, investment, financing, European Union funds, banking, cash holdings

JEL codes: E22, G11, G12, G30, G38, G41, K4

## 1. Introduction

There is a general perception that corruption has a detrimental impact on investment, the so-called “*sanding the wheels*” hypothesis (Méon, and Sekkat, 2005), and affects firm’s financial decisions (Smith, 2016). However, the empirical evidence of these effects is mostly concerned about developing nations and is relatively scarce in the case of the European Union (EU), for many often viewed as one the least corrupt economic areas in the World (Mungiu-Pippidi, 2013). At the same, time the exact mechanisms that companies can use to mitigate the risk of corruption are far less well understood than its consequences (Sena et al, 2018).

The presence of corruption, either at the country or public institutions levels, is likely to lead to reduced investor confidence (Battaglia et al, 2021). It may also decrease foreign direct investment (Habib and Zurawicki, 2002) as foreign investors are hesitant to invest in countries with high levels of corruption due to the potential risks of losing their investment or facing extortion by corrupt officials. All of this in turn can lower overall economic growth (Mauro, 1995). Corruption is also expected to distort competition (Emerson, 2006), due to unfair advantages being granted to those who engage in corrupt practices, leading to a misallocation of resources and potentially curbing innovation (Veracierto, 2008). In addition, corruption may also introduce distortions in the composition of public spending (Mauro, 1998), thus reducing the effectiveness of government policies and actions.

Given these concerns, the EU has implemented several measures to combat corruption, such as the creation in 1999 of the European Anti-Fraud Office (OLAF) and the formation in 2017 of the European Public Prosecutor's Office (EPPO). However, corruption remains a significant issue in many member states (Mungiu-Pippidi, 2013), with the potential to harm the entire EU economy (Graeff and Svendsen, 2013).

The papers in this special issue were chosen from a larger set presented at the EUMODFRAUD conference (see following section) held in 2021 at FEP-Faculty of Economics, University of Porto, Portugal. These studies aimed at bringing new research insights that could contribute to a better understanding of the causes and effects of corruption at the EU level. Their particular focus was the impact of corruption on corporate financing and cash policies, corruption disclosure and mechanisms that could moderate the effects of corruption in a European setting.

## 2. The EUMODFRAUD Conference

The EUMODFRAUD conference took place on 17 and 18 June, 2021 in electronic format and was jointly organized by the EUMODFRAUD European Research group, the Observatório de Economia e Gestão de Fraude (OBEGEF), the Faculty of Economics of the University of Porto, Portugal (as the conference host) and the Faculty of Economics of the University of Burgos, Spain.

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The focus of the conference was the development of studies analysing the factors that could help to explain and prevent fraud and corruption practices in European organizations and institutions, and that might, directly or indirectly, pertain to the usage of European Union (EU) funds. An additional particular interest was, more broadly, the financial factors and consequences of corruption and fraud in Europe. In this way, the topics could include financial corporate decision making adopted by managers, boards, politicians and other relevant stakeholders in both public and private organizations that may be relevant for the prevention of corruption. Also welcome were papers related to the bankruptcy risk of firms due to corruption attitudes and their decisions on capital structure, on the use and consecution of financial EU funds, the liquidity, provisions or dividends. Finally, the influence of Fintech in money laundering regulatory risk evaluation,

the effect of financial culture and the financial system of the firm's propensity to bribe were also considered relevant topics.

The Conference benefitted from the contributions, as Guest Speakers, of Ruth Aguilera (D'Amore-McKim School of Business at Northeastern University), with an address on "Corporate Corruption in Management Research", Florencio López-de-Silanes (SKEMA Business School), who provided a communication on "Private Contracts and Trust Around the World" and Ilan Alon (School of Business and Law at the University of Adger) who presented the topic "Corruption and Governance in International Business Research".

### 3. Articles in this Special Issue

The papers in this special issue are a selection of papers presented at the EUMODFRAUD conference that were subsequently submitted for blind refereeing under the usual procedures adopted by the European Journal of Finance for its regular issues. These studies addressed, in particular, the consequences of corruption in major financial decisions like investment, cash holdings and financing with a focus on EU countries, companies and public institutions.

Within this general context, de Andrés et al (2023), the first paper in this issue, tackle the issue of accounting transparency in the banking industry. These authors address in particular the reasons behind the disclosure of corruption-related information by banks based in GIPSI countries (Greece, Italy, Portugal, Spain and Ireland) for the 2011-19 period. These are the countries that, aside from Ireland, have been observed to have "*regressed, rather than progressed*" on the issue of corruption since joining the EU (Mungiu-Pippidi, 2013, p.3). As one of the effects of corruption perception is to reduce the willingness of investors to fund investments (Voyer and Beamish, 2004), this is a potentially very relevant concern. Using a sample comprising 88 banks, de Andrés et al (2023) document that the level of disclosure on corruption-related matters is lower for banks involved in corruption scandals, even after a corruption event becomes public or after controlling for internal governance mechanisms. In addition, the authors find that country-related institutional and regulatory characteristics can influence the level of disclosure on corruption. This points out at the importance of reinforcing regulatory mechanisms in GIPSI countries to reduce the levels of information asymmetry and improve reporting transparency in the banking sector, alongside with the indispensable establishment of appropriate internal and external controls in that industry.

Alonso et al (2023) address the issue of financing in the European Bond markets. The authors show that corruption in the public sector (as measured by a Corruption Perception Index) leads to an increase in bond yields and coupon rates in the private sector while also reducing the levels of funds raised through corporate bond issues. This means that, aside from the relevance, pointed out by de Andrés et al (2023), of regulatory concerns with individual industries and firms, an effective fight against corruption cannot take place without also tackling corruption at the public sector level. In fact, as Alonso et al (2023) observe, relevant spillovers on the functioning of financial markets can take place simply because corruption is not being controlled at a more fundamental public sector level. As a result, ultimately investment and economic growth can seriously be harmed due to costlier and lower levels of capital markets financing available for companies if corruption is not being dealt with adequately by public institutions. An additional insight from Alonso et al (2023) is that perceptions of corruption affect the functioning of the economy not just at the public sector, but also private companies. And since perceptions of corruption change only very slowly through time, decisive and long-range actions are needed to sharply modify these perceptions so that these damaging effects may be controlled as quickly as possible.

Still at the corporate level, Elvira-Lorilla et al (2023) analyse another dimension of the impact of corruption on corporate financial decisions, the decision to invest in liquid assets. Acknowledging that existing theories suggest either a positive ("*bribery hypothesis*") or negative ("*shielding hypothesis*") sign for the impact of corruption on cash holdings, the authors analyse the influence of corruption at both the country and firm levels. In this context, the authors take the novel approach of considering the anti-bribery or anti-corruption policies in place at the firm according to its Corporate Social Responsibility (CSR) practices as a proxy for

its corruption exposure. Taking a sample of 1219 listed firms from 21 EU countries for the period 2008-19, the authors then show that corporate anti-bribery policies provide a partial mediating effect on the (negative) relation between country-level corruption and cash holdings. Specifically, Elvira-Lorilla et al (2023) report that the lower the country's corruption level, the stronger the company's anti-corruption policies. In turn, stronger policies of this kind are observed to lead to an increase in cash holdings. This last result is consistent with the perspective that with stronger anti-corruption policies at the firm level there is a reduced risk of the firm being a target for corruption (expected under the “*shielding hypothesis*”, found to be consistent with the authors’ empirical findings). In a nutshell, one may infer that country level corruption practices lead firms to implement potentially less optimal cash policies. However, firms may react to a more corrupt environment by implementing CSR policies that are more stringent on fighting corruption therefore potentially helping to re-establish more adequate cash policies. As in other papers published in this special issue, one relevant conclusion is that anti-corruption practices at the public sector and firm levels are anything but complementary: both can be a significant influence on fighting corruption but probably work best when implemented simultaneously.

The impact of corruption on corporate investment is further explored in a European setting by García-Gómez et al (2023). These authors report, as in previous research, evidence consistent with the “sanding the wheels” hypothesis of a negative impact of country-level corruption on investment but observe that this can be moderated by cultural elements (Hofstede, 1980, 1991; Hofstede et al, 2010). Accordingly, the authors document that high levels of uncertainty avoidance, power distance, masculinity and indulgence lead to an increase in the magnitude of the impact of corruption on investment. Conversely, longer term orientation and individualism have the opposite effect. An interesting consequence of the author’s analysis is the recognition that the fight against corruption must be adapted at country level according to national cultural characteristics. Another inference is the encouragement of governmental policies that could provide a greater focus on, and incentives for, a longer-term perspective in corporate decision-making. The same could be said about ensuring a greater stability in public policies and in the legal or fiscal environment so as to reduce uncertainty levels for the corporate world as much as possible. So, even if cultural dimensions change only slightly through time, still some measures may exist to prevent the worst of damages of corruption on investment and economic growth.

In the final paper of this special issue, Alcántara et al (2023) investigate the driving factors for the effective usage of European Structural and Investment Funds, assembling for this purpose a new database of 1024 programmes for the period of 2007-14. The authors report that basically all the programmes analysed do not meet the initial deadline and need an extension in order to spend the full amounts allocated. They also find that 45% of the funds are not used by the initial deadline and a tenth of the programmes fail to use over 10% of the allocated funds. When investigating the causes for the ineffective usage of funds, Alcántara et al (2023) observe that not just the institutional environment (accountability, law and order, corruption perception) are relevant factors but so are the quality of management and education at the public level. One thus could conclude that aside from the fight against corruption and improvement in public sector accountability, investing in education and in the reinforcement of management quality of public officers could be key drivers for a more efficient usage of EU funds. Some potential solutions that one may speculate about to address this issue could well be the reinforcement of meritocracy (Charron et al, 2017), the adoption of more attractive remuneration systems or managerial incentives (Mwitta, 2000) and, as suggested by the authors, even the outsourcing of fund management. But this is ultimately no more than extending well-tested private sector management principles to the sphere of the public sector.

#### 4. Conclusions and Future Research Directions

The papers in this special issue suggest that the fight against corruption in the EU is a complex one. A relevant insight is that a number of improvements in public policies can be useful for achieving this goal.

One is the reinforcement of better disclosure requirements of corruption-related matters for the banking industry (and, we could argue, other sectors as well), as suggested by Andrés et al (2023). The benefit of this would be to improve the ability for banks secure funds under better terms, and thus help the financing

of the entire economy. In more general terms, it could also help to reduce the Corruption Perception Index of the country, a dimension that has been observed to change only too slowly over time, with the benefit of creating better conditions to finance investment and spur economic growth.

A second sphere where public actions could also be relevant is the creation of direct incentives and governmental policies to overcome cultural obstacles in the form, for instance, of little long-term orientation and high levels of uncertainty avoidance, as is the case of many of the GIPSI countries covered by Andrés et al (2023). This could include the definition and provision of incentives for long term corporate and public goals. But also a greater stability of government policies and of the regulatory and legal environment fostered by the enforcement of an enlarged political consensus over these goals in each country.

A third area that is pertinent to public actions was suggested by Alcántara et al (2023) in the context of the management of European Structural and Investment Funds. This is the creation of conditions for improving management quality and education of public officers, which, as we argued, might be done through means of a greater focus on meritocracy and the implementation of adequate remuneration systems that could incentivize a continuous improvement of the quality of public management.

However, government actions alone are not sufficient for an effective fight against corruption in the EU. As Elvira-Lorilla et al (2023) in this special issue observe, the adherence to anti-bribery or anti-corruption corporate policies in the context of a firm's Corporate Social Responsibility (CSR) practices can provide a strong signal for its commitment to fight corruption. Indeed, as these authors show, in firms where this is observable an effect is found on its cash holdings policies. This of course can only take place if conditions exist for adopting adequate crucial corporate governance systems while adopting a strong anti-corruption corporate culture (Liu, 2016). Thus, just as firms can benefit from better funding conditions when the country-level corruption perception is lower, it is also possible to avoid some of the worst consequences of corruption by adopting strong firm-level anti-bribery policies. If these two forces are at work simultaneously then this is likely to compound their individual effects.

There are several other interesting future research directions for studying the causes, effects and mitigating factors of corruption in the EU. First, the impact of EU institutions and policies on corruption: There is most certainly a need to study in greater depth, and particularly within a financial and governance perspective, the impact of EU institutions and policies, such as the European Anti-Fraud Office (OLAF) and the European Public Prosecutor's Office (EPPO), on corruption in the EU. This could include an analysis of the effectiveness of these institutions in preventing and prosecuting corruption, as well as the challenges they face in their work and their impact in the corporate world.

A second area of interest could be the examination of the relationship between corruption and economic inequality in the EU. This could include an analysis of how corruption affects income and wealth distribution, as well as the impact of anti-corruption policies on reducing economic inequality.

Also, comparative studies of corruption levels and trends in different EU countries could provide valuable insights into the factors that contribute to corruption in specific contexts, as well as the effectiveness of anti-corruption policies in different settings.

Research could explore more deeply the link between corruption and environmental sustainability in the EU. This could include an analysis of how corruption affects environmental policies and regulations, as well as the impact of anti-corruption measures on promoting sustainable development.

Finally, with the increasing use of digital technologies in government and business operations, research could well investigate further how corruption manifests itself in the digital era and explore the potential of digital technologies to prevent and detect corruption.

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