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1

Introduction

1.1 Introduction

Multinational corporations (MNCs) play a critical role in the global economy. By most estimates, production by multinational enterprises now accounts for over one-fourth of the world's output and one-third of world trade. Moreover, many scholars believe that the investments of multinationals, commonly known as foreign direct investment (FDI), have beneficial effects on economic growth, transferring technology and managerial expertise as well as providing capital.

A rich literature exists on firm-level decisions about FDI, but much less rigorous attention has been devoted to the national level. Why do certain countries attract multinational firms? Conventional wisdom holds that nations woo multinationals by lowering taxation levels. This act, in turn, results in invidious fiscal competition—the race to the bottom (RTB) thesis, as this phenomenon commonly appears in the literature.

In this study I show that the fiscal competition among governments to attract FDI has been grossly exaggerated. Fixation on the race to the bottom thesis has diverted attention from an even more important factor—the major political determinants of FDI flows. Foreign direct investment entails a substantial and lasting ownership stake in a venture in a host country. Activities of host governments affect the economic performance of the economy. Thus, perceptions about future conditions and future economic policies in the host inform investment decisions today. I assert that political factors have a marked influence on these decisions: governments that can commit to future economic policies conducive to multinationals' interests will achieve higher levels of FDI inflows.

In this book I argue that political institutions that provide commitments to these "market-friendly" policies for multinationals will systematically attract higher levels of foreign direct investment inflows. Which government policies prove beneficial to multinational operations? Which political institutions provide multinational corporations with credible commitments to these market-friendly policies? These emerge as the central questions of this book.

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My overall theoretical perspective underscores that political institutions can provide credible commitments to sets of economic policies. In other words, political institutions can enhance the stability of economic policy, directed toward both multinationals (levels of taxation, for example) or more general economic policy that affects the domestic market. Institutions affect policies, and policies affect multinational operations.

My argument does not state that multinational corporations prefer static government policies. Strong economic performance necessitates policy change in a world of dynamic political and economic conditions. In the global economy, governments must make adjustments to economic policies according to the domestic economic situation (monetary and fiscal policy) and negotiate with other nation-states on the terms of international economic agreements (bilateral treaties, monetary cooperation, work within international organizations, etc.). For institutions to have value, they must allow for the policy flexibility required for changing economic conditions.

For example, in the realm of monetary policy few economists argue that governments should have fixed monetary policy (with the exception of some monetarists and their proposals on monetary constitutions). Instead, most scholars argue for the independence of central banks, institutions isolated from short-term political pressures, but not completely unaccountable to the country's citizens.[1] In short, independent central banks are institutions that limit policy autonomy and partisan control of monetary policy, but they also maintain some degree of policy flexibility. Elected politicians can no longer manipulate monetary policy, but monetary policy does remain responsive to changing economic conditions.

The main thesis of this book centers not only on the fact that political institutions that provide credibility are valuable to multinationals, but also that these institutions must be analyzed within a dynamic context. Political institutions that can make credible commitments to some level of policy stability and retain the necessary policy flexibility foster an environment multinational corporations desire. That is, political institutions must provide commitments to market-friendly policies both today and in the future. Those that can make this intertemporal commitment to multinational corporations will attract higher levels of FDI.

In this book I discuss and empirically test the the impact of three varieties of political institutions on flows of foreign direct investment in one hundred countries from 1970 to the present. I supplement my quantitative analysis with a series of interviews with representations of multinational corporations, investment promotion agencies, investment location consultants, and political risks analysts and insurers.

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First, I argue that democratic political institutions can provide promises of market-friendly policies. The literature on the democratic peace points to a number of causal mechanisms linking democratic institutions to higher levels of credibility in the international system. Many of the same mechanisms also translate to higher levels of credibility when dealing with multinational firms. The institutional checks and balances associated with democratic systems decrease the likelihood of policy reversal, providing multinationals with a de facto commitment to policy stability. This policy stability allows multinationals to more accurately forecast budgeting needs according to future macroeconomic conditions and tax schedules, to hedge against currency risks, and to make managerial decisions in response to the predicted macroeconomic environment. In general, policy stability provides multinationals with greater assurances that the conditions that promoted entry into the market in the first place will persist.

Although multinationals value policy stability, democratic institutions also create incentives for governments to pursue policy changes that favor multinational corporations as well. I argue that the "audience costs" associated with democratic governance provide political leaders with the proper motivation to tailor policy toward multinationals.

In response to any negative policy change, multinationals can threaten political leaders that harm multinational operations by refusing further investment in the country, or by pulling out existing investments. This possibility exists in both types of political systems—authoritarian or democratic. Unlike authoritarian regimes, however, in democratic systems citizens have the ability to replace leaders with tarnished reputations through electoral mechanisms. Voters who want to reap the benefits of future FDI will choose candidates with the best reputations on election day. Therefore, political leaders must be wary of developing bad reputations, leading them to avoid policies that hamper multinationals' operations. While this system does not guarantee market-friendly policies, legislation that hinders multinationals in democratic societies nonetheless generates substantial political costs for leaders because the political position of multinationals proves even more "privileged" (in Lindblom's 1977 terms) than that of domestic businesses.

Second, I argue that veto players, defined as institutions that can block or stall policy change, can have a positive impact on multinational corporations. However, these veto players, like central banking arrangements, are complex, and simply providing a bias toward the status quo (make policy difficult to change) doesn't guarantee a more conducive environment for multinationals. I argue that one type of

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veto player demonstrates the important properties of credibility and flexibility: federal political institutions.

I define federal political institutions as institutions that allow regional units (states or provinces) representation at the national level. In the United States, states have both constitutionally guaranteed rights and institutionalized representation in the Senate (senators are selected from states). In other countries, such as Malaysia, subnational units have a formal veto over legislation. While the institutional structure of federal systems varies, I argue that one common theme exists. Federal political institutions increase the number of veto players in a political system and hence promote the kind of policy stability that multinationals like. Policy changes less readily as subnational governments become involved in national policy either through representation in one or both houses of a legislature or through the existence of formal veto authority.

Moreover, political federalism tends to produce market-friendly policies. Unlike Weingast's (1995) "market-promoting federalism" argument, I do not contend that competition among subnational units leads to market-friendly policies; rather, the differing incentives of subnational units from the central government regarding the treatment of multinational corporations holds the key to ensuring their enticement. That is, competition between states for multinationals holds little explanatory value. Instead, the complex relationship between the central government and subnational governments provides assurances of future economic policies that multinationals will prefer.

I argue that central governments have incentives to renegotiate policies with multinationals, such as taxation rates, after investment takes place, or to change macroeconomic policy without regard to the effects on multinationals. Indeed, a time inconsistency problem of government policy toward multinationals emerges. Governments often promise multinationals the world prior to investment, but once that commitment has been made, the central government has incentives to backtrack on these enticements. In centralized (nonfederal) systems, the national government must weigh the benefits of policy change against the negative reputation effects to the central government. In these systems, governments suffer constraints only when reneging on a contract with a multinational affects their reputation and thus their ability to attract other multinationals in the future.

In federal systems the incentive structure differs slightly. Although FDI benefits national economies in the aggregate, many of the specific goods are local, such as employment creation and spillovers on the local economy. I argue that these localized benefits depend on the pro-

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ductive operation of the multinational firm. Thus, subnational units possess both the incentive and the ability to veto legislation that would hamper the operations of the multinational, leading these corporations to prefer to invest in these types of systems.

One theme of this book centers on the effect of federal institutions on foreign direct investment inflows. I find that *politically* federal institutions, those that give regional units (states or provinces) representation at the national level, attract more FDI than unitary regimes. On the other hand, *fiscally* federal institutions, those that give regional units (states or provinces) the ability to tax and spend autonomously from the central government, have no impact on multinationals' investment decisions.

Third, I explore the impact of the International Monetary Fund (IMF) on foreign direct investment inflows. Countries in economic crisis sign agreements with the IMF that provide capital and conditions on future economic policies. IMF conditionality ties future loan disbursements to specific economic policies. One might think that IMF conditionality should help lock governments into a particular, market-friendly, policy equilibrium, spurring higher levels of policy stability and therefore leading governments under IMF programs to attract higher levels of FDI.

I argue, however, that while IMF agreements do promote policy stability, they also promote policies that do not attract multinationals. The IMF conditions loans on economic reforms, highlighting fiscal austerity among other things. These plans often lead to decreased spending on market-promoting public goods such as education and infrastructure—both of which are important to multinationals.[2] IMF conditions may actually increase political instability and social unrest by prescribing austerity policies in low-income and middle-income countries. These policies can create a societal backlash that may lead to escalating levels of protests and violence, along with electoral instability as incumbent governments fall from office. On balance, the IMF loans, and the conditionality associated with these funds, may increase levels of policy stability, but multinationals perceive them negatively due to the political and economic effects of these policies.

In an analysis of the impact of IMF programs I find that countries under IMF agreements tend to enjoy lower FDI inflows. These countries attract 28 percent less FDI, even when controlling for the macroeconomic factors that led these countries to seek IMF support in the first place. These results provide clear leverage over what has become a dense research thicket in recent years—the effects of political institutions on growth. No consensus exists, for example, on whether democ-

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racy, federalism, and IMF programs promote economic growth.[3] If FDI significantly drives growth, my results have powerful implications for the policy choices of national governments and for the behavior of international institutions such as the IMF.

1.2 The Conventional Wisdom: The Race to the Bottom Thesis

The myth of capital mobility hinders our ability to understand FDI flows. Much of the literature on the competition for FDI assumes that multinational corporations remain mobile in their investment decisions. According to this perspective, multinationals search the world for investment opportunities, playing governments against one another, entering and exiting domestic markets at will in an attempt to obtain higher returns. However, this view of high capital mobility—of frictionless investment across national borders—contravenes decades of research on FDI that has focused on *imperfect* market approaches in the study of multinational firms.

The race to the bottom thesis rests on this myth of high capital mobility. Scholars who argue this position assert that domestic governments must pander to multinational corporations, attracting them with the only viable tools at their disposal: regulation and fiscal policy.[4] Domestic governments, for example, loosen environmental protection, relax labor standards, and alter patterns of government fiscal policy. Governments must attract multinationals, the proponents of this thesis contend, by decreasing levels of capital taxation, leading either to lower levels of government spending or a shifting of the burden of taxation from capital to labor.

In reality, multinational investments, while relatively liquid ex ante, become much more illiquid ex post.[5] Once a multinational corporation commits resources to an investment location, it remains relatively immobile. Although multinationals may enjoy considerable bargaining power prior to investment, a large degree shifts to the host government once it secures the deal.[6]

This ex-post immobility of multinationals forces firms to try to predict the future policies of host governments. Politicians may attempt to make assurances on future policies, but governments have the incentive to change policy once a multinational has devoted substantial resources to the project.[7] Governments that can credibly commit to a specific policy equilibrium, ensuring policy stability, should attract higher levels of FDI by lowering political risks for multinationals. More importantly, governments that can offer market-friendly policies assure multinationals of a favorable policy environment for their oper-

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ations. This ability to provide multinationals security on future policy proves central to attracting FDI.

By ignoring the complexity of investment decisions, the race to the bottom thesis overemphasizes the importance of fiscal competition for FDI and downplays the importance of the political factors that affect government policy. The following sections elaborate on the importance of political institutions on FDI inflows.

1.3 Democratic Institutions and FDI: Theory

The role of democratic political institutions on foreign direct investment remains seriously understudied. Many scholars and pundits argue that multinationals prefer to invest in dictatorships.[8] Dictators do not respond to an electorate, giving authoritarian leaders more room to maneuver and negotiate with multinationals. Although this argument seems persuasive, the view that multinational enterprises prefer authoritarian regimes is presumptuous. Indeed, few studies have actually examined the links between political regimes and multinational corporations. Given the tremendous literature on the effects of democracy on economic performance and international relations, these links between multinational corporations and political regimes remain glaringly underdeveloped. Even if one assumes the argument that multinationals prefer to bargain with authoritarian leaders, a number of other channels emerge through which democracy could affect FDI inflows.[9]

Profit-maximizing multinational enterprises will weigh the varying factors that impact operations in host countries. In this book I identify three mechanisms—information, representation, and credibility—through which these companies prefer democratic institutions over authoritarian regimes for their investments. These three mechanisms are:

Information. Democratic countries attract multinationals because of the better information available on government policy and current political and economic conditions. A large literature on the democratic peace in international relations highlights the role of information and democratic governance.[10] Democracies offer more transparency, both in their economic and political affairs. Moreover, domestic political processes produce commitments to external actors in democracies (Gaubatz 1996; Bennett 1997). These domestic political processes provide information to investors, allowing multinational firms to react to proposed changes in government policy before they are enacted.

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Representation. Foreign investors may find avenues to pursue favorable policies, either directly or indirectly. Foreign investors can lobby government officials directly for their preferred legislative outcomes in democracies, but not in autocracies. Hansen and Mitchell (2000) find that foreign firms in the United States engage in lobbying activity just as frequently as domestic firms. As Hillman and Ursprung (1988) state, "Under representative democracy, foreign participation in domestic politics can take the form of campaign contributions, or other transfers directly aimed at influencing the trade-policy position taken by a political candidate."[11] The difficulties of influencing policy in authoritarian regimes negatively affect overall FDI inflows.

Even more importantly, MNCs may find vested interests in democratic systems already in place. A foreign MNC, once it sinks capital into a country, shares many of the same preferences as domestic producers.[12] If these democratic systems take the domestic producers' interests into account, the government will provide legislation favorable to the domestic producers and foreign investors.

Authoritarian regimes, however, may offer businesses the opportunity to influence policy decisions as well. Much of the nonacademic literature on multinationals assumes that firms prefer to bargain with authoritarian regimes, where authoritarian leaders appear willing to offer them substantial influence over government policy. According to this theory, authoritarian regimes would attract higher levels of investment.

Although this argument seems logically compelling, little empirical support exists that multinationals prefer to influence policy through these channels. For example, Wei (2000) finds that multinational corporations prove reluctant to invest in political systems with high levels of corruption. Multinationals may be more than willing to engage in corrupt deals with authoritarian leaders, but lobbying stands as the preferred mechanism for influencing policy.

Credibility. Although democracy's effect on information and representation remains important, in this book I stress its policy-enhancing nature. As highlighted earlier, multinationals face large political risks in their investments. Governments, or more specifically political institutions, that can help to decrease these political risks will attract higher levels of FDI, all else being equal.

Democratic governments make agreements with other nation-states credible (Cowhey 1993; Fearon 1994; Gaubatz 1996; McGillivray and Smith 1998; Leeds 1999). Explanations for this fact from previous scholarship range from the institutional checks and balances within democratic systems to the "audience costs" generated by elected leaders. Logically following from this large literature, democratic governments

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may also be more credible in their dealings directly with multinationals for these same reasons. These institutional features of democracies lead to higher levels of FDI inflows.

One mechanism that leads democratic governments to higher levels of credibility in terms of economic policy rests on the number of veto points in a democratic political system. These veto players can include chambers of the legislature, a supreme court, separation of the executive and legislative branches of government, or federal actors.[13] Democratic governments have these institutional constraints in place, making the possibility of policy reversal more difficult. As argued earlier, multinationals offering large illiquid projects may prefer to focus on countries where a lower probability of policy reversal exists once the investment has been made.

More importantly for multinationals, democratic institutions provide them benefits through the existence of audience costs. International relations theorists find democratic leaders accountable for their actions, including reneging on a promise or threat. These audience costs can also affect multinational investors. If governments make agreements with multinational firms and renege on the contracts after the investment has been made, democratic leaders may suffer electoral costs. The potential for these electoral backlashes may constrain these leaders.

Some scholars would be quick to point out that democracies experience higher levels of leadership turnover, which could have a negative impact on policy stability and ultimately country credibility. This theory was not supported by the qualitative evidence I collected for this project. Conversely, most interviews with multinational corporation representatives, investment promotion agencies, and location consulting firms supported the theory that democracies provided lower levels of political risks for multinationals. According to an interview with the deputy head of the Latin American Research Department for UBS Bank, democratic systems may lead to slightly more political volatility, but they provide less risky environments. This same theme ran through most interviews.

McGillivray and Smith (2000) point to a way in which leadership turnover could be associated with higher levels of credibility. They argue that political leaders play an "Agent Specific Grimm Trigger Strategy" where political leaders refuse to cooperate with other political leaders that have "defected" in the past. Multinationals can also play this strategy with governments that institute legislation or reverse policy in ways that negatively affect multinational corporations. Essentially, firms can hold individual leaders politically accountable for policy and refuse to cooperate (invest) in the future. In democracies, citi-

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zens who value the benefits of multinational production have the incentive and the opportunity to replace leaders with tarnished reputations through electoral mechanisms.

Given the influence of democracy on policy stability and content, I predict that the overall effect of democratic institutions should be positive. Democracies should be associated with higher inflows of FDI. Also, given the importance of these policies on the profitability of multinationals, the effects of these institutions should be comparatively large. The empirical results discussed later confirm both of these predictions.

1.4 Veto Players and FDI: Theory

Given the tremendous political risks of investments, multinationals want reasonable assurances on future policies. Multinational corporations may prefer to invest in countries with an institutional environment that biases policy toward the status quo. Dramatic policy change proves difficult, leading to a lessening of political risks. Henisz (2000) proposes this argument.

Two problems plague this logic. First, as Treisman (2000a) shows in the case of federalism and inflation, institutional structures that make policy change difficult can lead to either better or worse inflation performance. These status quo institutions, or veto players in the language of Tsebelis (1995, 2002), lock countries into an inflation equilibrium. Countries with policies conducive to low levels of inflation maintain future low levels of inflation. Countries with high levels of inflation become trapped, where current policies adversely affect inflation levels but resist change because of the institutional environment.

Using this reasoning, we would predict that countries with good or market-friendly policies toward multinationals benefit from a higher number of veto players. Countries with environments not conducive to multinational corporations (and attempting to attract FDI) struggle to implement necessary economic reforms because of the status quo bias of the institutional environment.

Second, a richer theory on the relationship between veto players and multinational corporations needs to be developed further. Veto players may exist within in the political system, but they need incentives to overrule policy change that would harm multinationals. A clear understanding of the institutional structure and preferences of the veto players remains necessary to understand their impact on FDI inflows.

I argue that while looking at the overall number of veto players reveals little about FDI inflows, certain types of veto players can grant market-friendly policies for multinationals. Politically federal institu-

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tions can provide these benefits to multinationals. Subnational actors can potentially offer "veto points" within the political system that enhance the credibility of host governments. The value of these veto points depends on the exact type of federal institutions.

An important theoretical distinction exists between political federalism and fiscal federalism that must be untangled to understand the independent effects of these institutions on multinational production. Before embarking on a discussion of *political* federalism and *political* decentralization, one must contrast these political arrangements with the growing literature on *fiscal* federalism and decentralization. Fiscal federalism and fiscal decentralization entail a degree of regional government autonomy from the central government in both taxing and spending. Although these works on fiscal decentralization provide important academic contributions, they miss an important institutional element of federal systems.

Weingast (1995) amends the literature on fiscal federalism, arguing that for states to be "market-preserving" federal countries, five conditions must be met:

1. A *hierarchy* of governments with a clear scope of authority must exist.

2. The *autonomy* of each government must be assured through some set of institutions.

3. The subnational governments are the primary agents responsible for *regulation* of the economy.

4. A *common market* of free trade between subnational units is guaranteed.

5. Subnational units face a *hard budget* constraint.

Weingast stresses that while the first two conditions may ensure a politically federal system as envisioned by Riker (1964), the final three conditions are necessary to give the subnational units enough autonomy to constrain the central government.

The definition of *politically* federal systems employed in this analysis is based on political relationships between the central government and local/regional governments. In contrast to Watts's (1999) conception of federalism as a combination of "shared-rule and regional self-rule," the working definition of political federalism in this study rests solely on the shared-rule dimension.[14] Specifically, political systems where regional actors affect *national* policies epitomize politically federal systems.

Political federalism differs from political decentralization, which encompasses the second part of Watts's definition, self-rule. Regional units often hold functional authority over certain policy areas, including autonomous regions within a polity that possess some degree of political autonomy but no real effect on the crafting of national policy.

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The working definitions of these three concepts are:

1. *Fiscal Federalism*: Subnational units hold the primary responsibility of spending and raising revenue as well as regulating economic activity within their subnational territorial area.

2. *Political Federalism*: Subnational units do not tax and raise their own revenue but do help craft national policy. They also shape (in ways that will be described later) legislation at the national level.

3. *Political Decentralization*: Subnational units have autonomy over policy within their subnational territorial unit, short of taxing and spending their own revenue. They have no role in creating national policy.

These differing conceptions of federalism have potentially different effects on FDI inflows. Although most studies focus on the market-enhancing nature of fiscally federal systems, political federalism could provide substantial benefits to multinational investors. In politically federal systems, subnational units can provide a de facto veto on central government legislation.

This increase in the number of veto players provides higher levels of policy stability in a Tsebelis-style framework. More importantly, I argue that these veto players in federal systems have the incentives and the power to protect the operations of multinational firms. Multinational investments provide benefits to the nation as a whole (the central government) and benefits that are localized (concentrated in one or more subnational unit). Benefits include increased tax revenues, technology transfer, and foreign exchange at the national level and employment creation at the local level. These localized goods depend on the profitable operation of the multinational firm.

In a simple model constructed in chapter 4, I show that these differing incentives of the central and subnational governments can provide multinationals with a credible commitment to market-friendly policies. This market-preserving federalism only occurs within systems where the central government holds the power of taxation and subnational units have some degree of political power. Only *politically* federal systems provide commitments to market-promoting policies. These political systems attract higher levels of FDI.

1.5 International Monetary Fund Agreements and FDI: Theory

Although domestic political institutions can have major effects on government policy, and ultimately FDI, international institutions can also affect policy in ways that affect FDI inflows. In chapter 7 I explore the ramifications of signing agreements with the International Monetary Fund on FDI inflows. Countries in severe economic crisis turn to the

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IMF for "lender of last resort" funds. These funds often come with explicit IMF conditionality, where disbursements of IMF funds hinge on specific macroeconomic reforms.

Signing a loan agreement with the IMF can provide international investors with a limited credible commitment to a specific package of future economic policies. Countries that sign IMF agreements face more than just reputation costs; they will incur actual fiscal costs in terms of lower levels of funding from the IMF for reversing policy. IMF packages should decrease the level of policy instability.

Unlike democratic institutions and federal institutions, IMF packages, while decreasing policy instability, do not ensure market-friendly policies. There are theoretical arguments for both positive and negative effects of IMF programs on domestic economies. Financial markets, in this case FDI flows, should provide the answer to whether or not foreign investors value these reforms. Economic reforms that will stabilize the economy and provide the foundation for robust future macroeconomic performance should be valuable to multinational corporations. Countries that sign IMF agreements should then be associated with higher FDI inflows.

At the same time a possibility exists that IMF programs could have a detrimental effect on multinational investors. Signing of IMF agreements could lock governments into an inefficient policy equilibrium. If the conditionality associated with IMF loans proves worse than the current economic policies, foreign investors will react negatively to IMF agreements.

Although on the surface this explanation may sound far-fetched, the negative impact of IMF policies is a distinct possibility. The IMF often prescribes austerity packages that may impose political and economic costs on domestic economies and multinational corporations.[15] For example, IMF conditionality may impose spending constraints on domestic governments. Governments must slash government spending to conform to agreed upon budget deficit levels. This decrease in spending can translate into a lower provision of public goods, such as education and physical infrastructure. If IMF conditionality forces governments to provide lower levels of market-enhancing public goods, multinationals may react negatively by refusing to invest in these countries.

Perhaps even more damaging, I argue in chapter 6 that the institutional structure of the IMF could lead to economic policies too "austere" to promote long-run macroeconomic recovery. Using a simple theory adapted from the literature on central bank independence, I argue that the system of weighted voting by relatively conservative actors leads to preference biases toward an overcontraction of the domestic economy.

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Given this relationship, no a priori reasons exist why one should assume that the macroeconomic reforms prescribed by the IMF would attract foreign investors. They may provide credible commitments to a specific policy equilibrium, but the value of this equilibrium to foreign investors is unknown at best, and leads to an overcontraction of the domestic economy at worst. The overall effect of IMF agreements on FDI remains strictly an empirical question. The empirical results discussed below find a strong negative relationship between IMF programs and FDI inflows.

1.6 The Race to the Bottom and FDI: Empirical Results

In chapter 4 I study the effects of government fiscal policy decisions on FDI inflows. In an analysis of fifteen OECD countries from 1970 to 1993, I test the race to the bottom thesis by estimating the impact of taxation and spending on FDI inflows.[16] Contrary to the race to the bottom thesis, I find no support that levels of capital taxation, labor taxation, or social security transfers negatively affect FDI inflows. I also find no obvious relationship between partisan composition and the levels of FDI inflows.

The only support I find for the race to the bottom thesis rests on the fact that levels of government spending do affect FDI inflows, but not in the way that most scholars suggest. Indeed, I find that the overall level of government consumption across countries does not impact FDI inflows. On the other hand, some evidence exists that firms respond to levels of government spending. I conclude that firms respond to levels of government consumption, but no real pressure appears for the highest consumption (and tax) countries to conform to the policies of the lowest consumption (and tax) countries. In conclusion, I find very little overall support for the race to the bottom thesis.

1.7 Democratic Institutions and FDI: Empirical Results

In this book I examine the relationship between FDI and democratic institutions using a number of ordinary least squares (OLS) regressions. The first set of regressions relies on cross-sectional data for eighty countries on the determinants of FDI in the 1990s. These regressions reveal that democratic political institutions promote as much as 78 percent more FDI flows than authoritarian regimes. These robust results stand even when I control for other political factors.

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A second set of regressions uses panel data to explore the effects of democratic institutions on FDI inflows from 1970 to 1998 for over one hundred countries. In this set of tests, I construct a number of Ordinary Least Squares regressions with robust standard errors using annual FDI inflows as a percentage of GDP for the dependent variable. As with the cross-sectional results, these regressions uncover that democratic institutions have a positive and statistically significant effect on FDI inflows. Moreover, these flows prove massive, with democratic institutions attracting almost 70 percent more FDI as a percentage of GDP. The cumulative effect of democratic institutions after ten years of continuous democracy amounts to an added stock of FDI of roughly 20 percent of GDP.

In the third set of empirical tests, I correct for the selection bias in democratic institutions by using a treatment effects selection model. As pointed out by Przeworski et al. (2000), the study of the economic effects of political regimes suffers from this selection bias. Democratic institutions in low-income countries seldom survive, collapsing into authoritarian regimes and leaving us with few observations of democracies in these low-income countries. Since these lower income countries often attract high levels of FDI as a percentage of GDP, the standard OLS regressions are biased against democratic institutions.

Using this selection model, I find the regressions biased and the effects of democratic institutions on FDI vastly underestimated. The selection-corrected estimates of the effects of democracy emerge roughly three times larger than the OLS results. Democratic institutions positively affect FDI inflows even more than originally estimated.

The final set of empirical tests explores the credibility-enhancing nature of democratic institutions by analyzing the effects of democracy on country sovereign debt ratings for eighty countries from 1980 to 1998. While not a direct test of the credibility-improving character of democratic institutions for multinational investors, it does help us more clearly examine the causal mechanism. The ex-post/ex-ante bargaining nature of FDI parallels the dilemma faced by political leaders attempting to obtain loans from foreign lenders. Governments make promises on the repayment of a loan, but once secured these conditions may not be met. Reputation costs come with defaulting, but often the short-run political and economic incentives outweigh this consequence.[17] Creditors must attempt to predict the potential of default by examining the country's economic conditions and political institutions along with future world macroeconomic conditions. My empirical results find a strong positive and statistically significant effect of democracy on sovereign debt ratings.

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1.8 Veto Players, Federalism, and FDI: Empirical Results

To untangle the effects of political and fiscal federalism on FDI inflows, I employ a number of OLS time-series-cross-sectional regressions using net FDI inflows as the dependent variable. To test the independent effects of fiscal federalism and political federalism on foreign direct investment, I utilize three key independent variables. I operationalize fiscal federalism as the local government's share of revenue as a percentage of GDP from IMF sources.[18] For political federalism, I construct an ordinal measure of federalism from a number of sources for over one hundred countries from 1975 to 1995. To test the impact of veto players, I utilize a measure of veto players from the World Bank's Database of Political Institutions.

The estimated effects of political federalism on FDI prove positive and statistically significant. Politically federal countries attract higher levels of FDI, even when controlling for other political and economic factors. The effects on fiscal federalism and veto players are neither consistently positive nor are they statistically significant. These findings on the positive effects of political federalism and the null result on fiscal federalism and veto players have academic importance beyond the study of FDI flows. These results show that the economic effects of federalism hinge on the definition of federalism used. The lack of attention paid to these differing conceptions of federalism could help explain the lack of consensus on the overall effects of federalism on macroeconomic performance.

My final set of empirical tests explores the credibility-enhancing nature of subnational institutions by analyzing the effects of veto players, fiscal federalism, and political federalism on country sovereign debt ratings for eighty countries from 1980 to 1998. I find that both politically federal and fiscally federal systems have a positive impact on credibility for foreign lenders, while veto players have no impact.

1.9 International Monetary Fund Agreements and FDI: Empirical Results

To test the effects of International Monetary Fund agreements on FDI, I examine the effects of IMF programs on FDI inflows for one hundred countries from 1970 to 1997 using a number of time-series-cross-sectional regressions. Standard OLS analysis on this topic suffers from obvious selection bias; only countries in economic crisis sign IMF agreements. To correct for these effects I employ a treatment-ef-

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fects selection model. This model relies on annual observations of FDI inflows and corrects for the selection bias of countries under IMF programs by predicting IMF participation through a number of economic control variables.

The empirical results establish the selection-corrected effects of IMF programs negative and statistically significant. Countries that sign IMF agreements attract lower levels of FDI—28 percent less than other countries. These results remain robust under a number of alternative specifications.

1.10 Qualitative Evidence

One criticism of quantitative work is the inability to test the causal mechanisms. In my empirical analysis I show that democratic institutions, federal political structures, and relations with the IMF affect FDI inflows. To explore the mechanisms linking political institutions and policies to FDI flows, I engaged in substantial fieldwork in 2004, interviewing representatives from country investment promotion agencies, multinational enterprise location consultants, political risk analysts and insurers, and decision makers at multinational corporations. A complete list of all interviews can be found at the end of the References section. In these interviews I asked open-ended questions on what factors were important in multinationals selecting investment locations, and I followed up these questions with specific questions on how they evaluated the importance of specific policies and institutions.

First, I selected a number of investment promotion agencies with variation on the key independent variables. These investment promotion agencies are generally government agencies engaged in the marketing and facilitating of multinational investments. For example, the Thailand Board of Investment, a government agency chaired by the prime minister and staffed with government and private-sector officials, markets Thailand as in investment location and administers financial incentives to facilitate FDI. Most of these investment promotion agencies are often the first contact for multinationals considering an investment in their representative country and all of them routinely interact with multinational corporation's decision makers.

Table 1.1 lists the democracy, political federalism, and IMF participation average scores from 1970 to 1998 for the eight investment promotion agencies I interviewed. I will discuss the construction of these measures in greater detail in the following chapters, but for simple presentation I will briefly introduce each variable. Democracy is a 0–20 measure of the level of democracy, where 0 is an authoritarian regime

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TABLE 1.1.
Investment Promotion Agencies

Country	*Democracy*	*Federalism*	*IMF Packages*
Brazil	10.89	1.67	0.46
Bolivia	12.21	0	0.61
Canada	20	2	0
Costa Rica	20	0	0.64
Hungary	8.22	0	0.46
Ireland	20	0	0
Malaysia	14.79	2	0
Thailand	12.64	0	0.29
Dataset Average	9.87	0.24	0.30

and a 20 is a fully democratic regime. Federalism is a measure of subnational actors (states, provinces, etc.) and their influence over national policy. Federal nations are scored a 2, mixed nations a 1, and unitary states a 0. The IMF measure is the percentage of the years in my sample (1970–1998) that the country was under an IMF program. To be clear, Canada was fully democratic throughout the time period (Democracy = 20), federal (Federalism = 2), and was not under any IMF agreements during this period (IMF = 0). Brazil, on the other hand, is more complex. For much of the time period it was an authoritarian regime (Democracy = 10.89), although it maintained political federalism during much of the time period (Federalism = 1.67), and was under IMF agreements 46 percent of the time (IMF = 0.46). Thailand shares a similar authoritarian past (Democracy = 12.64), but it was consistently unitary throughout the period (Federalism = 0) and was under IMF much less regularly than Brazil (IMF = 0.29). These investment promotion agencies have substantial variation in these key independent variables both across countries and over time.

Interviews with these agencies generally confirm the empirical results presented in this book. First, few investment promotion agencies considered tax rates or financial incentives as primary motivations for multinational investments. The exception was Ireland's investment promotion agency, which argued that financial incentives are a central aspect of FDI decisions. Most conceded that taxes were important, but these were generally secondary considerations for multinationals.

Second, there is overwhelming support that political institutions are an important determinant of FDI. For countries such as Hungary and Costa Rica, these were key determinants of FDI. For some nondemocratic countries such as Malaysia, the investment promotion agency explained the electoral process and Malaysia's political system and argued that it is democratic. Other authoritarian regimes in the sample did

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point out the level of political stability or contract law, but at no point did they highlight their political system as a positive for multinational investors. Democratic countries were quick to point out their political institutions; authoritarian countries either claimed they were democracies or simply argued that these specific political institutions were not of central importance. No investment promotion agency made any claims that nondemocratic institutions were conducive to FDI.

Third, there is limited support for the impact of federalism and subnational policies affecting FDI. Most agencies argued that multinationals preferred the "one-stop shop" model where multinationals only had to manage relations with the central government. Some agencies did highlight how subnational governments quite often would ally with multinationals to push for favorable national policies, although this evidence was less systematic than the importance of democracy for multinationals. No investment promotion agency made claims about the number of veto points in the political system as an important determinant of FDI.

Fourth, most of the countries in my sample are either currently under an IMF agreement or have been under an IMF agreement in recent years. These investment promotion agencies held nuanced views of the role of IMF policies on FDI inflows. No agency made the claim that IMF agreements, and the conditions imposed with these agreements, had a positive impact on FDI. Most agencies argued that these were not serious considerations for investors. The exceptions are two countries with recent financial crises, Brazil and Malaysia. Interviews with the Brazilian central bank and representatives from the Brazilian stock exchange confirm that access to IMF capital was an important consideration for multinationals, although the specific conditions were not important. The agency responsible for investment promotion in Malaysia argued that Malaysia's decision to not take an IMF package after the 1998 financial crisis actually was viewed as the correct strategy by multinationals. In both cases, the evidence suggests that IMF capital can be important, but IMF conditions have no impact (Brazil) or a potentially negative impact (Malaysia) on FDI inflows.

I also interviewed representatives at political risk assessment and insurance organizations.[19] These interviews also provided more evidence on the causal mechanism linking specific political institutions to higher FDI flows. These organizations, such as the World Bank's Multilateral Investment Guarantee Agency (MIGA), Canada's Export Promotion Canada (EPC), and the U.S. Overseas Private Investment Corporation (OPIC), both engage in political risk assessment and provide political risk insurance. In their political risk models, which predict government expropriations, political violence, and government restrictions on capital flows, political institutions are important. In most

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models, established democracies are predicted to have lower political risks than most other types of political systems.

These interviews were relatively silent in terms of subnational politics. All interviews confirmed that counting the number of veto players had no real impact on political risks, while the evidence was murky on the impact of federalism on FDI inflows. Generally these agencies either ignored subnational politics, arguing that they were not central to political risk, or argued that federalism was a complex institutional structure, in some cases decreasing political risks and in other cases increasing political risks.

None of these models have formal measures of the number of veto players, nor specific conditions on IMF loans. They do, however, consider good relations with the IMF as an important determinant; for example, EDC argues this is a possible predictor of exchange rate controls, but it is flows of capital for crisis-prone countries that is important, not conditions. None of the models specifically examined the details of IMF conditionality.

As a further exploration of the causal mechanisms in this book, I interviewed representatives from three companies that provide plant location consultation. These consultants specialize in helping multinationals select sites for foreign investments. In most cases, consultants highlight that tax rates and tax incentives are not decisive factors for multinational investments, while political risks can have an important impact on multinationals' decisions. Interviews with representatives of these location consultants further support the empirical evidence presented in this book and highlight the causal mechanisms linking democracy and federalism to higher FDI inflows, and how IMF programs are often associated with lower FDI inflows.

Finally, I interviewed representatives from a number of multinationals firms that engage in activities in both developed and developing countries. These multinationals are large and small firms, representing a number of industries. Table 1.2 provides a list of the multinationals contacted, their industry and main product line. Interviews with key decision makers, company presidents, and public relations staff both support the empirical findings in this book and provide detailed evidence on how political institutions affect FDI inflows. None of the multinationals interviewed highlighted tax rates or tax incentives as the primary motivation for investment decisions. In many cases, tax rates had essentially no role in their investment decisions.

Numerous representatives of multinationals highlighted the benefits of investing in democracies, and no multinational made any claim that nondemocratic regimes provide a more conducive investment environment. Many multinationals, such as Alcan, simply stated that demo-

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TABLE 1.2.
Multinationals Interviewed

Company	*Sector*	*Main Product*
Alcan	Manufacturing	Aluminum Products
Citigroup	Service	Financial Services
Daimler Chrysler	Manufacturing	Automobiles
Inamed	Manufacturing	Medical Devices
Intel	Manufacturing	Semiconductors
L. L. Bean	Service	Textiles
Multi-mix	Manufacturing	Electronics
Weststar	Manufacturing	Contract Manufacturing
UBS	Service	Financial Services

Note: All interviews were conducted by the author with representatives of the national promotion agencies, with the exception of Brazil and Bolivia. For Brazil I interviewed an Investor Relations representative at the Central Bank of Brazil. For Bolivia I interviewed B-G Consulting, the company that facilitated a number of major investment promotions for Bolivia.

cratic governments provide lower risk environments. Other firms, such as Intel, articulated that their best insurance against adverse policy changes is to exert influence over the policy process. In systems where lobbying or other means of formal influence are most effective, usually in democratic systems, Intel is exposed to lower political risks.

Interview evidence on the role of veto players and federalism is a bit more mixed. No representative argued that the number of veto players in a system lowered political risks for the firm. Conversely, some multinationals did highlight the importance of local and regional governments in lobbying on behalf of the firm. This evidence was less systematic than the evidence linking democracy to lower political risks.

Finally, none of the multinationals argued that IMF conditionality helped reduce political risks or ensured a more favorable macroeconomic environment. Some firms, such as UBS, argued that IMF capital can be important, but IMF conditions are often aimed at performance targets and not appropriate policies. For many firms, IMF programs had little impact on perceptions of political risk. In chapter 7, I provide more details on these interviews.

1.11 Conclusions

The findings presented in this book, when incorporated with the existing work on FDI, provide an explanation of the distribution of foreign direct investment across countries. The empirical results point to

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the importance of political institutions on the political risks associated with foreign direct investment. These political institutions have massive effects on inflows of foreign direct investment. Understanding these political factors verifies comprehending the magnitude of the investments from multinationals. From a public policy perspective this book maps out the types of institutional arrangements most conducive to FDI.

These findings, while cumulatively adding to our general understanding of FDI flows, also debunks some myths of political institutions' effects on FDI. First, I show that government fiscal policy does not significantly determine FDI inflows. Government levels of spending and taxation affect FDI inflows in only marginal ways.

The relationship between multinationals and authoritarian regimes stands as another myth prevalent in public policy debates. Although the logic that multinationals prefer to bargain with dictators may have some conceptual appeal, a number of reasons exist why multinationals would prefer to invest in democratic regimes. Empirically the results prove rather conclusive—democracies attract more FDI.

A third myth relates to the market-preserving nature of federal institutions. As academic scholars debate the benefits of fiscal decentralization, and the World Bank pushes for fiscal decentralization in the developing world, the importance of more clearly understanding the effects of federalism on macroeconomic performance becomes even more important. This book stresses that the exact definition of federalism becomes central in more clearly understanding these effects. More specifically, the extensive focus on fiscal federalism and fiscal decentralization has overlooked the importance of political federalism.

Finally, and perhaps most timely in terms of public policy, the International Monetary Fund's role on macroeconomic performance needs examining. Recent debates have analyzed the effects of the IMF on long-run economic growth and short-term, portfolio capital flows. This study focuses on the nature of IMF programs on long-term, FDI inflows. These FDI inflows become important mechanisms for economic development and serve as an important barometer on the future of the economy. Essentially, by understanding how firms react to the signing of IMF agreements, we can examine how firms perceive the future of the economy. The empirical results in this book find that IMF programs lead to lower levels of FDI inflows.

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