SUBSIDIZING MULTINATIONAL CORPORATIONS: IS THAT A DEVELOPMENT POLICY?

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ABSTRACT

Foreign direct investment (FDI) is a major factor in the globalization scenario. However, contrary to the core pro-market tenets of the economic school supporting globalization, the flows of FDI have grown side by side with a whole array of FDI subsidies dispensed by the “visible hand” of the state. Scholars have studied the links between FDI and economic growth and between subsidies and actual flows of FDI, but scant attention has been paid to the links between subsidized FDI and development. This paper tries to fill that void by looking at the consequences of FDI subsidies for the fiscal deficit, competitiveness, social progress, democracy, governance, and cultural assets critical for development. Policy documents and the academic literature that touches tangentially upon some of these links show that subsidizing FDI has a negative impact on these development variables. I also consider policy issues related to development.

RESUMEN

La Inversión Extranjera Directa (IED) es un componente clave del proceso de globalización. Sin embargo, en oposición a los fundamentos de mercado del paradigma económico que acompaña la globalización, los flujos de IED han crecido a la par de una batería de subsidios otorgados por la “mano visible” del estado. La academia ha investigado la relación entre IED y crecimiento económico y el impacto de los subsidios en los flujos de IED, pero ha prestado poca atención a la relación entre IED subsidiada y desarrollo. Este artículo intenta llenar ese vacío, explorando las consecuencias de los subsidios otorgados a la IED en el déficit fiscal, la competitividad, la situación social, la democracia, la gobernabilidad y en algunos activos culturales que en el mediano plazo pueden ser de importancia crítica para el desarrollo. Artículos académicos que tangencialmente han estudiado el tema y documentos de trabajo, ofrecen suficiente evidencia como para afirmar que los subsidios a la inversión extranjera tienen consecuencias negativas en esos componentes del desarrollo. También se hacen algunas consideraciones sobre opciones de política.

INTRODUCTION

Most developing countries grant subsidies to foreign direct investment (FDI) as a key component of their development strategy, but the development consequences of that strategy have been neglected in the literature. My objective in this paper is to contribute to filling that void. I argue that such a strategy has a negative impact on critical development variables such as public finances, competitiveness, social conditions, democracy, governance, and entrepreneurial culture. I suggest that instead of continuing to engage in the subsidy race, most developing countries should coordinate the race's elimination and move on to attracting FDI through productivity fundamentals such as R&D, quality of the labor force, transparency, less red tape, better infrastructure, less crime, core public sector efficiency, rule of law, private property protection, social peace, and political stability.

Multinational corporations (MNCs) generate nearly one third of the world's output and an even larger proportion of world trade. They had been increasing their share of the world economy even before Washington Consensus–related reforms reshaped public policy all over the world and even before the Reagan-Thatcher-Xiaoping pro-market push at the end of the 1970s and the beginning of the 1980s. MNCs were able to penetrate even the protectionist and nationalistic settings prevailing in most of the developing world before open economic models became fashionable.

Many national and subnational governments, in both rich and emerging economies, have placed FDI at the center stage of their growth strategies.[1] Thus, from a situation in which there were severe controls on capital movements and narrow limits to foreign ownership, countries moved beyond just opening markets to granting a whole array of subsidies in order to attract FDI.

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[1] For the World Trade Organization (WTO) "FDI can be a source not just of capital, but also of new technology and other intangibles such as organizational and managerial skills, and marketing networks. It can also boost trade, economic growth, and employment in host countries, by providing a stimulus to the production of locally produced inputs, as well as to competition, innovation, savings, and capital formation. Furthermore, FDI gives the investor a stake in the future economic development of the host country. In short, it is a key element for promoting growth and progress in developing countries" (WTO 1996, Chapter 4).

This has been the norm in most countries, from one-party communist states such as China or Vietnam to Washington Consensus (WC)[2] loyalists such as Guatemala or near loyalists such as Chile, from small countries to large, and from poor countries such as Nicaragua to rich entities such as some US states and European countries, from fundamentalist Islamic Shiite states such as Iran[3] to officially Catholic ones such as Costa Rica.[4] So it appears that all ideologies, from the WC to communist state capitalism, have converged in setting their sights on subsidizing FDI as a key component of their development strategies. It does not matter if the country has a regime that has historically fought against capitalism and private investment or if the country proclaims the ideology of market forces. Both types of countries have acted the same when dealing with MNCs. Beyond merely tolerating FDI, countries have entered into fierce competition (referred to in the literature as "subsidy wars," "incentives bidding," or "tax competition") to attract MNCs by rolling out the red carpet with the "visible hand" of state dirigisme.

This remarkable convergence towards an interventionist—rather than "invisible hand"—approach to attracting FDI has occurred while international

[2] Throughout this paper "Washington Consensus" (WC) does not refer precisely to the policies John Williamson listed in his now famous 1989 paper "Latin American Adjustment: How Much Has Happened?" (Williamson 1990), where that term was coined. I use the term to refer to the overall market-oriented development policies fashionable since the beginning of the 1980s. Birdsall, de la Torre, and Caicedo (2010) make an important distinction on this matter. On the other hand, it is now common within academic and political circles in the United States to claim that the WC is no longer in vogue. That is a gross mistake. The free trade agreements (FTAs) drafted and pushed by the US administration and some Latin American business interests include some key components of the WC ideology plus a few more fundamentalist market tenets. In fact, FTAs are nothing less than WC Plus, enjoying such high-powered legal status that their modification would be more difficult than a modification of the constitutions of the poor countries that have ratified them.

[3] Iran has 24 free trade zones where it grants general tax exemptions and other advantages to foreign investors (Iran 2006). See also Ali Sarlak and Abolhasani Hastiani (2008).

[4] In Costa Rica the Free Trade Zone Regime grants beneficiary companies: 100 percent exemption on import duties on raw materials, components, and capital goods, 100 percent exemption on corporate income tax, 100 percent exemption on export taxes, local sales and excise taxes, and profit repatriation taxes, and 100 percent exemption on capital taxes, in addition to other benefits (CINDE 2010).

financial and trade institutions[5] have turned a blind eye to or even supported and encouraged the policy of subsidizing MNCs.[6] This in spite of the fact that these institutions have been unwaveringly harsh in their cross-conditionality towards poor countries concerning other neoliberal agenda issues such as privatizations, free trade, or deregulation. In fact, this approach to attracting FDI has become the most glaring of the unwritten tenets of the WC.[7]

Small countries such as Costa Rica, recognized as rather successful in terms of equality and social development, have become so committed to FDI that in the mainstream political narrative success is squarely equated with the flow of FDI. For example, it has been a long time since any Costa Rican president, in his or her May 1 address to Congress about the state of the country, has bothered to mention the number of micro or small firms created or how many small firms have grown or how many jobs have been created by these firms. In regard to FDI, however, there are detailed, nearly real-time statistics on job creation, investment, origin, location, sectors and subsectors, exports, etc. All these data are frequently used to herald the success of economic policy and have become the core components of presidential speeches and press conferences and of most media criteria to gauge government judiciousness.[8] Should anyone dare to suggest leveling the field,

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[5] Examples include the International Monetary Fund (IMF), the World Bank, the WTO, and some United States government departments (Agency for International Development, the Treasury, or the US Trade Representative).

[6] In fact what was expected, as Buthe and Milner put it, was that "…the central political problem for LDC host governments that want to attract FDI is how to assure foreign investors of their commitment to liberal economic policies" (2008, 744).

[7] The WC explicitly contemplated the elimination of subsidies and a broad tax base, both of which have little to do with policies of transfers and tax exemptions to FDI (Birdsall, de la Torre, and Caicedo 2010, 8). That is what makes the silence of the Washington institutions that promoted the Consensus concerning the proliferation of those subsidies so remarkable.

[8] Regarding policies towards small and medium enterprises (SMEs), ECLAC asserts that "the institutions that design these policies wield little influence and suffer from a shortage of effective policy instruments. In the 1990s SME-promotion agencies in several countries were raised to the ministerial or vice-ministerial level, but this higher status has not come hand in hand with more power to execute policy" (2010, 117). Ferraro also notices that in Latin America, policies supporting SMEs "are designed and executed by government departments without political weight, and they lack financial and qualified human resources and proper starting information" (Ferraro 2009, slide 14). His data show that, except for Uruguay, Costa Rica is the country in the region that budgets fewest

doing away with, or just taming some of the magnanimous incentives that benefit MNCs, he or she would be accused of endangering investment, jobs, and exports.

However, the objective of this paper is not to look at the consequences of FDI for development or at the possible conceptual contradictions between the pro-market discourse of some global and local agents and their defense and promotion of specific interventions via subsidies to FDI. My objective is to look at possible consequences for development of *subsidizing* FDI and then to look at some related policy issues. Specifically, I will explore and try to support with existing research the consequences of subsidized FDI on the fiscal deficit, competitiveness, social development, democracy, governance, and cultural values important for development.

RESEARCH FOOTPRINT

There have been important theoretical advances explaining the rationale for multinational investment[9] and abundant literature exploring the connection between FDI and economic growth (with mixed results).[10] Furthermore, quite a lot of econometric attention has been paid to the links between FDI subsidies and actual FDI flows to a given country or region. However, less attention has been paid to the consequences of FDI on other developmental variables,[11] with the

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resources to SMEs as a percentage of GDP (Ferraro 2009, slide 15). On the issue of financing, see also ECLAC (2010, 118).

[9] E.g., Dunning (1977 and 1981).

[10] E.g., Echavarria and Zodrow (2005), who found a close causal relationship between FDI and economic growth. On the other hand, Dabla-Norris et al. assert that “the empirical evidence on the growth benefits of FDI, based on cross-country evidence, has been largely inconclusive” (2010, 13). Alfaro et al. found that “the macro empirical literature finds weak support for an exogenous positive effect of FDI on economic growth” (2010, 242) and that “although there is a widespread belief among policy makers that FDI generates positive productivity externalities for host countries, the empirical evidence fails to confirm this belief. In the particular case of developing countries, both the micro and macro empirical literature consistently find either no effect of FDI on the productivity of the host country firms and/or aggregate growth or negative effects” (Alfaro et al. 2010, 254). Azman-Saini, Zubaidi Baharumshah, and Hook Law, for their part, report “conflicting results” (2010, 1079).

[11] According to Washington University in St. Louis, the “indirect impact of multinationals on domestic societies remains understudied” (2010). However, the issue

exception of short-run GDP growth. Attention to the consequences of *subsidized* FDI on those variables has been scant to nonexistent,[12] both at the academic and the policy-making level. For instance, in spite of the political importance given to FDI subsidies in Costa Rica, the Ministry of Finance has evaluated neither the fiscal cost nor the developmental consequences of those subsidies.[13]

Most scholarly research has concluded that subsidies play a role in attracting FDI once alternative locations meet a basic set of conditions, including political and social stability, quality of the labor force, infrastructure, macroeconomic stability, rule of law, and an independent judiciary.[14] Subsidies would not be decisive against shortfalls in these areas but become paramount for choosing among competing complying locations.[15]

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has been put forward. See, e.g., Farrel, Remes, and Schulz: "Whether investment incentives are, in general, a good policy, or a good policy for developing countries, is by no means clear" (2004, 53).

[12] A notable exception is the extraordinary work by Eva Paus who reaches similar conclusions to those reached in this paper. See, e.g., Paus and Gallagher (2008) and Paus and Cordero (2008).

[13] "…the Minister of Finance does not have assessments of the results and the benefits derived by the country from income tax exemptions" (author's translation) ("…el Ministerio de Hacienda carece de evaluaciones sobre los resultados y los beneficios derivados para el país, que el otorgamiento de las exoneraciones en el impuesto sobre la renta representa"). Contraloria General de la República de Costa Rica (2010, 12).

[14] E.g., Jiménez and Podestá (2009, 21).

[15] As stated in the text, there are no clear-cut results on the effect of subsidies on FDI and actual intake. E.g., Hines found a "growing body of recent evidence that tax systems influence the volume and location of FDI" (2001, 4). Harry, Newlon, and Altshuler, support that view (1998, abstract). On the other hand, Nassar reports "empirical evidence has not been supportive of significant effects of tax policy on investment. Policymakers maintain that tax holidays play an important role in attracting foreign direct investment, while the literature questions their effectiveness" (2008, 4). Jensen supports this view: "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 inflow" (2006, 14). He also reports "in most cases, consultants highlight that tax rates and tax incentives are not decisive factors for multinational investments" (19) and that "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" (20). Jensen and Malesky, for their part, found "that politicians can use tax incentives to take credit for investment flowing into their district, or deflect blame for losing the competition for mobile firms. Thus, fiscal incentives, while economically inefficient, may be a useful tool for politicians to win reelection" (2010, 1). For additional findings about the irrelevance of subsidies as a tool to attract FDI see: Jensen et al. (2010, 1); Thomas (2007, 12, 14); Aldaba, who found that "tax incentives, no matter how generous, will not be able to compensate for the deficiencies in the

Why has the academic literature had little interest in looking at the connection between FDI (subsidized or not) and development? One reason might be that academics interested in the issue of FDI are of the persuasion that gross domestic product (GDP) growth is the same as development or that GDP growth has a close causal correlation with development. On the other hand, it might just be that some of that literature belongs to the field of "economic growth" and is not part of what it is generally referred to as "development economics."

If the former, then theory and research on the link between FDI—and specifically subsidized FDI—and development would be at the stage reached by development economics half a century ago when the concept of development was equated with GDP per capita. That state of the art contrasts with the recognition by multilateral bodies like the United Nations Commission on Trade and Development (UNCTAD) that there is a pending agenda concerning FDI and development.

> "The evolving Transnational Corporation universe, along with the emerging investment policy setting, poses three sets of key challenges for investment *for* development: to strike the right policy balance (liberalization vs. regulation; rights and obligations of the State and investors); to enhance the critical interfaces between investment and development, such as those between foreign investment and poverty, and national development objectives; to ensure coherence between national and international investment policies, and between investment policies and other public policies. All this calls for a new investment-development paradigm and a sound international investment regime that effectively promotes sustainable development for all." (UNCTAD 2010)

UNCTAD goes on to stress that "making International Investment Agreements work effectively for development remains a challenge" (2010). In contrast to this assessment, developed countries strongly push such agreements,

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investment environment" (2006, 29); and Wells et al. (2001, ix). Dabla-Norris et al. (2010) did not even explore if subsidies have an impact on FDI. On another dimension, Hamlin, Giersh, and Norton assert that the societal ethics of the potential host country play a key role in the location decisions of MNCs: "locations have attributes which make them more or less attractive to mobile resources. The behavior of the residents—more precisely, their economic ethics—is among the more important competitive factors.…The global competition of firms and locations demands a morality of efficiency which is based on honesty" (1996, 40).

incorporating them as part of most free trade agreements with developing countries.

Whatever the reasons for the lack of attention in the academic literature to the link between FDI and development, the purpose of this paper is to start to fill that void by exploring the specific relationship between subsidized FDI and some key development factors, drawing on existing scholarly literature as necessary.

THE NATURE OF SUBSIDIES

Investment incentives are not new. Many of the transport canals built by the private sector in Europe and North America at the beginning of the 19th century benefited from land grants, monopoly guarantees, and tax exemptions. Later in the century, cities in the United States offered subsidies to railroad companies to induce them to pass through their territory. Costa Rica handed large chunks of land to a foreign company in 1884 as an incentive to built a railroad and operate train services to its Atlantic Coast. However, paradoxically, the systematic policy of granting FDI a whole array of subsidies has boomed after the proliferation of pro-market reforms all over the world in the last thirty years. No sooner had countries moved from inward-looking industrialization policies and controls on FDI towards more open, neutral regimes that they started to provide FDI with special incentives.

Some of the literature makes a distinction between "subsidy" and "incentive,"[16] viewing a subsidy as a transfer of resources either monetarily or in kind (land, buildings, etc.) and an incentive as any sort of tax exemption or abatement, monopoly guarantee, red-tape waiver, or the like. My interest is to look at the impact of any favorable or non-neutral treatment granted to a firm or group of firms on particular developmental variables. I will include as subsidies or incentives (among others): tax IOUs, tax credits, tax deferrals, tax exemptions (property, indirect income, imports), infrastructure development, industrial space,

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[16] E.g., Monge-González, Rosales-Tijerino, and Arce-Alpízar (2005).

land, capital grants, regulatory flexibility, red-tape waivers, and accelerated depreciation.

A country with a very high cost structure and other negative conditions (e.g., bad infrastructure, low quality of the labor force, social unrest, political instability, tortuous red tape, high incidence of crime) may have a level of FDI lower than what politicians deem appropriate. One solution may be to do away with all or part of the standard corporate taxes in order to compensate for the extra costs derived from such a set of conditions. In such a case, the revenue lost should be considered a tax cost for the country. In fact, making those costs explicit instead of denying that they occur could be a critical step towards bestowing political feasibility on the changes required to improve the cost structure and other relevant conditions in the country. Paradoxically, this may turn out to be the only way to make an FDI-centered development strategy sustainable in the long run.

The FDI menu of benefits is very wide and has changed through time both voluntarily and as a result of decisions made at the World Trade Organization (WTO). Some countries have favored FDI not only with tax exemptions but also with budget transfers linked to nontraditional exports. The WTO has requested countries to phase out subsidies—depending on the degree of development—specifically those related to exports. However, given that in small economies FDI is focused mainly on exports and that eliminating subsidies for FDI is not part of the WTO agenda,[17] in practice export-linked subsidies remain an important component of the policy menu. This benefit might be explicitly stated in the legal set up of the country or it could be the unavoidable outcome given the "entry" requirements contemplated in the law.

Most of these subsidies are delivered within the framework of legally established institutions under names like "Free Zones," "Export Processing Zones," "Special Economic Zones," and "Draw Back Regimes." These tools for subsidizing MNCs and FDI have been the key component of growth strategies baptized with diverse names like "Export Oriented," "Outward Looking," and

[17] As Lall and Nar report "WTO rules do not prohibit all selective interventions, only those that affect trade"(2004, 19).

"Technological Cluster." The International Development Bank (IDB) has been promoting a new name lately: "Productive Development Policies" (PDPs), probably with the objective of differentiating pro-FDI subsidies and distortions from those characteristic of the import substitution industrialization (ISI) model[18] championed by the Economic Commission for Latin America (ECLA).

There is no single rationale for the strategy of subsidizing FDI. Host country policy makers justify subsidies to MNCs mainly on the basis of employment generation. This presumably follows from a belief that country wages are not sufficiently low to fulfill the profit expectations of the corporations. At a more academic level, part of the rationale put forward by the neoliberal approach to development in order to justify the strategy of subsidizing FDI is the existence of market imperfections[19] such as externalities and economics of scale.[20] On the other hand, rich countries have also historically granted incentives in order to retain and attract investment and some policy makers in emerging economies have argued that subsidies are necessary to level the field and get their share of FDI. Finally, another, similar reason for the proliferation of these non-market tools is the competition among emerging economies for specific investments. In fact, in many cases countries have acted as bidders at an auction, vying for the attention of an MNC in so-called bidding wars, tax wars, or tax

[18] In an effort to frame these market distortions as market oriented, Monge-González, Rivera, and Rosales-Tijerino, working as IDB consultants, state: "In a broader sense, PDPs should be designed to improve the quality of the national business climate. As long as a sound business development and competitiveness strengthening process is created, market forces should play the central role in the efficient allocation of productive resources and productivity growth. However, upgrading competitive capacity and shifting factors of production is time and resource consuming and requires much investment. An active role of government could facilitate the resource allocation process. The debate on the case for targeted interventions is based on the existence of various kinds of market failures, which would justify the design and implementation of industrial policies, in order to enhance the productive capacity of a country" (Monge-González, Rivera, Rosales-Tijerino 2010, 3).

[19] See, e.g., Agmon: "Internalization: MNCs are trying to internalize benefits via vertical integration and governments are trying to internalize benefits of foreign investment. Then all has to do with imperfect markets. So one thing is for sure, market failures explain the subsidy approach to MNC subsidiaries" (2004, 11).

[20] This is the same rationale put forward by structuralism and the old ECLAC-Prebisch schools for agricultural subsidies, ISI, and public sector involvement in strategic sectors such as telecommunications, steel, mining, and energy.

competition.[21] In those cases subsidies might reach levels far above the level required to compensate for negative local conditions and/or to internalize social benefits. Just as ISI protectionism ended up in tariff redundancy, tax wars might be leading to FDI subsidy redundancy.

In 1995, with the aim of creating the best conditions for MNCs, the Organization of Economic Cooperation and Development (OECD) put together a set of guarantees and protections that became known as the Multilateral Agreement on Investment (MAI).[22] The objective was to open up the agreement, inviting non-OECD countries to become members and thus able to consult on its contents—and be subject to them. The MAI proposal was strongly opposed by civil society organizations from both north and south,[23] and eventually it failed as a multilateral agreement. Nevertheless, its contents have become an inherent component of bilateral investment agreements and have been integrated into the FTAs that the United States, for instance, has promoted with developing countries, but with even more advantages for MNCs than the original OECD MAI.[24] As we shall see in the section on democracy, the "Investment" and "Dispute Settlement" chapters of these treaties amount in fact to a new generation of privileges and support policies for MNCs.

This new set of privileges, added to their traditional tax and financial subsidies, constitute an overwhelming advantage for MNCs. The question is: in the face of these trends is there any space left for the implementation of a sustainable strategy of economic, social, and political development? The following sections tackle this issue.

SUBSIDIZING FDI AND DEVELOPMENT

Development is the process of improving the quality of life of a country. That improvement depends, in part, on economic growth and on the proportion of individuals in any society with access to basic material goods and quality

[21] See, e.g., Oman (1999), Lopez and Umaña (2006), and Figlio and Blonigen (2000).
[22] OECD (1998).
[23] See, e.g., Hormeku (1998).
[24] See, e.g., USTR (2004, Chapter 10 and Chapter 20).

services, enjoying a sense of security, benefiting from democracy and freedom, and having broadened choices and basic capabilities.[25]

The question then becomes: what are the positive or negative consequences of subsidized FDI on these development variables? For those depending on government action and public funding, we will look at the fiscal impact of the strategy of subsidizing FDI and the related consequences of investments to build sustainable competitiveness and social development. On the other hand, development so defined is also determined by government effectiveness and cultural attitudes. Therefore, we will also look at the connection between the policy of subsidizing FDI and governance, the quality of democracy, and cultural values, such as entrepreneurship, all of which are critical for long-term economic growth and development.

Fiscal Consequences of Subsidizing FDI

The strategy of attracting FDI through subsidies can have a negative impact on public finances for several reasons. In the first place, depending on the type of subsidy, there is the direct cost of the capital transfer—land, buildings, special road infrastructure, industrial park space. If the subsidy consists of a tax exemption, accelerated depreciation, or a tax credit, the fiscal cost is the revenue forgone by the country.[26] However, there is disagreement on whether a tax dispensation of any sort constitutes a subsidy and a budgetary cost.[27] For some researchers,[28] tax exemptions have no budgetary cost, because (addressing the Costa Rican case), "these exemptions are granted to foreign firms that set up shop in the free trade zones and that, without such exemptions, might not have come to Costa Rica."[29] This point of view is at variance with that of the OECD, which recognizes that any difference between the standard taxation of a country and that

[25] For this definition of development see Sen (1999).
[26] See Goñi, Lopez, and Serven (2008, 11).
[27] Also referred to as "tax cost" or "fiscal cost" (Jiménez and Podestá 2009, 23 and 24).
[28] Perhaps a little bit too eager to erase any doubts about the wisdom of subsidizing MNCs!
[29] Monge-González, Rosales-Tijerino, and Arce-Alpízar (2005). Following this criterion these authors did not include as a cost the total tax exemption granted by Costa Rica to FDI under its Free Zone regime in their cost-benefit estimations regarding FDI.

applied to a given firm or group of firms should be considered as a transfer or indirect subsidy (OCDE 2003). In fact, if Monge-González et al.'s criterion was to be followed, forcing a bank to exempt small farmers from paying the full market interest rate should not be considered a cost for the bank because without the subsidy the farmers might have not borrowed the money in the first place. By the same token, exempting, say, teachers from paying tolls on a highway should not be considered a cost for the owner of the road since without such exemptions the teachers might not have used the highway to start with. Similarly, exempting some consumption goods from VAT or excise taxes should not be recorded as a fiscal cost because without such exemptions families might not have consumed those goods at all.[30]

Therefore, subsidies, including tax exemptions, have a direct fiscal cost and, in some cases, not a small one. In Costa Rica 53 percent of exports originate in firms that operate under legal arrangements that allow them to avoid paying any taxes (Monge, Rivera, and Rosales-Tijerino 2010, 29). In 2010 the tax forgone due to these exemptions reached $363 million (Promotora del Comercio Exterior de Costa Rica 2011, 6), equivalent to 0.91 percent of GDP or 18.2 percent of the year's fiscal deficit.[31]

But, subsidizing MNCs also has important indirect consequences for the overall effectiveness of the tax system. First, when the wealthiest firms in the world, owned by foreigners, get grants or pay little or no taxes at all in a poor country, it becomes very difficult to make any tax reform aimed at increasing tax

[30] Farrel, Remes, and Schulz quite straightforwardly stress that it is not right to argue that these type of incentives to MNCs are costless: "Many economic development and elected officials believe that offering incentives is costless because incentives are only awarded if you receive the investment. First, if the investment would have been made without receiving incentives, the government will have directly given away grants or mortgaged future tax revenues. Second, there are opportunity costs to be considered; there might have been a better use of government money than attracting a business. Third, there are administrative costs" (2004, 26). Wells et al. also stress that "tax holidays amount to subsidies" (2001, 29).

[31] With that amount of money the government could grant an $80/month scholarship for 12 months to more than half of all students in the public school system or could provide basic housing to 36,000 poor families per year, eliminating the country's entire housing shortage (200,000 homes) in just over five years.

revenues—either by increasing rates or by imposing harsher penalties against evasion—palatable for local firms, consumers, and workers. How, for example, to get the informal sector to become formal tax payers while there is a formal, modern sector routinely promoted as a show case and as an example to follow that nevertheless does not pay taxes?[32] Even medium-size and relatively large local entrepreneurs complain about the "bias in favor of foreign companies regarding tax incentives" (Monge, Rivera, and Rosales-Tijerino 2010, 23). Gómez Sabaini recommends that governments "reduce tax exemptions in order to strengthen the perception of fairness" because "tax payers need to be sure that taxation is fair…and that the other tax payers are also engaged by the system" (2010, 28). Therefore, when subsidies are granted to MNCs, politicians find that it is practically impossible to pass tax legislation,[33] in spite of its urgency in countries that have tax burdens insufficient to meet basic development requirements in education, health, or infrastructure. As ECLAC has stressed, "a decrease in corporate tax, combined with generous concessions, makes it difficult to increase revenue by expanding the tax base" (2010, 232).

For the same reasons that it is politically difficult to increase tax revenue when MNCs are subsidized, tax officials find it morally unwarranted to enforce tax legislation on the locals when they are aware of the favorable treatment granted to corporations. When asked about the apparent lack of resolve in collecting taxes, a tax official in Costa Rica answered, "I do not feel comfortable

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[32] Or as Nassar found, "tax holidays doled out to large domestic and foreign investors led to pressures from small investors for similar treatment. As a result, the corporate tax system has become complex, and its ability to raise revenue in an equitable and a less distorting manner impaired, which further perpetuate tax avoidance and tax evasion" (2008, 4). According to Wells et al., "differential tax rates—low on investments with incentives and correspondingly high on others—further the feeling among taxpayers that the tax system is unfair, encouraging taxpayers to manipulate the allocation of profits and to cheat on reporting gains" (2001, 26). The same observation is made by Gómez Sabaini (2005, 14 and 67), Agosin et al. (2005, 86), and Contraloría General de la República de Costa Rica (2002, 166) for the case of Costa Rica. See also Gómez Sabaini, Jiménez, and Podestá (2010, 185–86).

[33] Of course, we could always blame politicians for not explaining the fundamentals of welfare economics and market imperfections to their constituencies, or, if the conviction of the politician is that subsidizing MNCs will yield results for everyone in the future, we could always call them on to explain why in the long run not all of us will be dead!

tackling Costa Rican tax payers harshly while some very rich foreigners do not pay taxes at all."[34]

A second indirect effect of subsidizing FDI on the fiscal situation is that other sectors of society—such as public sector unions, farmers, old age pensioners, single parents—not only strengthen their bargaining position in order to keep benefits that might be excessive but feel entitled to claim more.

This constant fight for justice as perceived by each actor in society is of paramount relevance in the shaping of final outcomes in a democracy's public policy design process. Granting that even under a dictatorship some balancing act is called for in spite of the overwhelming and unchallenged power of the decision maker, there is no doubt that under such a regime it is far easier to ignore complaints and calls for justice.[35] However, under a democratic system, any policy should be able to fend for itself in terms of justice. Groups may seem to accept what they perceive as unjust but then they will try to level the field by encouraging patronage politics or exerting organized group pressure—or by illegal means. In the face of subsidies awarded to FDI, different sectors of society might have ended up in a silent struggle to get entitlements and avoid and evade taxes, in what amounts to a "race to the bottom" concerning the public purse (and societal values).

Subsidies are promoted by interested MNCs, by politicians trying to find quick fixes to development bottlenecks, and by investment promotion agencies. The later are normally well financed, isolated from the rest of society, and do not have to face the fiscal problems caused by subsidies to MNCs. Their success depends on FDI intake regardless of collateral negative consequences.[36]

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[34] Conversation with the author.

[35] That is why care ought to be taken when recommending reforms implemented under dictatorial regimes to governments functioning in a democratic setting. This is the case of most of the reforms enacted by dictatorships in countries such as Chile, South Korea, Taiwan, and Singapore and that today are deemed positive and constantly presented as good examples in both academic and journalistic circles.

[36] Some researchers have noticed this: for example, Wells et al. state that "demands for tax incentives often come from investment-promotion offices, whose positions are driven by agency problems and the hidden nature of the costs of incentives" (2001, 44).

Whether the above factors explain the low tax burden and the structural fiscal deficits prevailing in most Latin American countries is a matter that requires further research, but some policy makers in the region[37] would argue that the demonstration effects of the strategy of subsidizing MNCs is at the root of the problem.

Government expenditure on competitiveness

The negative fiscal impact of the strategy of subsidizing FDI often undermines the struggle to improve core productivity and sustainable competitiveness.

How do economies become competitive and achieve sustainable growth? The literature agrees on two main sources of economic growth: factor accumulation and productivity growth.[38] The first refers to the quantity of physical and human capital incorporated in the production process. The second refers to the quality of capital and labor and the degree of efficiency with which they are employed. The quality of these factors of production depends on their level of knowledge and technology.

The central debate within the field of development economics has to do with the issue of efficiency or productivity. Without denying the importance of high quality capital and labor, the neoliberal school places its bets on the *allocation* of resources and its neoclassical proposal that, barring market imperfections, free markets are the best way to achieve the optimal and most productive allocation of resources. The central tenets of neoliberal policy are property rights, privatization, open economies, and deregulation, so as to allow the price system to perform its allocation role. This pro-market framework coupled with strict discipline concerning fiscal and monetary policy sets the stage for competition and economic growth to take off.

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[37] "The Ministry of Finance, on the other hand, expressed concern about the fiscal burden of the Export Promotion Zones incentives" (Monge, Rivera, and Rosales-Tijerino 2010, 22). At the academic level also there has been concern about revenue forgone (Oman 1999, 43).

[38] See, e.g., Abramovitz (1991, 13) or Solow (1962, 77).

At the other end of the spectrum[39] are the advocates of structuralism and industrial policy. In this view, in many economies markets fail in performing their important role of pricing and allocating resources according to scarcity and best competitive use, but the main cause of this failure is not policy-promoted distortions but severe market imperfections (public goods, economies of scale, factor mobility, and heterogeneity and lack of information) and protectionism in the industrialized economies for agriculture, textiles, etc. Additionally, within this school the poor *quality* of resources is considered another major bottleneck for efficiency, productivity, and competitiveness. Since many of the goods needed to improve the quality of labor and capital correspond to public goods or face markets in which there are externalities, economies of scale, and poor intertemporal information, then the state must participate in order to guarantee an optimal supply, either directly or by means of regulations and subsidies that induce the private sector to do so.

Therefore, if with different priorities, both neoliberalism and structuralism[40] give importance to the quality of capital and labor. There is agreement that goods like education, health, R&D, and infrastructure are important for economic growth and sustainable competitiveness. Furthermore, both schools would agree that when there are market imperfections the stage is set for the state to play a role in providing some of these goods. The neoliberal school might be inclined to leave the private sector to supply R&D and infrastructure, but especially after the

[39] Setting aside socialism and Marxism, ideologies that have survived only in Cuba and North Korea and that do not have a major say in any other country, and some new left-wing paths, like the XXI Century Bolivarian one, which has not made a development proposal public.

[40] The intention here is not to take a journey across all existing main development schools. Suffice it to say that Douglass North's "Institutionalism" (see, e.g., North 1991) and Lawrence Harrison's "Values Matter" (see, e.g., Harrison 2000 and Harrison and Huntington 2000) put together might become very influential in the forthcoming years, not as substitutes for or competitors to neoliberalism or structuralism but as key complements. The policy consequences of the North and Harrison paradigms will need to be considered by both the pro-market and the more interventionist schools if they are to yield the growth results they expect. North's view that entrenched institutions typical of most developing countries lead to efficiency-destroying high transaction costs and Harrison's suggestion that values have important consequences in efficiency should not be overlooked any longer by the development literature.

generally accepted failure of at least some pillars of the Washington Consensus, these schools would not cross swords over the role of the state as regards education and health. Additionally, there is little disagreement that social stability, responsible macroeconomic management, an independent, modern, and strong judiciary, suitable protection of property rights, rule of law, low crime and adequate policing have an impact on competiveness. These variables have a strong effect on productivity and the efficient use of the factors of production (by influencing transaction costs) and therefore on competitiveness.

As was discussed above, an economy in which FDI is heavily subsidized might end up in a structurally difficult fiscal situation, leading to consequences such as macro instability due to the fiscal deficit, social instability due to lower expenditure on poverty reduction and social programs, and less expenditure on the quality of the factors of production and on the supply of certain public goods critical for the productive sector (e.g., infrastructure, policing)—a set of conditions reducing the competitiveness of the economy.

Therefore, the level of FDI intake itself might be negatively related to the level of subsidies granted to FDI, given that FDI is influenced by the same variables that have an effect on competitiveness (quality of the factors of production, availability of certain public goods, social stability, and fiscal prudence). While FDI might be directly positively correlated to subsidies,[41] it might also be—indirectly—negatively correlated. The sign of the net link will depend on whether the direct or the indirect correlations have a higher absolute value. We can see this more easily with a very simple formulation, where:

$FDI = f(S, C)$, and since $C = \S(S)$, then:

$FDI = f[S, \S(S)]$, where:

FDI = flow of foreign direct investment

S = subsidies

C = competitiveness of a given country determined by the quality of factors of production, the availability of certain public goods, social and macro stability.

Assuming that the higher the level of subsidies and of competitiveness of a

[41] See note 15 on this issue.

country, the higher the level of FDI, then: $f'_S > 0$ and $f'_C > 0$. On the other hand, assuming that the higher the level of subsidies, the higher the fiscal deficit and the lesser the funds available for investment in human capital, infrastructure, R&D, policing, social development and thereby the lower the flow of FDI, then: $§'_S < 0$. Therefore:

$\partial FDI/\partial S = f'_S + f'_C * §'_S$. If $|f'_C * §'_S| > f'_S$, then subsidies will reduce FDI to a given country over time.

Most research on the factors determining FDI has found that once certain basic conditions are met MNCs choose locations according to the level of subsidies offered. Most of those basic conditions are the ones gathered in variable C. What has not been done is to study and if possible econometrically determine the link between subsidies, the fiscal situation, and the C variable and, therefore, the comparative absolute value of the coefficients of the direct and indirect factors influencing FDI. However, some authors have thrown light on the relative sizes of these coefficients. It is what leads UNCTAD to assert that "excessive incentives can be contained and channeled into more effective areas such as investment in public infrastructure which has the potential to raise economic productivity in general, as well as to enhance the climate for investment" (1996, 76). Görg, Molana, and Montagna found that MNCs might prefer to invest in countries that do not offer tax exemptions because the supply and quality of public goods will be in better shape. Using data for eighteen OECD countries for the period 1984–1998, they found strong evidence "that redistributive social welfare state policies are valued by MNEs. Our results suggest that competition between governments for international investment may be more muted than what is implied by the tax-competition hypothesis and that corporate taxes do not necessarily deter FDI if the revenue is used to provide public goods that improve the environment in which MNEs operate" (2009, 36). Perhaps this trade-off is stronger in poor countries where the likelihood of instability is the greater and where infrastructure is not as good as in the OECD countries. In that case it might be that MNCs would not mind paying corporate taxes as long as they perceive that such a situation is associated with higher expenditure on social development and infrastructure.[42]

Paus and Gallagher stress that there have been very few technological backward linkages in Costa Rica, one of the most successful FDI magnets in Latin America. They relate this lack of technological spillover effect to the subsidies awarded to FDI.

> "One important reason for the lack of upward movement is the insufficient development of domestic knowledge-based assets that would make it attractive for MNCs to move production in the country into technologically more sophisticated areas. When Intel–Costa Rica celebrated 10 years of operations in Costa Rica in March 2007, Intel president Craig Barrett criticized the lack of technological advancements in the country and the insufficient attention to progress in education. It is ironic that the tax exemptions granted to Intel and other TNCs under the rules of the Zona Franca mean that these companies do not directly contribute to an increase in the tax revenue needed for significant improvements in infrastructure and education. Costa Rica's tax ratio of 13 percent is too low to fund all the needed investments in infrastructure and education" (Paus and Gallagher 2008, 70).[43]

Another possible negative impact on long-term competitiveness of the strategy of growth based on subsidizing FDI might result from the potential

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[42]Hernandez-Villalobos also addresses this issue when suggesting that "governments should carefully analyze if the benefits of FDI are so important as to justify a policy of tax exemptions, or if it is better to fully charge them taxes in order to spend and improve in areas that as they improve become themselves assets in the attraction of FDI" (2010, 34). Jensen states that if expenditure constraints force "governments to provide lower levels of market-enhancing public goods, multinationals may react negatively by refusing to invest in these countries" (2006, 13). Thomas also addresses this issue and asserts that one possible consequence of "mortgaging future tax revenues through abatements and other tax-based incentives, is that a government will have insufficient funds for important programs, including ones that contribute to economic development such as education or infrastructure" and therefore "incentives may not even have their desired effect" (2007, 17). This same view is presented for the case of Costa Rica by Contraloría General de la República de Costa Rica (2002, LV). Swank reaches the opposite conclusion in the case of advanced economies (1998, 691).

What in fact we might have here is a vicious circle in which more subsidies to entice FDI lead to fiscal pressures, macro instability, and less investment in human capital, infrastructure, R&D, policing, social development, the justice system and, therefore, to reduced competitiveness and less FDI, more subsidies to compensate, etc. So it might be that in addition to the "race to the bottom" (concerning tax wars among locations) widely mentioned in the literature, there might be another, related race to the bottom within countries as a result of that vicious circle.

[43] For a highly positive assessment of Intel's impact on Costa Rican development see Rodríguez-Clare (2001).

distorting static effects on allocative efficiency. This is the quintessential concern of the neoclassical school and its critique of industrial policies and is at the heart of the WC opposition to the ISI model in the 1980s. FDI subsidies might, as some have argued, correct market imperfections but on the other hand they might reallocate resources from national to foreign firms, from small to large firms, from supplying internal markets to supplying foreign markets, from knowledge-intensive industries to low-wage-labor intensive-fast-return processes, from competitive to noncompetitive firms, from competitive to noncompetitive countries, from efficiency-competitive to subsidy-competitive firms, and from market-chosen to policy-maker-chosen firms.

Finally, as a policy for improving competitiveness by getting comparative advantage to play a critical role in resource allocation, the policy of budgeting subsidies to MNCs would be consistent with neoclassical theory—which is the backbone of the WC movement—only if the country's fiscal situation is its comparative advantage. This will come about if the opportunity cost of fiscal resources in a given country relative to the cost of other factors of production is lower than the corresponding comparative cost in the trading partners. However, in poor countries the low quality and quantity of public services and the low tax burden make the opportunity cost of fiscal resources very high relative to that of other productive resources such as labor.

Therefore, even if FDI has a positive impact on short-run economic growth (something on which scholarly econometric research reports contradictory evidence), when that FDI is subsidized it may have a negative impact on competitiveness and thereby on long-term growth.

Government expenditure on social development

On the other hand, if a consequence of the strategy of subsidizing FDI is to squeeze the fiscal position, as explored above, then countries committed to that strategy would be narrowing their space to finance a proper social policy.[44] This

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[44] Rudra (2008, xv) asserts that it is the middle class that gets hurt by globalization and its related policies.

effect has been observed even in the case of rich countries like the United States. Figlio and Blonigen concluded “as local governments offer tax relief as incentives for new plant investment, the potential cost to the local community is lower levels of government services per capita” (2000, 355).[45] By the same token, Lahiri asserts “tax competition for FDI can lead to reduced tax revenue and thus public good provision” (2009, 1–2).[46]

One of the most successful poverty and inequality reduction policies is universal access to upwardly mobilizing tools such as education and health. However, when the government fails in the delivery of those services or when their quality is lacking, instead of mobilizing upwards, they end up mobilizing

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[45] In spite of the fact that these authors are analyzing outcomes of subsidized FDI for a rich country, they conclude: “The large wave of foreign direct investment (FDI) flows into the United States in the past two decades adds another dimension to the competition for investment. Beyond the potential adverse welfare effects described above from state and local competition, foreign firms’ gains from the incentives accrue to capital owners that likely reside primarily outside the United States. In addition, foreign plants may be less involved in the local community (e.g., through charitable giving) than domestic ones, which could lessen local benefits from the investment. These issues, along with the potential ‘prisoner’s dilemma’ problem with state incentives, have even led some to recommend a U.S. government ban on state incentives to foreign investors” (Figlio and Blonigen 2000, 339–40).

[46] Avi-Yonah and Tittle are also quite unambiguous on this issue: “every country has a sovereign right to decide the level of public services it wishes to provide, and the level of taxes needed to fund those services. However, tax competition can be harmful when the benefits of lower or no taxes are apportioned exclusively to FDI investors, and the host country's tax burden is shifted to immobile segments of society like land and workers” (2002, 3). Other authors confirm this view, and have noticed: “these incentives are not free. When a state offers business tax incentives, but must also provide its usual level of services, then the costs of the incentives are borne by other state taxpayers—usually residents—in the form of higher taxes” (Fisher and Peters 1997, 137). Nassar reports that “tax competition for mobile capital could lead governments to adopt inefficiently low corporate income taxes and, as a result, provide sub-optimal level of public goods” (2008, 5). Jiménez and Podestá also emphasize the possible social consequences of subsidizing FDI because “it reduces the tax burden of the benefited sectors, which results in less revenue for the treasury and has an impact on equity” (2009, 21). The same view is held by Thomas: “The potential equity problem with investment incentives is straightforward: the incentives are paid to owners of capital, but are paid for by average taxpayers. This makes the post-tax, post-incentive distribution of income less equal than it would have been without the subsidy” (2007, 11). UNCTAD also addresses the issue of the equity consequences of subsidies: “The effects might be both distorting and inequitable because the costs of incentives are ultimately borne by the public and, hence, represent transfers from the local community to the ultimate owners of the foreign investment” (1996, 15). See also Agosin et al. (2005, 88), Hecock and Jepsen (2010, 7), Gómez Sabaini, Jiménez, and Podestá (2010, 185–86), and Alvarez Estrada (2009, 25).

downwards. The poor and the lower middle class stay where they are but the middle class opts for buying services like education, health, and policing from the private sector. Thus, middle-class families end up paying twice for those services: once when they pay their taxes and their social security contributions and again when they pay the corresponding private fees for services.

This outcome should be of special concern to Latin American countries, most of which are facing deep inequality and where, according to ECLAC, "it is clear that the present tax burden is insufficient and the tax structure is inadequate for modernizing the productive structures and achieving greater social equality" (2010, 69). In Latin America less than one third of tax revenue comes from direct taxes, with the bulk coming from indirect taxes (2010, 228).[47] As a result, income distribution after tax payments is even more unequal than beforehand. This pro-inequality tax structure is the result of "the preferential treatment and tax loopholes that characterize the region's tax systems, resulting in considerable forgone revenue. As regards income tax, most of the countries afford preferential treatment to capital income through a series of exemptions or special incentives" (ECLAC 2010, 228).

Another social consequence of FDI in general is the change in the wealth ownership structure of a country. Unlike borrowing, FDI as a source of foreign savings[48] contemplates a permanent ownership transfer. Some countries (e.g., China) hold ultimate ownership of fixed assets like land and buildings, but this is not the case in Latin America. So FDI is a short-run short cut towards importing savings but with long-standing consequences in the foreign vs. national and large firms vs. small firms ownership structure.

It might be argued that these negative social consequences of FDI are unavoidable in the context of globalization. But what is being questioned in this paper is the wisdom of having poor countries subsidizing such irreversible processes. As Kurtz and Brooks point out, the strategy of subsidizing MNCs, while…

[47] See also Gómez Sabaini and Martner (2008, 83).
[48] As UNCTAD has stated, "compared to other capital flows, FDI inflows remain the largest component of net resource flows to developing countries" (2006, 4).

> "…interventionist…is not downward redistributive. Instead, the supply-side interventions sketched above are likely to privilege the better-off, skilled workers and export-oriented business owners, rather than the poorest and most vulnerable in society. While they distort market prices, they are producer subsidies, not redistributive social programs. They therefore rest on a political foundation of business interests as well as relatively privileged educated and skilled workers. For these reasons we label this strategy embedded neoliberalism, to distinguish it from its more egalitarian European analogue"

(2008, 241). This issue is particularly relevant in Latin America, given its unequal socioeconomic structure.

To summarize, in terms of equity and social development, subsidized FDI has three negative impacts. First, it squeezes government finances, preventing social expenditure to benefit the poor. Second, it fosters a tax system that, instead of serving as a leveling tool, concentrates income in favor of foreign direct investors, who are wealthier than the rest of the population. And, third, it shifts the ownership structure, strengthening the position of large foreign-owned firms, rather than creating the conditions for the development of local ownership (which might result from a strategy of national entrepreneurship development or from a policy not centered on subsidizing FDI).

Certainly FDI generates employment and in some cases most of the workers (e.g., the textile drawback industry) come from the poorest sectors of the population. It is also true that in some cases—very few unfortunately[49]—outsourcing might benefit small local enterprises. But to trust that these byproducts of subsidizing FDI can compensate for the negative effects described above would imply the acceptance of "trickledown economics" as the model for social development and poverty reduction, something that hardly anyone would defend nowadays.

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[49] Apart from outsourcing cleaning and gardening services, MNCs very often buy inputs from their own affiliates or opt to squeeze suppliers at rundown prices, taking advantage of their monopsony (sole purchaser) power. See Paus and Gallagher (2008) who concluded that outsourcing tends to be negligible. This is not a surprising result. Instead of the specific outsourcing, employment and export targeting, and rigorous monitoring of compliance enacted in Taiwan, South Korea, China, etc., the Latin American countries, perhaps with the exception of Brazil, have granted subsidies to FDI free of conditions and, in any case, have not scrutinized for proper compliance.

Richard Sweeny, a former employee at the US Treasury Department (the institution that called the shots for the Washington Consensus) puts it bluntly when he asserts that in the international competition for investment some view the "pressure on government policies as a 'race to the bottom,' to see who will have lowest tax rates, lowest social expenditures, least protection of the environment, and so forth." He adds, "the race to the bottom is more often to be welcomed.… some governments, compelled to cut tax rates, and thus social expenditures, are appropriately disciplined by the market" (1993, 76–77).

There is little doubt that there has been a strategy of granting subsidies of all kinds to MNCs in spite of their likely social and developmental consequences and, conveniently ignoring any contradictions with the hands-off-state model imposed by the WC on the agricultural sectors, national industries, and public utilities of developing countries.

To avoid severe social consequences, perhaps attention should be paid to ECLAC's call for "a progressive abolition of exemptions from direct taxes, for the sake of greater equity and efficiency" (2010, 234).

Political-Cultural Consequences of Subsidizing FDI

Consequences for democracy

The strategy of subsidizing and protecting FDI creates a vested interest of foreign agents in political decisions directly connected to their rate of profits. This is likely to induce those agents to intervene in the political process to the detriment of the power of the "sovereign." Thus democracy might be undermined. In addition, the special "protections" awarded to MNCs in the most recent FTAs promoted by the United States and other developed countries severely undercut the scope of host countries' democratic decision making.

Democracy means that a country is able to determine and control its future by delegating power to politicians, who promote policies similar to those favored by the majority of its people. The neoliberal agenda, within which FDI-subsidized promotion has acquired strength, might in itself weaken the voice of the majority. Neoliberal reforms reduce the role of the state and thereby "also reduce the scope of political decision making" (Kurtz 2004, 272). At first sight there does not appear to be a meaningful connection between the strategy of subsidizing FDI and democracy building or weakening. However, when a country gives FDI a major role in its growth strategy—to the point that, in spite of nationalistic proclamations and/or equality objectives, it is willing to grant MNCs subsidies and special shelters—democracy may be in danger.

Researchers have not directly explored the link between traditional subsidies to MNCs and democracy but some light has been cast.[50] Nathan M. Jensen, in what should be considered a seminal work (2006), has looked at the effects of several variables on FDI, among them democracy. He found that democracy has a positive impact on FDI[51] because MNCs feel that their subsidiaries are safer under democratic regimes since legislation intended to hinder multinational interests "in democratic societies nonetheless generates substantial political costs for leaders because the political position of multinationals proves even more 'privileged'…than that of domestic businesses" (Jensen 2006, 3).

Jensen carried out extensive fieldwork in several countries. For example, in Costa Rica the government was shaping a new tax law and some policy makers had expressed the need to revise tax subsidies to MNCs downward. Jensen reports that Intel minimized the political risks of negative tax changes. Why? Because Intel could "count on their influence with the central government, specifically through lobbying both individually and with groups of likeminded foreign and domestic firms" (2006, 96). He also found that "firms, such as Intel, say that their best insurance against adverse policy changes is to exert influence over the policy process" (21). This confession reveals a thoroughly antidemocratic and illegal practice.[52] Jensen's findings corroborate what many policy makers have

[50] See, e.g., Agmon: "The higher is the level of investment by MNEs in a given state, ceteris paribus, the weaker is the control of this state, and the less relevant is its geopolitical uniqueness" (2004, 18). See also Basinger and Hallerberg (2004).
[51] For a different viewpoint see Busse (2003).
[52] The Costa Rican Constitution forbids foreigners any involvement in local politics, when it states that "Foreigners …. may not intervene in the political affairs of the country…" (Article 19)

experienced when proposing reductions of the subsidies afforded to MNCs.

Jensen's objective was not to analyze the impact of subsidized FDI on democracy but the opposite: the impact of democracy on FDI flows. Surprisingly, at the end of his book, he reverses the causality direction of his enquiry and his finding that democracy has a positive impact—and somehow concludes that FDI does not have a negative impact on democracy (154**)**. Some of his findings throw important light on this direction of causality and the information he uses is more revealing of this connection than that going from democracy towards FDI flows. But the only likely conclusion, in keeping with his findings and his narrative about Intel's behavior and other stories, is that MNCs might carry out democracy-weakening lobbying actions.[53] He concludes that democracy benefits FDI, because in a democracy MNCs can influence decisions—which is precisely why they weaken democracy.[54]

Other researchers have utilized the concepts of "structural" and "instrumental" power in order to pinpoint the channels for the political leverage wielded by MNCs in Argentina and Chile.[55] Structural power derives from the threat of opting out of the country if subsidies are removed, and instrumental power works through the politicians who serve the interests of the MNCs. Fairfield (2010) found that in Chile MNCs were protected by instrumental power and in Argentina more by structural power. Once a country is convinced by its leaders that MMCs have to receive subsidies, MNCs have power to influence decisions, undermining the role of the local majority in decision making and thus weakening democracy.

There has to be intensive campaigning for a long time to get a majority of voters to accept that FDI is so important that, in spite of further enriching very wealthy foreigners, it deserves subsidies and protections that the country could

[53] The fact that such lobbying, supported by hidden campaign contributions, takes place in advanced democracies like the United States, as has been widely reported (see, e.g., Dowd 2010), throws light on what is actually taking place in less transparent developing countries.
[54] Dunning has addressed institutional development and its connection with FDI by asking, when does institutional development "lead to more FDI and when is it a consequence of FDI?" (2006, 219).
[55] See, e.g., Fairfield (2010, 39–44).

not afford for its poor. When a country reaches that stage, MNCs have acquired such formidable leverage in the life of the country that local decisions become increasingly shaped by their wants. Patrick Egan carried out research in order to determine if MNCs, rather than being passive subjects of policy, might become agents of change. His findings suggest "that it is no longer appropriate to think of multinational corporations solely as subject to host country action. Instead, it is more likely that these corporations retain agency through time and can indeed have an impact on host country economic reforms" (Egan 2010, 2).

As mentioned above, FTAs reward MNCs with a new generation of privileges and guarantees. This new set of special shelters constrains the scope of national policy, thus weakening democracy, and has attracted the attention of organizations such as UNCTAD (2010, xii and 22).

A few examples may be helpful. First, FTAs forbid performance requirements (USTR 2004, Chapter 10, Article 9) that set severe limits on the use of key development tools historically practiced by modern developed countries. Second, treaties redefine expropriation so as to include what is called "indirect expropriation" (USTR 2004, Chapter 10, Article 7 and Annex 10-C), whereby the member countries cannot implement an action that "interferes with distinct, reasonable investment-backed expectations," which implies that in certain cases if a government decision reduces the expected rate of profit of an investment, then the MNC must be compensated as if it has been expropriated.[56] This again restricts the space for government policy making. Third, even in the face of a balance of payment crisis, treaties prohibit a country from limiting or postponing in any way any transfer of funds that a MNC desires to carry out (USTR 2004, Chapter 10, Article 10.8). Fourth, after the enactment of an FTA, countries can increase investment opportunities for the private sector but cannot reduce them. In short, after ratification, countries can privatize but not nationalize (USTR 2004, Chapter 1, Article 1.2). In the case of telecommunications the Central American Free Trade Agreement (CAFTA) dictates that "the Parties recognize the

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[56] Buthe and Milner note this point: "FTAs are important because they assure foreign investors that host governments will not change their policies in ways that reduce the value of the investments" (2008, 742).

importance of relying on market forces to achieve wide choices in the supply of telecommunications services. To this end, each Party may forbear from applying a regulation to a service that the Party classifies as a public telecommunications service" (USTR 2004, Chapter 13, Article 13.15). Fifth, countries have to consent to arbitration whenever a MNC so chooses (USTR 2004, Chapter 10, Article 10.17), thus providing the MNC with a privileged conflict resolution path regardless of whether the firm is locally registered or not. This, in practice, ranks the local judicial system, a core institution in any democracy, as second rate or unworthy of trust for the sole advantage of MNCs. As UNCTAD has noted, before 2010 this tool had been used on 357 occasions and "the overwhelming majority of these 357 cases were initiated by investors from developed countries, with developing and transition countries most often on the receiving end" (2010, 21).

As can be seen, these (and numerous other) privileges awarded to MNCs in FTAs severely hamper democratic decision making. Buthe and Milner emphasize that "trade agreements may boost FDI precisely because they have not just economic but also political effects, most importantly because these international institutions enshrine commitments to open markets and liberal economic policies.… In sum, trade agreements institutionalize commitments to liberal economic policies" (2008, 745). These authors found that "governments pay for this increased inward FDI with a loss in policy autonomy" (742). Lall and Nar report that some authors have found that "multilateral and bilateral investment agreements…restrict the policy autonomy of developing countries" (2004, 18). For their part, Hopkins and Simmons hold the view that treaties "tie the government's hands through altering the legal (and normative) setting in which policy is carried out" (2005, 624). Malesky states that present literature on FDI "has tended to concentrate too heavily on political factors that attract investment, while neglecting the role investors have in altering domestic institutions and policy" (2008, 115).

Certainly, democratic institutions (legislative bodies and referendums) have ratified these treaties, but the tools chosen to graft them onto the legal framework of each country have been far from democratic. At least in some countries the treaties have been forced by raising the threat of losing export access to developed countries' markets.[57] So, for example, the second Bush administration warned countries that if CAFTA was not ratified the Central American countries would lose Caribbean Basin Initiative (CBI) benefits. This was an empty threat because CBI had no termination date and because the required legislative action would have been rejected by Democrats in Congress, but both the US administration and the local elites interested in CAFTA took hold of the argument in order to scare those working for CBI-related exporting activities. Therefore, the procedure of ratification itself undermines democracy and as a result does not ameliorate the antidemocratic consequences of the new advantages afforded to MNCs by these treaties.

Perhaps the most glaring evidence of the negative impact of FTAs on democracy is that a common theme (put forward as an advantage) among FTA promoters both from developed and developing countries is that the treaties *lock in economic reforms*, meaning that after enactment the population of member countries are bounded in the kind of decisions they can make into the future.[58]

The political equilibrium resulting from a majority of inhabitants of a poor country supporting subsidies for rich foreigners (the corollary of traditional FDI subsidies), the lobbying practices confessed by some MNCs, plus the new generation of benefits for MNCs incorporated in FTAs, give rise to important questions about the impact of subsidized and protected FDI on the quality of politics and democracy in host countries and thereby on their development possibilities. So even if there are positive, short-run GDP growth effects derived

[57] In what Hobbes called "sovereignty by acquisition" as opposed to true sovereignty, which he referred to as "sovereignty by institution" (Martinich 2005, 125).
[58] See, for example, USTR (2003, 5). See also what two former US secretaries of defense have stated, in Cohen and Perry (2005). In the same direction, see the World Bank assessment: "DR-CAFTA commitments promise to 'lock in' a number of the policy and regulatory changes implemented in recent years for the opening of competition in previously protected sectors (e.g., telecoms, financial services, energy) and the modernization of key norms and procedures in areas such as government procurement, intellectual property rights and the treatment of foreign investment, by locking in current levels of access of investors (and bidders) from the U.S." (2006, 4).

from FDI, when it is subsidized or over-protected, democracy may weaken, thereby undermining future growth and development itself, since democracy is not only instrumental but also intrinsic to the development process.

Consequences for governance

Governance, defined as the degree of efficiency of government in decision making and in the execution of decisions, depends in part on the degree of *fairness* perceived by different constituencies. If there is to be government bias (privileges, affirmative action, subsidies), most sectors would accept it as *fair* if it benefits the weaker groups within society. If, on the other hand, government-support policies, subsidies, or incentives directed towards the most economically well positioned, then other sectors become overzealous in their fight to "level the field." In this situation governing becomes cumbersome, unwieldy, and slow, and gets entangled in constrained negotiating, explaining, and justifying. Subsidizing MNCs has these effects on governance, hindering any tax reform aimed at increasing government revenues (see above) and reducing overall governance.

Governance also depends on the degree of trust of the people in their leaders. Trust depends heavily on ethical standards but also on the credibility they inspire. If the people find contradictions between their leaders' proclaimed reasons and their actual actions, then their credibility stock starts to wane, decisions start to be questioned, and again governance is the victim, with the aforementioned risks for democracy and development.

The strategy of subsidizing FDI, promoted by politicians in many emerging economies as a (if not *the*) core component of growth strategies, took place at the very same time that leaders were crusading against industrial-ISI policies, agricultural subsidies, and public sector involvement in the provision of services. The resource misallocation logic, put forward to back the dismantling of tariff protection, subsidies, etc., granted generally to poor local agents, was not called for when granting subsidies and special protections to MNCs. The arguments about externalities and other market imperfections used to justify the neo-interventionism supported by neoliberalism were equally tenable in connection with the protections awarded by ISI interventionism. Thus unless there are two economic theories, one for foreign-owned capital and another for local producers, which of course is not the case, then we are dealing with a glaring and so far unexplained contradiction. This has not been overlooked by local civil society groups and intellectuals, leading to the additional tarnishing of the credibility of politicians, and the consequent loss of efficiency in the governing process.[59]

Any deterioration in the governance level in countries that come from behind and that have quite a lot of catching up to do can become critical—even more so if democracy is not thoroughly consolidated. In such a setting, a convoluted slowness might evolve into disillusionment with democracy and the search for alternative solutions (or for irresponsible, populist, self-proclaimed development sorcerers!). None of this helps development.

Consequences for entrepreneurial culture

The strategy of subsidizing FDI may have severe consequences for the consolidation and growth of the entrepreneurial drive required for development. To get to the point at which a poor democratic country accepts subsidizing rich foreign firms, in spite of a slim public purse and plenty of unsatisfied local needs, a lot of campaigning and propaganda is required. That "educational" effort is directed towards convincing the people that there is no choice but to trust that FDI will develop the country.

Within the growth and development literature there are diverse views regarding the role of the state, the consequences of industrial policies, the incidence of institutions and values, the relevance of religion, geography, and climate but there are no doubts concerning the important role of entrepreneurship. From Karl Marx to Alfred Marshall, Max Weber, Walt Rostow, Joseph

[59] The Washington Consensus institutions have been the subject of many a condemnation by populist and not so populist forces in numerous developing countries, one of the reasons being their key role in the edification (backed by heavy-handed cross-conditionality) of those two contradictory attitudes towards market interventions.

Schumpeter, Thorstein Veblen, and of course modern Chinese communists,[60] all agree on the important role of entrepreneurs in combining factors of production, understanding and creating consumer demands, developing and adopting technological progress, marketing goods and, in sum, acting as catalysts of progress.

The educational and cultural consequences of creating political room for subsidizing MNCs may result in enduring bottlenecks for development, not measurable in econometric correlation runs between GDP growth and FDI flows series. The implicit (often explicit) narrative backing this strategy is that in order to have the privilege of getting MNC investments, a country must give them what nationals had better not get because it would not be as cost effective. The necessary cultural counterpart to accepting that strategy, in the context of the poverty levels and fiscal deficits prevailing in developing countries, may be to accept that these investors are superior beacons of production, technology, and entrepreneurship relative to the local population. Often the promotional language utilized to smoothing the path of subsidy approval for MNCs has the objective of convincing legislators and public opinion that everything will be taken charge of by outside persons and firms and that the host country just has to keep its house in order, give those subsidies, and progress will take off just like that.

In economic terms, what is being assumed in developing countries is that the marginal development effect of subsidies to FDI is so much higher than the marginal development effect of investing in education, R&D, health, infrastructure, housing policing, environment, SMSEs, or the justice system that, in spite of severe shortages in those areas, it is development-wise to channel those scarce resources towards subsidizing MNCs.

This of course is not the theory that explains the success of the developed countries. Furthermore, there is no evidence that in their quest for progress their policy makers even pondered the existence of trade-offs between those options. In a country like the United States it is frequently stated that wealth creation and the

[60] See, for instance, Elliot (1980) on Marx's and Schumpeter's views on some of these issues.

wellbeing of the country depend primarily on the proliferation of medium and small enterprises.[61] It would certainly be unthinkable to have politicians and economists measuring economic policy success by how many, say, German MNCs have invested in the United States. Rich counties have granted subsidies (and still do) to investors, but generally they are their own investors. Certainly, a given rich country might have also subsidized some foreign investors but first that country would also have firms investing in other countries;[62] second, their level of development is so high that the alternative cost of granting those subsidies would be much lower that in the case of a developing country; and, third, citizens in developed countries have not been induced to believe that FDI is a critical factor in their development, so there is no the danger of suffering any negative cultural consequences.

In order to understand the intensity and effectiveness of the "education"[63] required to move on with the strategy of subsidizing FDI, let's just think about the amount of convincing that would be required in the United States, Spain, France, Japan, Canada, or Britain to persuade people not only to receive foreign workers with "red carpet" treatment but to give them better tax conditions than those afforded their own workers and extra legal protections (comparable to the ones afforded to MNCs in FTAs—national treatment, special conflict-resolution arbiters, etc.). The only way for the people of these countries to accept granting those privileges to foreign workers would be to have carried out such intensive education that people eventually become convinced that foreign workers are better than their own workers in at least some aspects (more hard working, more honest, more productive), that they can do things that local workers are not able to do, that they adapt to technology better, etc. For the sake of making a more

[61] See, for example, President Obama's words "We measure progress by the success of our people. By the jobs they can find and the quality of life those jobs offer. By the prospects of a small business owner who dreams of turning a good idea into a thriving enterprise" (Obama 2011).
[62] Furusawa, Hori and Wooton point out than when a firm is owned or partly owned by the nationals of a given country, the country might be interested in entering into a subsidy war since even if the firm chooses another country that offers higher subsidies the firm's share holders will benefit (2010, 3 and 4).
[63] The term brainwashing is being avoided deliberately.

precise comparison with the concerns of this paper regarding the consequences of subsidized FDI on development, the point of the example is not to prove the challenge (and for sure it is a tough one!) of inducing people to accept foreign workers but to show the likely cultural consequences of getting people to accept *subsidized* foreign workers.

If a society reached the point of acceptance of such subsidies to foreign workers, would it not have a demoralized working class, unsure of itself, filled with resignation, so much so that a majority of its members would agree with extending favorable treatment to migrant workers?

By the same token, the promotion of subsidized FDI in developing countries may erode important and required development assets, such as entrepreneurship, the desire for ownership and accumulation, a sense of achievement, self-confidence, self-belief, risk taking, and healthy nationalism. These cultural values are intrinsic to development but also critical tools for sustainable competitiveness and long-term growth. The national education that necessarily precedes and then accompanies the strategy of subsidizing MNCs might severely weaken those key cultural requisites for development.

In countries like Costa Rica, the heavy-handed promotion[64] of subsidized FDI has had visible cultural consequences. Many Costa Ricans' business dreams are to sell their property to a foreigner. All over the country, there are signs marketing properties not with a "Se Vende" but with a "For Sale" sign. New law and commercial firms have emerged not to sell goods to new markets but to focus on the real-estate business. Thus, by the same token that presidents are constantly emphasizing the importance of FDI and traveling to meet MNCs to inform them about and offer them the subsidies at their disposal in the country, many individuals, instead of working, investing, and producing, have become relentlessly committed to waiting for a gringo to appear on their doorstep to buy their property. This is not only the case with farmers. Manufacturing concerns,

[64] Reminiscent of the way in which Margaret Thatcher, as British prime minister, "educated" a majority of Britons into accepting her privatization policies: her favorite phrase was "there is no alternative," which became known as the TINA strategy in opposition quarters.

hotels, banks, brands, and supermarkets have been sold by the hundreds to MNCs, at the same time that the government has opened the public utilities market to them.

This FDI culture is compounded by the fact that some countries have chosen to surrender to external institutions the design of their very development strategies. Both the structural adjustment programs fashionable during 1980s, which were drafted by the World Bank, and FTAs, drafted by the Office of the United States Trade Representative (USTR) and implemented by many a country, have been mass-produced by these institutions and prepackaged for developing countries regardless of their historical paths, institutional setups, and specific aspirations. Thus, many countries have not only deposited in the hands of foreign capital the main thrust of their production dynamics but have also entrusted foreign interests with the design of their development strategy.[65]

In the case of Latin America it is as if after nearly 200 years of independence some policy makers and other influential interests have ended up convinced that the peoples of their countries are unable to design their development strategy, to modernize the productive structure, to tap human resources, to penetrate foreign markets, and to drive development. Quite apart from the wisdom of a strategy of growth based on FDI, the concern of this paper is with subsidized FDI and the resigned, anti-entrepreneurial culture that may result from the unavoidable "education" of the people of a poor democratic country towards accepting those subsidies. Negative cultural effects on growth and development may manifest in the long run and overshadow any short-run positive consequences of FDI.

[65] In fact, what some countries have done is to contract MNCs as their investment and exporting agencies—paying them with subsidies—at the same time that their governments have outsourced to the WC institutions the design of the development strategies.

POLICY DIRECTIONS

If subsidies by poor countries to wealthy foreigners are undermining democracy, governance, local entrepreneurial drive, and investments in infrastructure, education, R&D, and other fields critical for sustainable development, then it is urgent to revise that policy. But the choice to move from the potentially anti-development subsidy race currently engaging most countries towards investments in those core competitive factors might not be easy given "prisoner dilemma"[66] considerations. Countries should coordinate the elimination of subsidies and move on to attracting FDI through improvements in productivity fundamentals.

Competition among countries for FDI through subsidies (the so-called race to the bottom) might determine not total FDI in competing locations but just the distribution of a given total according to the specific subsidies of each location. In that case MNCs would be getting monopoly rents at the cost of host country wellbeing. If a subsidy compensates the investor for negative location factors, any subsidy above the cost of those factors would be unnecessary and countries will save resources without losing investments if subsidies are limited to that cost.[67] However, to set the optimal subsidy countries must coordinate instead of compete.[68]

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[66] If all countries eliminate subsidies, the share of FDI among countries will remain constant and the MNCs will be the losers. One country could eliminate subsidies without losing FDI if it enjoys hard-core competitive advantages.

[67] Or as Wells et al. put it: "There is no doubt that tax incentives are costly. The first and most direct costs are those associated with the potential loss of revenues for the host government. The effort here is to determine whether the new foreign investment would have come to the country if no or lower incentives were offered. In such cases, 'free rider' investors benefit, but the Treasury loses, and there are no net benefits to the economy" (2001, 94).

[68] López and Umaña (2006), Avi-Yonah and Tittle (2002, 41), Agosin et al. (2005, 94), Oman (1999, 65), and Moran, Graham, and Blomström (2005, 382) deal with this issue. Wells et al. (2001, 40) suggest an agreement in order to allow subsidies only by LDCs.

Jeffrey Sachs states that this coordination has become an urgent matter, since "fiscal adjustments are dominated by sharp cuts on public services combined with reductions on corporate tax rates. The social contract is under threat. Only international co-operation can now solve what is becoming a runaway social crisis …"

He also says, "yet to get to the right place, countries cannot act by themselves. Even the social democracies of northern Europe, with their balanced budgets and high tax rates, are increasingly being pulled into the vortex of tax cutting and the race to the

A way to counter the race to the bottom would be to harden existing external commitments under the umbrella of the WTO with the aim of limiting or eliminating subsidies altogether. Here it may be possible to find common ground between developed and developing countries. In rich countries academic, political, and labor voices have called for the elimination of any tax abatements or tax concessions or fiscal transfers given overseas to outgoing FDI, arguing that such tax abatements lead to exporting jobs.[69] An agreement to eliminate subsidies to FDI might not be hard to muster within the WTO.

But the first best solution for a country that wants to attract FDI is to eliminate obstacles that hinder it and to strengthen existing conditions that might facilitate it: that is, the best policy is to invest in order to eliminate negative externalities and to improve on positive externalities. Here we can list, among others: infrastructure, human capital, R&D, policing, red tape, transparency, rule of law, efficient judiciary, equality, and "social peace."[70] This approach has the advantage that the government fiscal effort benefits all of society and addresses competitive issues directly instead of covering up for deficiencies with subsidies to specific firms, chosen according to technocratic criteria, at best, and, more likely, corrupt enticements.

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bottom. …. Multinational companies and their disproportionately wealthy owners are successfully playing governments against each other. …. As a starting point, the Organization for Economic Co-operation and Development countries should urgently convene a meeting of finance ministers to enunciate basic principles of budget fairness: … that recent trends towards unprecedented inequalities of wealth and income require increased, not decreased, taxation of higher incomes, including corporate profits; and that tax and regulatory co-ordination across countries are vital to prevent a ruinous fiscal race to the bottom" (Sachs 2011).

[69]However, there is a strong lobby defending outbound FDI in developed countries due to its increasing importance in MNC profits. For example, foreign affiliates accounted for nearly half (48.6 percent) of worldwide net income of US multinationals in 2006 from just 17 percent in 1977 (Slaughter 2009, 16).

[70] Researchers have found that the quality of institutions is the most important factor in growth and competitiveness. See, e.g., North (1990 and 1991). In their econometric work, Rodrik, Subramanian, and Trebbi found that "the quality of institutions trumps everything else" (2002, 4). Azman-Saini, Zubaidi Baharumshah, and Hook Law recommend: "Policymakers should create policies transparent enough for potential investors before using other measures for attracting higher levels of FDI" (2010, 1086). For a different view see Hausmann and Fernández-Arias (2001).

Ultimately the best strategy is to invest in development, so as to attract FDI through better conditions instead of attracting it by masking underdevelopment with subsidies.[71] The left, citing equity, and the right arguing allocative efficiency, might easily agree on the elimination of subsidies to MNCs, making this policy approach politically viable and perhaps even contributing to improved governance in polarized countries.

Unfortunately, policy makers often go for painkillers and quick fixes instead of addressing the root causes of the lack of competitiveness. The choice of non-Euclidian paths only rarely takes countries to competitiveness. As explored above, there may be a trade-off between subsidies and competitiveness, given that subsidies reduce the resources available to invest in education, infrastructure, and other competition-enhancing factors. Comparing Costa Rica with other Central American countries may help to evaluate that assertion. Costa Rica invested in development in the past, so it has better infrastructure, more social peace, less crime, and better human capital (measured by literacy and infant mortality rates and by life expectancy at birth) than its Central American neighbors. The country gives levels of subsidies to FDI comparable to those of the other countries yet it attracts more FDI than all the other countries put together.[72] While Costa Rica has also fallen into the subsidy race, there is little doubt that past development investments are working to attract FDI.[73]

However, the quick fix is generally more attractive to politicians in a democracy.[74] Sustainable, competitive investments do not yield results in the term of an administration, and in many cases achievements do not express themselves

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[71] This view has been put forward by Farrel, Remes, and Schulz who claim that "the multiple critiques of incentives means that there has been scope for unusual alliances bridging the usual left/right divides" (2004, 28).
[72] See Lopez and Umaña (2006, 93).
[73] The World Bank has concluded that "regardless of whether FDI independently contributes to growth, it is clear that policies and institutions that are important for growth would also be the ones that would attract FDI as well as enhance the impact of FDI on growth. Therefore, countries should focus on such policies and institutions rather than narrowly on how to attract FDI" (2005, 140)
[74] "Policymakers act out of frustration. It is difficult to deal with the real problems that keep investors away: political and economic instability, corruption, and red tape. It is easy (though costly) to pass a new law to offer more incentives" (Wells et al. 2001, xi).

in tangible assets. Typically this is the case with the quality of education and R&D. The non-attributable nature of most enduring development investments competes at a disadvantage against the short-run employment that might be generated by FDI. Under democracy, spending on subsidies to attract FDI might be more politically lucrative than investing in real competitiveness and development. The taxation race to the bottom inevitably leads to a public expenditure race to the bottom. The quick-fix strategy means that countries compete with short-cut taxation wars, not through the hard choices of investing in competitiveness.

Under these circumstances, the only policy option might be a second-best path, such as getting the WTO to institute limits on FDI subsidies. This path has its own complexities, starting with the fact that it requires multiparty engagement, which often leads to unpredictable outcomes. But the case for eliminating subsidy competition among poor countries should not be hard to make for the WTO and other pro-market institutions. While they have advocated openness and competition, they did not mean that countries ought to compete in terms of whose hand was fuller of subsidies in a growth strategy dependent on the visible hand of the state. Quite the contrary, the institutions have insisted on allowing the invisible hand of the market to play its role and on states focusing on "getting fundamentals right." Ideologically it should not be difficult for the WTO to get involved in the phasing out of any subsidies for FDI, especially if, as mentioned before, employment concerns might recruit rich countries to the task.

CONCLUSIONS

FDI is a big factor in world trade and economic integration. It has become increasingly so within the context of a worldwide consensus concerning the need to give a greater room to the "invisible hand" of the market in the allocation of resources. Yet the growth of FDI has been accompanied by a race among host countries to attract it, with the "visible hand" of the state eagerly granting subsidies. There has been plenty of scholarly interest in the links between FDI and economic growth and in the impact of subsidies on FDI intake, but hardly any research has been done on the impact of subsidized FDI on development. I have not addressed that overall impact. However, I have looked at the link between subsidized FDI and six critical development factors: the fiscal deficit, competitiveness, social development, democracy, governance, and entrepreneurship.

Research on the relationship of FDI to economic growth has had controversial results. Suffice it to say that even in the most developed countries, such as Japan[75] and the United States,[76] there have been voices opposing at least a certain type of FDI. While there is no specific research on the correlation between subsidized FDI and the development factors mentioned, at least tangentially several references give support to my argument that the relationship is negative, especially regarding the medium term. I have made the case by looking at the literature and by my own personal observation of the Costa Rican experience.

The burning questions that justify this area of enquiry are at the core of the development economics debate and also pertain to the future path of globalization. Answers are required for questions such as these:

- Is there within the Washington Consensus ideology and its pro-market-forces chorus a coherent explanation for its support for subsidizing FDI while since the mid-1980s it has condemned any subsidies for local industrial and agricultural firms as utterly inconvenient, backward, and self-defeating?[77]
- Where is the economic theory that supports a strategy that has poor countries subsidizing corporations that without any help had already penetrated most corners of the world?

[75] In fact Japan was forced by military means and the signing of what became known as the "unequal treaties" to accept FDI in mid-19th century.
[76] See, e.g., Marchick and Slaughter (2008).
[77] This in spite of the fact that the WTO has stated that incentives to FDI "are no different from any other kind of subsidy program," and that they are "vulnerable to political capture by special interest groups; there is considerable scope for introducing new distortions; and competition among potential host countries in the granting of incentives can drive up the cost of attracting FDI, thereby reducing or even eliminating any net gain for the successful bidder" (WTO 1996).

- Is there a development logic for poor countries subsidizing large and extra-large enterprises (LXLEs) while lacking the resources to help their own small and medium-size ones (SMSEs)?
- Is there an ethical foundation for poor countries funneling resources to very rich foreigners while being unable to provide adequate education and basic sanitary conditions for their own poor?
- In poor countries the low quality and quantity of public services and the low tax burden make the opportunity cost of fiscal resources very high relative to that of other productive resources such as labor. If market-oriented economic policy is about letting comparative advantages define resource allocation, what is the rationality of handing out tax exemptions and transfers to MNCs by countries whose comparative advantage is not to be found in their fiscal situation?[78]

In some cases, the analysis of these choices necessitates a zero-sum-game approach. However, as mentioned before, at least in terms of economic growth, both policy makers and some academics have put forward a rationalization anchored in the existence of market imperfections that within that limited framework might allow these subsidies to yield a win-win outcome.

Perhaps the rationalization for that apparent contradiction should not be looked for in economic theory but in politics and vested interests. Why were the Washington Consensus institutions adamant about the need to eliminate “trade-distorting” incentives[79] (the ones related to the ISI strategy) while, at least by omission, they deemed as convenient “location-distorting” incentives (subsidies for FDI)? The FDI subsidy war between countries and regions has converted the capital market into a “sellers’ market” where the sellers—the MNCs—have more lobbying capacity than the small farmers and local manufacturing SMEs that benefited from ISI trade distortions.[80] If the real Washington Consensus agenda

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[78] Perhaps appropriate for oil-rich monarchies like Saudi Arabia’s or for China whose government owns very profitable corporations and is the largest leasing landlord in the planet.
[79] See Birdsall, de la Torre, and Caicedo (2010, 7 and 8).
[80] This lobbying game is played on a global scale. See New York Times (2010).

was to open the door for MNC access to state monopolies, natural resources, and markets for their goods (subsidized like agriculture or otherwise), then everything would fall into place. Permissiveness in connection with the strategy of market interference through subsidies in order to benefit MNCs, instead of being a surprise, would have to be seen as a natural extension of that agenda. In that case subsidies to MNCs would have proliferated *not in spite of* the Washington Consensus but *because of it*. After all, these same agencies have used every tool at their disposal (IMF stand-by agreements, structural adjustment loans, and more recently, FTAs) to get poor countries to eliminate protectionist policies for local production and subsidies to local agriculture or to public utilities—in spite of the fact that the market-imperfections neoclassical argument to justify them can be argued much more convincingly than the case for subsidies for MNCs.[81]

The fact is that subsidies—including tax exemptions—are costly and distort markets. However, in as much as the Washington Consensus institutions have turned a blind eye to these distortions, local technocrats, consultants, and politicians equally committed to market fundamentalism have also struggled to demonstrate that pro-FDI subsidies are not market distorting while ISI subsidies are, instead of accepting that perhaps their standing is not ideologically chaste and that they like distortions as long as they benefit MNCs. The same eagerness to shield the strategy of development anchored in subsidizing MNCs from any questioning might be what drives their international and local advocates to deny the fiscal cost of tax exemptions.

In spite of the core tenets of the market-oriented doctrine, the Washington Consensus establishment and its local voices have not only justified subsidies for MNCs but have framed them in a strategy of growth based on open economies, market supremacy, and competition.[82] In a very elaborate linguistic maneuver, some “defenders of the faith” have stated that the tax-exempt investment regime

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[81] Furthermore, as Jiménez and Podestá point out, the use of these tools, now employed to favor MNCs, is currently more intensive than in the period of ISI (2009, 15).

[82] A good example of this posture is Monge-González, Rivera, and Rosales-Tijerino, who nevertheless acknowledge that “Costa Rica did not abandon industrial policy interventions, but its scope and objectives changed” (2010, 3).

of Costa Rica "can be seen as a new government effort to offset existing government failures, but not as a market failure." According to them, the policy imitates "a free trade policy, compensating for adverse public policies" (Monge, Rivera, and Rosales-Tijerino 2010, 27), supposedly in order to improve the competitiveness of the country. Similarly, "Colombia is likely to succeed in this competitive environment only if all of its policies—including its tax system—are conducive to attracting and retaining capital investments by foreign multinationals" (Echavarria and Zodrow 2005, 153). These positions are a far cry from the WC core view that getting the *fundamentals* right ("get the house in order") was just about all governments should do to become competitive.

Poverty and inequality may be weighing down many countries with democracy fatigue. Latin America has been fond of finding short cuts and mirages in its search for development. With most countries in the region near their 200th anniversary of independence, there seems to be more faith in MNCs as engines of development than in Latin America's own entrepreneurial potential. God-given raw materials and natural resources increasingly play a more significant role in economic growth than the creative endeavors of local men and women. On the other hand, the world economy is struggling to emerge from crises created by the largest financial corporations in the world's richest economies.

With that background, is this the time to continue investing in foreign corporations, or is it better to let markets allocate FDI flows while the resources being channeled into subsidizing them are reoriented towards investing in local entrepreneurial development, infrastructure, education, policing, R&D, or the environment? The analysis presented in this paper points to the second path.

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