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Investment incentives and the global competition for capital

by
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Investment incentives (subsidies designed to affect the location of investment) are a pervasive feature of global competition for foreign direct investment (FDI). They are used by the vast majority of countries, at multiple levels of government, in a broad range of industries. They take a variety of forms, including tax holidays, grants and free land. Politicians, at least in the United States, may have good electoral incentives to use them.[1]

The Philippines has been estimated to spend 1% of GDP on “redundant” investment incentives (the investment would have come without subsidy); Vietnam’s incentives were estimated at 0.7% of GDP in 2002; and US state and local governments spend approximately US$ 46.8 billion per year on location subsidies.[2] This is just the tip of the iceberg, as most countries’ incentive spending is poorly reported.

Like all subsidies, investment incentives tend to be economically inefficient and make income distributions more unequal (by transferring funds from average taxpayers to owners of capital). At times, they subsidize environmentally harmful projects, such as building a shopping center in a wetlands area.[3] Incentives are not always a bad policy, but their use requires taking potential problems into consideration.

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[1] Nathan M. Jensen and Edmund J. Malesky, “FDI incentives pay—politically,” *Columbia FDI Perspectives,* No. 26 (June 28, 2010).

[2] Kenneth P. Thomas, *Investment Incentives and the Global Competition for Capital* (New York: Palgrave Macmillan, 2011).

[3] C.D. Selzer, “The low road,” *Riverfront Times*, August 18, 1999.

Bargaining over incentives is characterized by major information asymmetries, leading to the likelihood of a government paying more than needed to attract an investment. Companies often conduct an incentives auction even when they have already made their location decision,[4] a clear sign of rent-seeking behavior.[5]

The past two decades have seen the spread of incentives to developing countries. Sometimes they find themselves in direct competition with industrialized countries for a particular investment. There are numerous cases in which developing countries have paid much higher incentives than those paid for similar investments in developed countries, reducing funds for infrastructure and education. A recent example is Goiás state's (Brazil) US$ 125 million subsidy to Usina Canada for a US$ 25 million investment in an ethanol facility in 2009, which came to over US$ 200,000 per job. In India, Gujarat state won a 2008 competition for the right to produce the Tata Nano. While subsidy estimates vary widely, they start at about US$ 800 million, far above the cost of Tata's investment.

Given the potential problems and risks of using incentives, many analysts have sought policies to control them. The most comprehensive approach is embodied in EU regional aid policy, which sets a maximum level of subsidy for every region in the European Union, with the highest subsidies allowed only in the European Union's poorest regions; many richer areas are banned from providing regional aid to any company. Moreover, these maxima are progressively reduced for investments over € 50 million, which helps put the brakes on the size of incentives. EU state aid rules require subsidies to be notified in advance to the European Commission and provide the Commission wide discretion to approve, prohibit or modify a proposed subsidy. The notification rules ensure a level of transparency seen in few other parts of the world. The EU rules have meant that Member States have given much smaller subsidies than US state governments for similar investments. For example, Hyundai received incentives of about US$ 117,000 per job from Alabama in 2002, but only about US$ 75,000 per job from the Czech Republic in 2007. Alabama's per capita income in 2006 was US$ 29,414 while the Czech Republic's was US$ 12,680 at current exchange rates and US$ 21,470 at purchasing power parity exchange rates. This and similar comparisons strongly suggest that EU regional aid control is effective in reducing investment incentives.

At the global level, no comparable rules specifically address location subsidies, although the WTO Agreement on Subsidies and Countervailing Measures applies to all subsidies and the OECD Declaration on International Investment and Multinational Enterprises provides for consultations. Subnational agreements in Australia and Canada prohibit subsidizing the relocation of existing operations (more successfully in the former than in the latter), and Vietnam, like the European Union, has variable subsidy limits for its provinces based on their per capita income.

Outside the European Union and several US states, information on incentives is only as good as a country's press corps. Australia and Canada collect reports on incentives from their states and

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[4] Greg LeRoy, *The Great American Jobs Scam* (San Francisco: Barrett-Koehler, 2005), p. 54.

[5] Anne O. Krueger, "The political economy of the rent-seeking society," *American Economic Review*, vol. 64 (June 1974), pp. 291-303.

provinces, but do not make this data public. Thus, transparency is the first step to reform in most of the world.

Beyond transparency, other reforms can make incentive policy more effective. This would include banning relocation subsidies, adopting job quality guidelines and "clawback" policies to reclaim incentives from firms that do not meet their investment or job creation commitments, requiring linkages with local enterprises, and adopting regional incentive control rules like those in the European Union.

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