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Incentives to create jobs: Regional subsidies, national trade policy and foreign direct investment☆

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ABSTRACT

A national authority wishes to attract foreign direct investment (FDI) to create local jobs. We analyse the optimal national trade policy when local authorities might offer subsidies to convince a multi-national enterprise (MNE) to invest in their jurisdiction. With centralised decision-making or with allocation of investment to particular localities, the central authority's optimal policy is to use a high tariff to avoid payment of any subsidy to the MNE. Despite this, some socially undesirable (but locally desirable) FDI cannot be avoided. If local authorities compete to offer subsidies to attract local investment, then the central government's optimal policy is to try to discourage FDI by choosing a low tariff. Despite this, some socially undesirable – and even locally undesirable – FDI prevails. We conduct our analysis both assuming an upper bound on tariffs, as would be consistent with trade liberalisation, and allowing tariffs to vary freely. The effect of increasing trade liberalisation depends heavily on the system of granting local subsidies: if the system is centralised, trade liberalisation decreases the range of parameters for which FDI occurs; if the system is decentralised and competitive, it increases this range.
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1. Introduction

Regional policy to attract foreign direct investment (FDI) and generate new jobs has been prominent in the recent discussion of how to stimulate local economies and relieve the effects of the global recession.[1] Jones and Wren (2008) note that, under European Union state aid rules, regional grants are one of the few means by which states can attract FDI. Where serious underemployment exists, for example, economic incentives are permitted to attract foreign firms as a way of resolving underemployment problems. Indeed, these authors comment that the UK and France devote half their regional policy budgets to financial incentives to attract FDI.

Many countries have similar local stimulus policies aimed at attracting foreign investment. A UNCTAD (2000) global survey notes that nearly all countries offered incentives targeted at specific sectors, while 70% of countries offered regional incentives. In many cases regional and sectoral incentives were integrated, so that only certain sectors received incentives in certain regions. More generally, these incentives take a variety of forms and may be offered over time or as a lump sum to assist with entry. Davies (2003) and OECD (2008) indicate that such incentives can affect FDI location decisions significantly.[2] Offering more detail on this for the case of the UK, Ernst and Young

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[1] See Ernst and Young (2011) or material from Scottish Development International at http://www.sdi.co.uk/ as examples of this.

[2] OECD(2008) finds in a review of studies on the effect of tax incentives that a 1% increase in effective tax rates results in up to a 5% decrease in FDI. Davies quotes similar findings for the responsiveness of FDI to changes in US state tax rates.

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(2011) find that tax/subsidy benefits, supporting infrastructure investments, and low administrative requirements are all important factors in the decision of firms to locate in a region or not. A major reason, also singled out in the report, for a state to offer these policies is employment gains, with 21,000 jobs created by FDI in the UK in 2010.[3]

As noted by the UNCTAD (2000) survey, in a federal system the package of incentives offered to the investor may include central as well as region-based incentives, while the process of agreeing a package may involve differing degrees of competition among regions. Such competition can create windfall benefits for investors: the report cites the case of Mercedes-Benz, which wished to establish a new car plant in the United States and contacted six states before deciding to accept a (generous) location package from Alabama. Similar competition among states to attract a Ford Motors assembly plant occurred in Brazil. The UNCTAD (2000) report goes on to enumerate an exhaustive list of regional policies towards FDI, illustrating that different countries have chosen different degrees of centralisation. Roughly speaking, the US and Europe seem to take a relatively decentralised approach (although this varies by country), many developing countries seem to take the approach of designating a limited number of regions (sometimes only one) that are allowed to offer the incentives without internal competition among regions, and some smaller countries (such as Singapore) take a purely centralised approach, where FDI packages can only be obtained from the national government. When a region is the designated destination, the actual negotiations for the incentive package can be delegated to the local authority.[4] Jones and Wren (2008) note that centralisation and the degree to which competition is permitted among regions within a country can also vary over time, documenting the vacillations in the UK system.[5]

FDI location decisions are affected by more than just regional incentive policies, however. A recent OECD report stated that "Trade policy is one of the main determinants of foreign firms in their investment decisions…High barriers to imports can include tariff-jumping FDI — FDI as an alternative to trade."[6] Even in federalised countries, trade policy typically is in the hands of the central government. For federal governments concerned that competition among regions can dissipate the rents that would otherwise accrue to the country from FDI, trade policy as a tool to avoid this destructive competition is one way forward. Intuitively, trade policy can deal with the problem of excessive local bidding in two ways: first, in setting high tariffs the central government can decrease the "bargaining power" of the multinational enterprise (MNE). This policy does not discourage FDI, but it can decrease the rents captured by the firm in the bidding. Another approach is to lower the tariff so as to make the (local) incentives required to attract the FDI prohibitively high for the region(s). This policy potentially eliminates FDI entirely in favour of imports, but also eliminates costly subsidy competition in the process. Where local subsidies would mount to levels that outweigh the country's gains, this can be a better choice for the nation as a whole.

This paper explores this intuition. We study whether and how trade policy can be used effectively with incentives when incentives can be decentralised by region and where regions may or may not be allowed to compete for the FDI. Following Brander and Spencer (1987) and the sense of the literature we have quoted as motivation, we postulate that FDI can increase local levels of employment. A single MNE considers investment into a country (or group of countries). Local authorities try to attract the foreign firm by offering subsidies, which can be thought of broadly in our model as any package of incentives to attract the firm (involving tax breaks, infrastructure investments and so on). Trade policy takes the form of a per unit import tariff set by the central government. In choosing the tariff, the central authorities take into account its effect on the bidding behaviour of the local authorities and the investment decision of the MNE.

Our first result is that, if both the trade and FDI attraction policies are centralised, FDI only occurs when it raises the country's welfare. FDI is induced optimally through a high tariff so that no subsidies are paid. This is consistent with the first of the two mechanisms outlined above: the tariff has the advantage of affecting the decision to locate but also the "bargaining position" of the firm, since it affects the attractiveness of the alternative of exporting.

We next consider the fully decentralised case where different regions compete for FDI. The crucial effect of this competition among regions is that the central government can no longer induce subsidy-free FDI by setting a high tariff. To the contrary, by fully committing the firm to the FDI route, a high tariff can increase the level of subsidy offered by the states in their attempt to compete for the jobs that the foreign firm surely will create in one of the local jurisdictions. In this case, then, the central government may find it optimal to avoid socially undesirable subsidized FDI by setting a low tariff, and so provide an incentive for the firm to switch to exports. By improving the outside option of the firm, the central government makes FDI a more expensive proposition for the localities, potentially making FDI prohibitively expensive. The central government curtails excessively expensive subsidy competition by *lowering* the tariff, which generates substitution into imports but reduces subsidy expense.

Finally, we consider the case where FDI is assigned to a unique zone within the country, which is allowed to provide subsidies for FDI but which does not compete with other regions. We find that in this case, the only difference with the fully centralised case may occur in the upper regions of costs, where the tariff may optimally be lowered to prevent subsidies' being offered.

Overall, when we compare regimes, we find that the range of levels of production efficiency for which FDI occurs under the optimal trade policies is larger with full centralisation or non-competitive bidding

[3] For further evidence of the positive effects of FDI on local employment see, for example, Blomstrom et al. (1997).

[4] The degree of delegation to the local authority can be a matter of intense debate. To give some examples, recent discussion about how to set up an Enterprise Zone comprising Northern Ireland has focussed on Enterprise Zones as a means of attracting FDI and on the degree of delegation of specific incentive negotiations to Northern Ireland as a local authority. See http://www.publications.parliament.uk/pa/cm201012/cmselect/cmniaf/558/55808.htm and http://www.publications.parliament.uk/pa/cm201012/cmselect/cmniaf/558/558we15.htm. Belgium used to operate a centralised system, where typically enquiries went through diplomatic channels to the central government, which then decided whether this opportunity would be for the "Flemish" or the "Walloon" region of the country, at which stage negotiations with the regional, provincial, or communal authorities could proceed. Interestingly, Belgium is now extremely decentralised, so that its two main regions would normally be trying to attract the same MNE's. China has followed a policy that has vacillated between more and less local control of approval of foreign investment projects, even within the limited number of economic zones in which FDI has been permitted in the past. For some sectors, central approval is required whereas for others an "automatic" route allows entry with approval by a delegated board. See http://www.indianembassy.org.cn/DynamicContent.aspx?MenuId=17&SubMenuId=11 for a description of current procedures. The right to grant tax breaks to FDI has been centralised, so that different regions could be favoured. For example, central and western areas have been given the right to allow tax incentives, while this right has been reduced for coastal areas. See http://www.chinalawblog.com/2010/05/china_foreign_direct_investmen.html. India, too, has modified its policy over time from a system of industrial licensing, largely controlled by the centre and including location restrictions, to one of largely decentralised policies at the state level. For discussion see Ahluwalia (2002).

[5] Following the abolition of regional development agencies by the coalition government, responsibility for the promotion of the UK as an inward investment location was transferred to the national level whereas it was devolved before. See http://www.bis.gov.uk/policies/economic-development/englands-regional-development-agencies. For further discussion of recent changes in the degree of centralisation of FDI incentives in the UK and current policy implementation from a user perspective, see also http://www.coast2capital.org.uk/articles/foreign-direct-investment.html.

[6] For a general outline of the many interactions among both tariffs and non-tariff barriers and foreign direct investment, including case studies and emphasis on developing countries, see Gage and Miroudot (2005). That paper outlines a host of interactions, including protectionist policies. Our goal is not to explore the interaction of trade and FDI policy in all its facets. Rather, we explore a part of the intuition in this type of work, making precise the interactions among the policies considered.

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