This chapter investigates the main approaches used to analyze competition for investment through investment incentives. We begin with general approaches to assessing the use of incentives, including Prisoners’ Dilemma, models in the Tiebout (1956) tradition, incentives as necessary to generate spillovers and the global vs. local efficiency matrix. Next, we move to a consideration of game theoretic models more complex than Prisoners’ Dilemma, either relaxing its assumptions or using a more general ‘subsidy game’. After that, the spotlight turns to statistical analyses of the effects of tax and incentives on investment. Finally, we survey significant case studies from both developed and developing countries.

Perspectives on incentives

This section groups competing perspectives on investment incentives based on their overall evaluations. First, some analysts come to positive evaluations using a variety of general arguments. For example, some studies argue that incentive competition enhances economic efficiency by leading to an optimal sorting of firms to localities with their preferred package of taxes and services, a line of thinking that can be traced to Charles Tiebout (1956). Another approach sees incentives as a way of ensuring that all socially valuable investments are made within an economy; in particular, investments that provide positive spillovers to actors beyond the investor, whose private returns are therefore lower than the social returns (and may therefore refrain from investing under certain circumstances). Dreyhaupt (2006) is a good recent illustration of this argument. Bartik (1991) argued that incentive competition could generate efficiency if it allocated investment...
from areas of low unemployment to those of higher unemployment; we can see an echo of this in European Commission decisions on state aid according a higher value to investments in lower income areas of the EU (a recent example is the approval of Polish regional aid for Dell; see European Union, 2009f, p. 39). Finally, strategic trade theory recommends the use of subsidies at times in industries with increasing returns to scale and imperfect competition. Second, negative interpretations see incentives competition as leading to insufficient investment in public goods due to loss of revenue (Oates, 1972). An alternative, though complementary view is based on seeing incentives competition as a Prisoner's Dilemma in which governments are individually better off but collectively worse off when they give location subsidies, a view that can be traced back to Stephen Guisinger (1985). Third, a mixed or contingent evaluation of incentives comes from the local vs. global efficiency matrix approach adapted from Cheshire and Gordon (1998) by Rodriguez-Pose and Arbix (2001), and subsequently used in several OECD reports.

The market for investment

Stephen Guisinger (1985) proposed the notion of a ‘market for investment’, and divided this market into three types based on the location to be served. Investment incentives differ according to market type. Domestic-market-oriented investment tends to garner the fewest incentives as the location choice is constrained to that market. Food processing is an industry that tends to fall into this category. By contrast, common-market-oriented investment requires the existence of a free trade area among jurisdictions, such that the entire common market can be served from a single location. Guisinger states that such investments tend to create intense bidding wars due to the company’s ability to locate in any of the jurisdictions. While his main focus was on the European Union, it can be argued that these dynamics also hold within large federal states such as the United States and Brazil. The automobile industry is an example of one where production and consumption tend to be located within the same regional market. Finally, some investment is oriented to the entire world market, as for example many branches of the computer industry. Certain types of computer investments may find competition coming from countries as geographically diverse as Ireland, Germany, Israel, Singapore and the United States. Again, we find that the competition among governments to obtain these investments is often intense.