Chapter 8

Controlling Incentives and Maximizing the Value of Inward Investment

This chapter analyzes the ways that policymakers around the world have tried to control investment incentives and evaluate their success. As discussed earlier, a number of studies, such as that of Head, Ries, and Swenson (1999) and Albornoz and Corcos (2007), offer theoretical justification for multilateral control of incentives. Here we consider several real-life attempts in that direction. First, I will discuss the rules and effectiveness of the most comprehensive disciplinary effort, that of the European Union. This section begins with a general outline of rules, followed by the most important framework applying to investment incentives per se, the Multi-Sectoral Framework on Regional Aid for Large Investment Projects. As we will see, these comprehensive controls have achieved the most success in disciplining investment incentives and bidding wars, but they lack a complete ban on the use of relocation subsidies. The various rules in the GATT Uruguay Round agreements that affect subsidies, including the Agreement on Subsidies and Countervailing Measures (SCM), the General Agreement on Trade in Services (GATS), and the Agreement on Trade-Related Investment Measures (TRIMS), are then explained. These constitute a relatively blunt tool for controlling investment incentives, and the transparency provided by the reporting requirements of the Agreement on Subsidies and Countervailing Measures is far less than that achieved in the EU. Third, we consider two subnational agreements on incentives among Canadian provinces and territories, and among Australian states. While Canada’s Code of Conduct on Incentives has failed to prevent provinces from using relocation incentives, the size of the relocating projects has declined from the 1990s when the provisions were adopted. Australia’s
Interstate Investment Cooperation Act has done a better, though still not perfect, job preventing subsidized relocations. Fourth, we will examine the contentious politics of subsidy control in the United States. While essentially all federal programs prohibit their use in funding relocation incentives, the two voluntary attempts by groups of states to ban such incentives both quickly failed. There is, however, a substantial amount of political organizing on subsidy issues in the US. The chapter finishes with an analysis of the disciplines that exist in a small number of the many bilateral investment treaties (BITs) and investment incentive agreements (IIAs) in force around the world, as well as in bilateral or regional free trade agreements. As these are aimed primarily at protecting investors’ rights, they do not really address control of incentives.

**European Union state aid control**

‘State aid’ is the term the European Union uses to refer to subsidies. Thus, state aid law applies to far more than investment incentives, but to all types of selective government support to business, even state-owned firms. Of particular interest for this report are the rules on regional aid, most notably the formerly stand-alone Multi-Sectoral Framework on Regional Aid for Large Investment Projects (‘Multi-Sectoral Framework’ or MSF). EU state aid rules begin from the presumption that subsidies should not be used by Member States unless they contribute to a goal of the European Union as a whole (not just that of a Member State) and do so in a way that is least distorting of trade within the EU. In other words, there must be a *quid pro quo* (the French term for this principle is *contrepartie*; it is sometimes translated into English as ‘compensatory justification’ or, more literally, ‘counterpart’): if a government gives subsidies to a company, it must contribute to the goals of the EU. Contributing to the development of backward areas, restructuring of firms in difficulty, research and development, controlling pollution, and employment support can all potentially serve this function.

A second critical element of state aid control is oversight: all subsidies must be notified to the European Commission in advance, and may not be implemented until they are approved by the Commission, which can prohibit or modify them if they are in violation of EU law. In the mid-1980s, the Commission began requiring the repayment of aid incompatible with Articles 87–89 of the Treaty of Rome that had been given without respecting the notification rules as the ultimate deterrent of non-notification. Since then, aid recipients and the Member States have fought against this in cases before the European Court of Justice (ECJ),