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State tax competition for foreign direct investment: A winnable war?

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Abstract

When a multinational firm invests in a country, potential host states compete for the firm by offering firm-specific tax reductions. Critics blast such incentives for transferring rents to the firm without affecting the investment decision. In fact, these incentives are tied to the firm's use of domestic inputs and therefore affect output decisions. With positive interstate spillovers, a federal subsidy is necessary to reach the national optimum without tax competition. Competition reduces state taxes and the need for federal subsidies. Also, under competition, the firm locates efficiently. Therefore, tax competition does not always reduce national welfare.

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1. Introduction

When a multinational enterprise (MNE) undertakes foreign direct investment (FDI), it does so through a two stage process. First, the MNE researches several possible locations and narrows its focus to a handful of potential sites. Then these potential locations bid

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Table 1
Automotive plant incentive packages

Company (Location)	Completion date	Company's investment (millions)	Estimated employment	Incentives	Total incentives (millions)	Incentive cost per Job
Motorola ^a (Quebec)	1999	\$300	500	Payroll tax credits, low-cost space	\$50	\$100,000
Mercedes ^b (Alabama)	1993	\$250	1400	Free land, employee salaries for one year, property tax relief, payroll tax credits, state spending	\$300	\$160,000
Toyota ^c	1988	\$800	3000	Job training; land purchase assistance; site preparation; skills center; highway improvements; educational programs for Japanese employees and families.	\$325	\$108,333
Diamond-Star ^c (Illinois)	1988	\$650	2900	Job training; road, water, sewage installation and improvements; land purchase assistance; property tax abatement.	\$118.3	\$41,000
Isuzu/Fuji ^c (Indiana)	1988	\$500	1700	Job training; road, highway, sewer improvements; land acquisition assistance; \$1 million cultural transition fund to aid Japanese workers and families.	\$86	\$51,000
Mazda ^c (Michigan)	1987	\$550	3500	Job training; road, rail, sewer, site improvements; special \$500,000 loan; tax abatements.	\$52	\$15,000
Nissan ^c (Tennessee)	1983	\$850	3300	Job training; road, sewer, water, rail improvements; local property tax abatements; company makes payments in lieu of taxes.	\$66	\$20,000
Honda ^c (Ohio)	1982	\$870	4200	Property tax abatement on buildings; previous \$16.4 million grant to Honda for adjacent motorcycle factory.	\$16.4	\$3,904

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