Fiscal competition for heterogeneous firms and the quality of local infrastructure services

Serena Fatica, Katholieke Universiteit Leuven
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Abstract

We study competition among regions to attract potential investors. Regions have two instruments at their disposal: direct financial incentives to firms and the quality of the local differentiated infrastructure. We compare two alternative compensation policies: uniform subsidies versus discriminatory aid. We find that, when the number of competing regions is exogenous, the quality level of the local infrastructure under the discriminatory policy maximizes social welfare. However, the number of regions actively seeking to attract investment is inefficiently high. In addition, it is shown that the welfare maximizing level of quality can be reached through quantitative limits to the financial transfers that decentralized jurisdictions are allowed to grant to producers.

Keywords: fiscal competition, regional development, infrastructure.

JEL classification: R58, H25, H70.