Non-technical summary

This paper examines the role of investment incentives in foreign direct investment (FDI) attraction. Specifically, the impact of an incentive scheme introduced in the Czech Republic in 2001 on territorial distribution of FDI is analyzed using aggregate district-level data. Other location FDI determinants are explored, too.

A main motivation for this study is the policy relevance of this topic. Based on existing empirical literature, FDI is regarded as an important factor in regional economic growth. Understanding the link between government policies and FDI distribution sheds light on the possibility to direct FDI flows into distressed regions. Moreover, government incentive schemes use large amounts of public money therefore a rigorous assessment of their efficiency is needed. Finally, there is a lack of previous empirical literature addressing this issue both in the Czech Republic and Central Europe.

A fundamental feature of the Czech investment incentive scheme is that the amount of the subsidy differs across districts, offering higher incentives in districts with higher unemployment rate and, thus, motivating investors to locate in more distressed regions. Three cutoff points of discontinuity are considered according to the design of the scheme which introduces three unemployment thresholds deciding in which of eligibility groups a particular district belongs to.

The identification strategy is based on regression discontinuity approach. The variation in FDI caused by unobserved heterogeneity among districts is assumed to be zero near each discontinuity. The variation explained by observed location characteristics is filtered out and the remaining difference in the FDI inflow presents the estimated impact of the incentive scheme.

The results indicate a positive and both economically and statistically significant effect for the first threshold (average unemployment rate). A shift from ineligibility to being eligible for the incentive scheme presents an increase of future FDI inflow per capita in a district by 8,000 CZK. On the contrary, the impact of second threshold is insignificant which can be explained by low marginal amount of the subsidy. The insignificance of the third threshold (1.5 x average unemployment rate) and may possibly be explained by the unwillingnes of investors to locate in a „stigmatized“ labor market even if compensated with a generous subsidy.

Among other FDI location factors, a connection to highway network and a common border with EU-15 significantly increase FDI inflow per capita (by 2,400 an 2,000 CZK, respectively). This findings indicate that for the most important factors for foreign investor is the proximity of target markets, infrastructure connection an at least some amount of subsidy. Adding extra amount of in case of worst regions in terms of unemployment has no significant effect on location decision.