Optimal policy for attracting FDI: Investment cost subsidy versus tax rate reduction*

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Abstract. This paper examines and compares two policies for a host government to attract FDI: investment cost subsidy and tax rate reduction. While investment cost subsidy is provided by the host government at the time that a foreign firm initiates FDI, tax rate reduction is applied to the instantaneous profit earned by the foreign firm after investment. We demonstrate that the optimal policy for attracting FDI depends on the profit uncertainty. There exists a critical level of the profit uncertainty: when the uncertainty is smaller than the critical level, investment cost subsidy is optimal; when the uncertainty is larger than the critical level, tax rate reduction is optimal.

Keywords: Real options; Foreign direct investment; Investment cost subsidy; Tax rate reduction

JEL classification: F21; F68; G11; G13

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