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Journal of Urban Economics 60 (2006) 327–349

JOURNAL OF Urban Economics

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Evaluating the impact of investment incentives: The case of Italy's Law 488/1992 ☆

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Received 4 October 2005; revised 17 March 2006

Available online 3 May 2006

Abstract

Italy's Law 488/1992 allows firms willing to invest in lagging areas to receive a public subsidy. By comparing subsidized firms with firms with rejected applications, this paper evaluates whether the program made investments possible that otherwise would not have been made. We find evidence that financed firms brought forward investment projects originally planned for the post-intervention period to take advantage of the incentives. We also find some support that subsidized firms may have taken some of the investment opportunities that unsubsidized firms would have exploited in the absence of incentives.
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JEL classification: R0; H2

Keywords: Investment incentives; Regional aid

1. Introduction

Financial assistance to manufacturing industry channeled through Law 488/1992 (Law 488) has for many years been the main policy instrument for reducing territorial disparities in Italy. Significant amounts of public money have been spent to stimulate investment. From 1996 to 2003, the funds distributed to industrial firms amounted to €16 billion and involved 27,846 projects, mainly in the southern regions. Law 488 allows firms willing to invest in lagging areas to receive a public subsidy that covers a fraction of the investment outlays. The incentives are

☆ The views expressed in the paper are those of the authors and do not necessarily correspond to those of the Bank of Italy.

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doi:10.1016/j.jue.2006.03.005

awarded through competitive auctions according to predetermined criteria, such as the proportion of firms' equity invested in the project; the number of jobs involved and the proportion of assistance sought.[1]

The extent to which investment incentives have an economic payoff has been at the forefront of economic research for decades (see, for instance, Hall and Jorgenson [22] and King [24]). Moreover, the role of incentives in reducing territorial disparities is a central topic in regional science (Faini and Schiantarelli [16], Harris and Trainor [23], and Gabe and Karybill [17]; see, also, Glaeser [18]). Although this literature is voluminous, there is no agreement on the effectiveness of investment incentives. Evaluating the effects of government sponsored projects, one has to face the question of what would have happened without the subsidies. That is, evaluating an incentive program is a counterfactual exercise. Since neither the subsidized firms nor the unsubsidized firms can be considered random draws, the challenge is to construct a valid control group. Moreover, to evaluate whether Law 488 made investments possible that otherwise would not have been made, two more issues need to be tackled. First, one has to analyze the extent to which additional investments have been triggered by time-substitution (Abel [1], Adda and Cooper [2], and Auerbach and Hines [5]). To take advantage of the incentives, firms could have brought forward investment projects originally planned for the post-intervention period. Second, one has to study the role of cross-sectional substitution (Klette et al. [25] and Lee [28]). Subsidized firms may have taken some of the investment opportunities that unsubsidized firms would have exploited in the absence of the incentives.

By adopting a difference-in-differences framework, this paper takes advantage of the auction mechanism that is used to allocate the incentives under Law 488. We compare a group of financed firms with a group of firms that applied for the incentives but were not financed since they scored low in the Law 488 ranking. As suggested by Brown at al. [10], the main virtue of the rejected application group is that it is very similar to the treatment group in terms of its characteristics. While the rejected firms are hardly a random group, they may be as close to a control group as is possible. We further check the reliability of the comparison group in two respects. First, we implement an intuitive version of the regression discontinuity design (Campbell [11]) and contrast financed firms just above the financing threshold in the Law 488 ranking with non-financed firms just below that threshold. Second, we construct a comparison group that mirrors the time-series pattern of the treated group before the program took place. This group comprises firms for the which the deviation with respect to the average investment growth rate of the treated firms is minimized. A central focus of the paper is to evaluate to what extent the impact of Law 488 is biased by time- and cross sectional-substitution. We deal with the former by using a long time series of post-intervention observations and the latter by restricting the estimates to firms that compete in geographically bounded markets or otherwise close to each other in their industrial distance.

When compared with the pool of firms that requested Law 488 grants without being financed, we find that financed firms initially increased their investments. The increase takes place in the second year of the treatment. However, we also find evidence of intertemporal substitution. In the years following the program, the investment activity of the financed firms slows down significantly compared to that of the rejected firms. Finally, the impact of Law 488 is more pronounced when the size of the market where the firms compete is small or when the firms are close in their

[1] Although this paper focuses on a particular type of financial assistance in a given country, its scope is much wider: investment incentives programs very similar to Law 488 are now being implemented in many EU countries. See Braunerhjelm et al. [8] and Yuill et al. [33].

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