Effects of investment subsidies in Italy on firm entry and exit

Sarah Fritz[1] and Catherine van der List[2]

[1]Halle Institute for Economic Research
[2]University of Essex

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In this research, we investigate how the EU's main place-based policy - the EU Cohesion Policy - impacts spatial disparities in economic growth of local geographic areas through its influence on firm entry and exit. Spatial disparities across and within countries in the European Union (EU) are profound and persistent, despite the EU's efforts to support job creation, economic growth and sustainable development in less developed regions. Indeed, the EU's place-based policy is also its main investment policy, amounting to one-third of the EU budget (371 billion Euros between 2014 and 2020). Financial resources from the EU Cohesion Policy are heavily concentrated on regions with GDP per capita below 75% of the EU average. Thus, transfers to targeted areas are large, roughly 3% of their initial GDP.

Despite five periods of funding for EU cohesion policy, its efficacy is still poorly understood. Recent empirical literature on the topic has found that investment subsidies increase employment in firms and areas which receive the funds, but provide mixed results on whether the programs increase wages and productivity (Criscuolo et al. 2019; Ku et al. 2020; Siegloch et al. 2022). However, despite the EU's objective to induce sustainable growth, such positive growth effects may not be long-lived (Becker et al. 2018; Barone et al. 2016). As new firms are a key driver of such long-term economic growth (Walsh 2023), we intend to bridge the gap in understanding the medium- to long-term effects of the EU Cohesion Policy through studying its impact on establishment exit and subsequent business creation in local economic areas in Italy.

Italy has been and continues to be one of the main beneficiaries of the EU Cohesion Policy. From 1989 onward, regions of the "Mezzogiorno" have received substantial fiscal transfers from the European Union. 30 years later, regions in the South of Italy continue to lag behind, with regional GDP per capita still being below 75% of the EU average. But, would regional disparities have been worse without the EU Cohesion Policy? Subsidies may drive entry, but could also suppress entry if the subsidies keep unproductive firms in business.

We aim to make several contributions to the existing literature:

First, we will study how EU investment support relates to firm creation. The stated goal of policymakers is to equalize economic outcomes across the EU in the long run, but the existing literature has focused on immediate employment, wage, and productivity effects of the policy. Firm creation is especially important to long-run growth in areas, as they drive the majority of new employment (Walsh 2023).

Second, we study how EU investment support relates to firm closure. Firm closure is an important question for three reasons. First, non-viable firms - colloquially known as "zombie" firms, could be the ones benefiting from the funding, in which case taxpayers' money is simply wasted. Second, the investment policy may be supporting firms in declining industries, slowing down factor reallocation towards more productive sectors of the economy. Finally, the policy may be leading to larger market shares for incumbents compared to a competitive economy, as incumbents are more likely to have the know-how and administrative resources to apply for the funding. In all three cases, entry of new establishments may be suppressed.

Third, taking our analysis of business entry and exit together, we will study the overall effect of the investment policy on a local economic area on in the medium- to long-term. We will be able to answer empirically whether, for instance, subsidies for new firm creation outweigh the potential negative effects of reduced exit in practice. Alternatively, given the poor economies in the areas targeted by the policy, it may be the case that in the absence of the policy new firms would not enter anyway. In this case the policy may be desirable. A marginal value of public funds calculation will provide an empirical method to study these overall effects (Finkelstein and Hendren 2020).

For our empirical analysis, we plan to use a close-election regression discontinuity design to compare municipalities with a mayor endorsed by the governing coalition of the region with those municipalities whose mayor is affiliated with the opposition. The regional government plays a crucial role as it is responsible for administering the funds from the EU Cohesion Policy. Beyond political favoritism, the idea is that successful application for the subsidy requires specific know-how and information asymmetries are more likely to be reduced in case of matching political affiliation. Muraközy and Telegdy (2016) find that in Hungary, for visible projects such as infrastructure projects, more funds are given to municipalities with the same political color as the regional government. Moreover, we are in the process of collecting data on the members of the regional government, to test whether more funds are directed to regional ministers' place of birth.

We use geo-referenced administrative data on the universe of projects co-financed by any EU fund in Italy for the 2007-2013 and 2014-2020 funding periods. This data contains detailed information about each project, including the municipal code where the project took place, detailed breakdowns of the sources of funding for each project, as well as daily-level information about the start and end dates. Importantly, we also have tax identifiers of the planning body, implementation body, beneficiaries, and executors of the projects.

For our outcome variable, we use data from two different sources. First, the Italian National Institute of Statistics (ISTAT) provides yearly data (from 2004 onward) at the 3-digit industry level by municipality on the number of active plants as well as the number of people employed there. Second, we use data on the number of firms entering and exiting at the 3-digit-industry level by province made available by Info Camere, the IT company for the Italian Chambers of Commerce which collects official data on Italian individual business persons and commercial companies.

In order to investigate the mechanism through which the subsidies impact firm entry and exit, we link the entities carrying out the projects co-financed by the EU, to firm-level data via their tax identifiers. In particular, we are able to match the subsidy data to Bureau van Dijk's historical Orbis database. This dataset contains general information on companies operating in Italy, their industry classifications, their financial statements and their ownership history data. The general information typically include the date and place of incorporation as well as their current and past status (i.e. active, dissolved, bankrupt etc.). Notice that since we are using the historical vintages, exiting firms are kept in the database, allowing us to observe both the time of exit and information about defunct firms.

In a nutshell, we will combine sources of data of geo-referenced projects with firm-level and municipal/provincial level data and undertake an empirical analysis of the effect of the EU cohesion policy on firm entry and exit.

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