CASH INCENTIVES VERSUS TAX INCENTIVES FOR REGIONAL DEVELOPMENT: ISSUES AND CONSIDERATIONS

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Introduction

Every change of government provides the opportunity to hang a question mark alongside existing policies and programs. A new government not only has less vested interests in or ties to programs established under the previous administration; it is usually also anxious to introduce changes to set itself apart from the government it replaced. So it was with the Mulroney government, when it came to power in the fall of 1984. In the regional development field, the new government opened a debate over the effectiveness of cash grants versus tax incentives as a regional development instrument.

The purpose of this paper is to review the strengths and weaknesses of both approaches. The objective is not so much to pick a clear winner, as to examine the advantages and disadvantages of each. The paper also attempts to broaden the debate by looking at political and administrative, as well as current economic circumstances.

The Case for Regional Cash Incentives

Government grants to industry to locate in designated regions have constituted the cornerstone of national regional development strategy in nearly all of the OECD countries for at least
A wide range of regional incentive instruments are available throughout the industrialized world. There are capital grants, investment grants, loans, repayable grants, loan guarantees, working capital and participation loans, equity participation, freight subsidies, duty remissions, operating cost subsidies, labour subsidies, and subsidies for counselling services.

Grants calculated on the basis of capital cost and expected number of jobs created have proven to be the most popular type of incentive. In the early 1980s, all OECD countries had at least one capital grants program for regional development purposes; only the United States failed to make it the basic element of the regional incentives available. In the case of Canada, the former Regional Development Incentives Act (RDIA) was based on both capital cost and number of jobs the project would create. The Industrial and Regional Development Program introduced in 1983 has a much broader base for providing assistance, but remains essentially a cash grant approach.

Supporters of cash grants to promote regional development point to a number of attractive features. Cash is provided in the early years of operations, precisely when it is most needed and most difficult to obtain. In addition, the entrepreneur is provided with a firm assurance of the terms of the financial benefit to be received.

Supporters of the cash grant approach also point out that, compared to tax incentives, the former is more easily understood by small and medium sized businesses. Tax incentives, they argue, can serve to complicate an already complex tax system. In addition, tax incentives are of limited benefit to firms just starting operations first begin.

They also argue that cash grants hold important advantages from an administrative point of view. They can be made discretionary, thus avoiding abuses and ensuring that assistance is provided only to project which are considered viable but which require help to get properly launched. Cash grants are a high profile, highly visible activity, placing the government in a favourable light. Considerable publicity follows whenever a grant is announced, with the number of expected jobs to be created for the community always highlighted. Sod-turning ceremonies and official openings of the plant invariably provide yet more opportunities for giving the government a "good press".

These considerations may well have influenced governments in Canada to be predisposed to regional development grants for the past twenty years or so. All provincial governments have at one time or another offered grants to firms for the capital cost of establishing new facilities; however, by far the most well known regional incentives program has been RDIA (Regional Development Incentives Act) administered by the former Department of Regional Economic Expansion (DREE). Under RDIA alone, over $1 billion of public funds were committed in the form of cash grants to the private sector in order to stimulate development in designated regions. A total of 7,120 offers were accepted out of 20,299 applications received from July 1, 1969 (or from inception of the program) to March 31, 1981. DREE revealed that the grants were expected to have generated $5.3 billion in investment and to have created 167,691 direct jobs. The cost for each direct job created amounted to about $5,000 for the life of the program. However, by the early 1980s, the cost per job under RDIA rose to about $10,000, as a result of inflation. Even this figure, according to former DREE officials, was in line with the cost-per-job ratio of other federal government programs of the time, notably the Enterprise Development Program of the former Department of Industry, Trade and Commerce.

The objective behind RDIA, when the program was first established, was to increase productive employment opportunities in slow-growth regions. Over the life of the program, however, amendments were introduced, so that by the time it was terminated it was no longer clear precisely what objective was being pursued.

The most important changes introduced to RDIA were the continuous revisions of the regional designation. When the program was first introduced, it was limited to the four Atlantic Provinces, the Gaspé, northern Quebec, northern Ontario, and essentially the northernmost regions of the four western provinces. All in all, the regions designated accounted for a little over 30 percent of the total Canadian population. Parts of Ontario, Alberta, and British Columbia were designated, it is now revealed, more as a gesture to ensure that these provinces would not feel completely left out of the federal government program. It was feared that if this had happened, they would, given their relatively strong fiscal position, have introduced on their own provincial programs which would be in direct competition with Ottawa's.

The program was revised in 1971 to provide a special level of grant assistance to the Montreal-Cornwall region and the Atlantic Provinces. In 1977, under the authority of the DREE legislation, a new Montreal Special Area program was established.


2 Interview with former DREE officials.
Other regions were also added, so that by 1982 RDIA covered 93 percent of Canada’s land mass and over 50 percent of the population. In addition to RDIA, a number of special regional incentive initiatives were sponsored through the federal-provincial General Development Agreements which saw the provinces actually deliver the programs.

All in all, there was such a variety of programs by the early 1980s, that it prompted Canadian Business [15:65] to observe that:

Staying abreast of the hundreds of federal and provincial aid and incentive programs for business could be a full-time job if you let it. Indeed, some firms are in the happy position of being able to employ staff or consultants whose sole function is to sniff out all the juicy morsels the politicians and policymakers throw into the public trough.

When the federal government reorganized in 1982 and disbanded DREE, it came forward with a new industrial incentives program. The Industrial and Regional Development Program (IRDP) is more comprehensive and differs from RDIA in several ways. For one thing, it applies throughout Canada, even in the highly developed regions of Toronto, Vancouver, and Edmonton. It also has four different tiers or levels of regional needs. The highest tier, tier 4, is designed for regions of greatest need as determined by unemployment levels, per capita income, and the fiscal capacity of the province. At the other end of the spectrum is tier 1, designed for the more developed regions of the country.

IRDP is also much more flexible than RDIA was. It can provide financial assistance to business and non-profit organizations through grants, contributions, repayable contributions, participation loans, and loan guarantees. In addition, a firm can become eligible for a host of initiatives under what is described as the “six elements of a product or company cycle”. The elements are climate (e.g., infrastructure facilities); innovation (e.g., studies on project feasibility); establishment (e.g., plant establishments); modernization and expansion; marketing (e.g., market research studies); and restructuring.

From its inception in July 1983 to March 31, 1984, the program generated 3,630 applications for assistance. From among these, DRIE made 549 offers, of which 381 were accepted. Tier 1 and tier 3 saw by far the most activity, both in terms of offers accepted and of expected number of jobs created [8].

One can conclude that, at least from the federal government perspective, the regional incentives approach to regional develop-

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The Case Against Regional Cash Incentives

Regional cash incentives, including Canada’s RDIA and IRDP, are not without opponents. Some firms are critical of them on the basis that the government is subsidizing unnecessary competition in their industry. This is particularly true of established businesses in designated regions where new firms start operations in their sectors with the aid of a government grant. But it is also true of established firms in non-designated regions. Such firms will often argue that the government is basically incapable of picking “winners” through its regional incentive programs. It too often jumps to the rescue of “losers”, thereby weakening firms that survive without assistance in all regions of the country.

Some also suggest that there is a political cost involved. Such programs do not always cast the government in a favourable light, nor do they always permit the local Member of Parliament to announce projects and new jobs for his riding. Projects receiving a regional grant can encounter difficulties and consequently heap a great deal of negative publicity on the government. The local MP is then called upon to defend the action of the government in giving public funds to a business that is unable to become viable in the marketplace, notwithstanding government assistance. Charges of incompetence can be hurled at the government, since the success of a regional grant is directly linked to the viability of the receiving firms.

Others suggest that, because a regional incentives program is highly visible, there will always be a bitter political debate over which region is “in” or “out” of the program. This debate invariably surfaces in the media, in caucus, and in Cabinet. The reason behind such a debate is obvious. MPs and Cabinet Ministers regard as one of their principal responsibilities the promotion of

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The program was revised on 9 November 1984. See “Adjustments to Industrial and Regional Development Program”, News Release, 9 November 1984.
the interests of the regions they represent. If they happen to sit on the government side, then the pressure on the part of their constituents to see their regions designated for regional development purposes is enormous. This is true even for highly developed regions. A few years ago, for example, a number of spokesmen for the city of Ottawa suggested that their region should be designated under DREE's RDIA program. DREE's first minister recognized full well the pressure to extend regional development programming, but explained that "the more you extend it . . . the more you weaken it" [5:2-62J.

It can also be argued that a regional incentives program entails considerable administrative costs. An expensive bureaucratic structure has to be maintained to deliver, monitor, audit, and revise the program. This is often overlooked when attempts are made to assess the effectiveness of regional incentives. Yet the cost can be considerable. The cost of maintaining DRIE's bureaucratic structure, for example, is estimated at about $220 million for fiscal year 1984-85 [4:22-12J. This figure represents only administrative overhead costs, including salaries, travel expenses, and other personnel benefits to some 2,800 employees. To put this in perspective, total DREE spending for RDIA grants to business never amounted to more than $118 million annually, even in the early 1980s when the program covered 50 percent of the population [7]. In the first nine months of operation, DRE's IRDP program committed a total of $82.6 million in financial assistance. The figure is low because it covers nine months only and thus is not an accurate picture of future annual expenditures. Nevertheless, it should be noted that much of DRIE's activities are concentrated around the IRDP program; thus if the program were dismantled, presumably it would entail a major cut in spending in DRIE's administration budget.

The ability of regional incentive programs to influence in a substantial fashion the location of economic activity has also been questioned. DRIE produced periodic reports on total number of grants awarded, total investment, and total number of jobs to be created under RDIA. But the issue was and is far more complex than this, and these figures only tell part of the story.

Though it is much too early to assess the impact of the new IRDP, a fairly extensive body of literature exists on RDIA. RDIA has been assessed from the point of view of income distribution, economic efficiency, and incrementality - the latter issue having been the subject of far more studies than the other two combined.

Essentially, a project is considered incremental if the firm would not have undertaken the project without a regional incentive, or would have located it outside the designated region. Several extensive evaluations have been undertaken on the incre-
RDIA. Dan Usher explained the problem of evaluating regional incentives succinctly when he remarked that “… normally one is taxed or subsidized for doing something regardless of whether one would do it or not in the absence of the tax or subsidy. It is as though the family allowances were restricted to children who would not have been conceived in its absence, or Crows Nest Pass rates restricted to grain that would not have been grown if freight rates were higher” [18].

The above discussion leads one to conclude that any attempt to assess the effectiveness of regional incentives programming in terms of its impact on slow-growth regions is subject to wide margins of error. About all that can be said is that things could have been much worse for slow-growth regions if no regional incentives had been available. But this we know intuitively and from the observations of a number of federal and provincial officials who have been involved in regional development programming over the years rather than from “hard” evidence.

The Case for Regional Tax Incentives

Much like the regional grant approach, tax incentives for regional development offer a wide range of options. These may be based on the purchase of raw materials, labour hired, capital invested, or profits, and may be granted through relief of either direct or indirect taxes [1;2]. The most popular forms of tax incentives, however, are accelerated depreciation and tax credits for investment expenditures.

Tax or fiscal concessions are often favoured by the private sector over grants, particularly by large national or multinational firms whose tax accountants often do not have to adjust their bookkeeping to handle tax concessions. The same is not true for cash grants, which often require separate and different bookkeeping.

Equally important is the fact that tax incentives are often hidden from public view so that they do not entail a stigma of “state aid” for recipients. This is not an unimportant consideration, particularly for the large firms who remember full well the 1972 Canadian general election, during which the New Democratic Party labelled large Canadian businesses as corporate welfare bums on the basis that they were recipients of large government grants [13].

Firms also prefer to have regional incentives delivered through the tax system because less bureaucracy is thought to be involved. Much of the red tape involved in calculating tax incentives can be handled by a firm's own accountants with a minimum of negotiation with government officials. Within the government itself, since tax incentives are merely adjuncts to the national tax system, they need little additional personnel to deal with them.

The private sector also claims to favour tax incentives because they encourage profitability and efficient operation. A cash grant, the argument goes, favours all companies that apply and grants are awarded to firms whether they are efficient or not. Tax incentives, meanwhile, are only of benefit to those able to compete in the marketplace and to turn a profit. Tax incentives, then, can encourage firms to reach maximum profitability and efficiency and thus bring added benefit to the region in which they are located.

From a government point of view, tax incentives also have advantages. Because they are frequently less visible than are cash grants, they do not entail anywhere near the same kind of intense political debate over which regions will benefit from the program and which will not. Similarly, because firms have to be profitable to take advantage of tax incentives, there is no danger of the negative publicity that follows when a firm goes under after having received government cash assistance.

Over the years, Canadian governments have not made use of tax incentives for regional development purposes to the same extent as cash grants. The federal government did introduce in the mid-seventies an investment tax credit which was formulated in such a fashion as to be more generous to firms deciding to locate in regions of slower economic growth. The business uses tax credit to reduce directly its federal taxes payable.

The investment tax credit is automatic and is calculated as a percentage of the capital cost of the investment. The credit ranges from 20 percent for the Atlantic Provinces and Gaspé to 7 percent in the more developed regions of the country. The tax credit can be claimed for investments in processing and manufacturing, as well as in selected resource industries, such as facilities for the operation of oil and gas wells, the extraction and processing of minerals and metals, farming, and fishing.

In 1980, Ottawa introduced a special five-year investment tax credit program [3]. The tax credit was increased to 50 percent, but in turn, the regional designation was considerably restricted. It applies only to 5 percent of the Canadian population, those living in regions suffering the most from unemployment and low per capita income. Under this program, however, the tax credit may only be claimed for processing and manufacturing facilities, as defined under the former RDIA legislation.

It is even more difficult to determine the impact of tax incentives on regional development than it is for cash grants. The information required to assess the role of investment tax credits
is simply not available. Revenue Canada, which administers the income tax act, does not provide any of the required data to enable anyone outside the department to review the program. About all that can be said is that former DREE officials report that the introduction of the 50 percent special tax credit did initially spur interest from a number of firms. That is about all we know of the success or lack of success of Ottawa’s investment tax credits for regional development purposes.

This, however, has not dampened the interest some have for regional tax incentives, including members of the Mulroney Cabinet who have spoken of it in highly positive terms. Some have suggested that we go beyond simple tax credits and look at tax contracts as a means of promoting regional development. Tax contracts would be more selective than tax credits, in that they could administer legally, which limits opportunities for negotiating informally with firms to locate in designated regions.

Equally important is that tax incentives, given that they are adjunct to the national tax system, do not lend themselves to coordinate efforts with other regional incentives. Officials operating regional incentive programs, be they federal or provincial, are not always able to combine their programs with tax incentives to attract a firm to a given location. Again, tax officials will invariably shun any cooperative effort with officials of other departments or governments to influence a firm’s locational decision.

From an administrative point of view it is difficult to forecast, with any degree of accuracy, the impact of tax incentives on the budget. Forecasting tax incentives, unlike cash grants, is made difficult because they are open-ended. Firms take advantage of them if they are in a position to do so, and the government has little control to increase or decrease participation in the program.

Some of the above difficulties could be dealt with through tax contracts which, for example, can enable the government to forecast future year budgetary requirements. However, tax contracts entail other drawbacks.

The first one is administrative. The question - who would administer tax contracts? - immediately comes to mind. Tax contracts have to be negotiated in advance with a particular firm. Negotiating precisely what is expected in terms of investment and job creation would require specialists on the government side to ensure that the terms are indeed what the government wants and also that they are respected. Though Revenue Canada officials may well have the capacity to carry out such a task, it is unlikely that many firms would welcome the prospect of negotiating with its officers. Businessmen, generally, are cautious of Revenue Canada, and a number of them would intuitively shy away from negotiating with its officers.
grants, which are more certain and received earlier. Moreover, since cash grants can be paid at any time in a given year, they can provide the necessary cash flow as the work proceeds. Tax contracts, on the other hand, may be of benefit only a year or two after actual expenditures are made. Consequently, the capacity of tax contracts to stimulate major investments is limited.

Summary: Cash Grants and Tax Incentives

It is clear from the above that both cash grants and tax incentives offer important advantages and drawbacks. One can argue the merits of each with equal conviction. What this suggests is that a debate based simply on the merits of one instrument over the other is of limited value. A government must first determine what it hopes to accomplish under its regional development policy before it can engage in a meaningful debate over cash grants versus tax incentives.

Canada’s regional industrial incentives scheme essentially dates back to the 1960s. At the time it was introduced, labour in some areas was scarce but considerably less so in others. Regional incentive grants were then viewed not simply as a means of developing slow-growth regions, but also as a way of easing the pressure of demand in the highly developed regions. Grants would divert economic activity to areas of high unemployment, thereby increasing national employment and output without fueling inflation. At the time, cash grants were preferred essentially on the basis that they would be more effective in diverting economic activity. Through a guaranteed cash payment, the government was in effect compensating firms for locating in designated regions.

Economic circumstances have changed considerably over the past sixteen years. The need for diverting economic activity from one region to another on the grounds of economic or national efficiency is no longer obvious. There are few areas, if any, in Canada whose economies are now so buoyant that they require measures to divert activity elsewhere. Job creation prospects in the manufacturing sector are not as positive as they were in the 1960s [11]. Equally important is the fact that the excess industrial capacity currently existing in the traditionally developed regions of the country can easily be brought back into production if required or, failing that, can be more efficiently transformed for new manufacturing demands than trying to establish new grants in slow-growth regions. Thus, the prospect for directing whatever new jobs will be created through cash grants is even less positive than it once was. And, as we saw earlier in this study, one should

bear in mind the uncertain success cash grants had even when the national economy was strong.

Current economic circumstances suggest that regional development policy should increasingly look to the indigenous potential in slow-growth regions, rather than attempting to divert firms from locating in regions of their choice with the lure of government funds.

Looking to local entrepreneurs, however, may well require new policy instruments. Among other things, entrepreneurs in slow-growth regions are often handicapped by the lack of capital to start up operations, a restricted access to most up-to-date technical knowledge, and the limited size of the local market. How then can governments assist them in overcoming these problems?

With respect to the lack of capital, cash grants still appear to be the most appropriate instrument because of their certainty and quick payment, but local entrepreneurs should not be subjected to the same kind of elaborate regulations employed for large grants given to national firms. In short, a small incentive to a local business trying to get started should not involve a lot of red tape, delay, and uncertainty regarding its ultimate worth. This may well suggest to the federal government that it should look to federal-provincial agreements with the “have-not” provinces, with the latter delivering the programs. It is well known that smaller provincial governments are more capable of delivering programs with a minimum of red tape than is the federal government.

Tax incentives and tax contracts offer limited potential for local entrepreneurs getting started in business for reasons already explained. The one exception which Ottawa should consider is the introduction of a tax scheme permitting local entrepreneurs to gather capital for investment purposes free of tax. One possibility would be a scheme modeled on the Registered Retirement Savings Plan, which would allow residents of slow-growth regions to put aside capital, provided that at some point they invest the capital in businesses in their regions. The federal government could also put in place measures designed to ensure that firms in peripheral and slow-growth regions have access to the latest technology in their sectors. Similarly, the federal government could make special efforts to identify new markets, either in Canada or abroad, for small businesses operating in slow-growth regions.

Where tax incentives or tax contracts can be of some benefit to slow-growth areas is with well-established national or multinational firms. The government could, through a highly selective process, seek out such firms which are planning new facilities and offer them tax incentives to locate in a designated region. For reasons outlined in this paper, such firms can find tax incentives
more appealing than cash grants. A highly selective process would also limit the need for an elaborate and costly bureaucratic structure.

Large and costly regional incentive grants of the kind to which we have grown accustomed are losing their appeal. For one thing, there is no convincing evidence that they have been successful in actually directing new economic activity to designated regions. Outside researchers, including the academic community, have raised more questions than answers. The onus to demonstrate clearly their usefulness was and is on the government department delivering the program. But this has never been done adequately.

References

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