

The impact of government grants: employment up, productivity down

Feb 1 2012

Henry Overman reviews new research on the effects of government grants on employment and productivity in the private sector.



The Great Recession has brought industrial policy back into fashion. Huge subsidies have been granted by governments around the world to private firms most dramatically in financial services, but also in other sectors like autos. Despite the ubiquity and cost of such schemes, rigorous evaluations of the causal effect of these “industrial policies” are rare.

In a [recent paper](#), (co-authored with Chiara Criscuolo, Ralf Martin and John Van Reenen of the CEP) we provide some of the most rigorous evidence to date on the impact of one such policy – Regional Selective Assistance.

Our research suggests that government grants to smaller firms in economically disadvantaged areas of Great Britain *can* increase employment, but that grants to larger firms have no effect. These positive impacts on firms translate in to wider area benefits. However, the resulting increases in local manufacturing employment and reductions in unemployment come at a cost in terms of productivity. Specifically, because RSA grants support employment in lower productivity firms while having no impact on firm level productivity, RSA lowers measured aggregate productivity by increasing the employment share of low productivity firms

Our research analysed the impact of expenditure on the Regional Selective Assistance programme over a 20-year period. We had access to every grant and examined every manufacturing plant in England, Wales and Scotland – over 2.3 million observations – before and after receiving government support. The main factor holding back credible evaluations of industrial policies is the absence of a clear identification strategy (i.e. a way to figure out what would have happened in the absence of policy). However, because European Union law changed over this 20-year period, some parts of Britain became eligible for subsidies and others saw their grants disappear. This enabled us to work out the impact of investment subsidies on firm performance by comparing similar firms that only differ in terms of their changing eligibility for treatment. We were able to assess the impact of RSA on investment, employment and productivity.

Our findings suggest a large effect of grants on recipient firms: a 10% investment subsidy causes about a 7% increase in employment with about half of this (3.6%) arising from growth in existing firms and half from firm entry. These effects are underestimated if analysis ignores the fact that the participants in the scheme are firms and areas who would otherwise perform badly. As I highlighted above, these positive employment effects are confined to smaller firms (e.g. with under 150 workers) possibly because larger firms are more able to “game” the system and take the subsidy without changing their investment and employment levels. Another possible explanation is that grants help remove the financial constraints faced by smaller firms.

The wider impacts on employment and unemployment at the area level suggest that positive effects at the firm level aren’t just about a shuffling of jobs from nearby firms who don’t receive financial support. In

fact, the new jobs created appear to come mostly from the pool of unemployed workers in the area, which is encouraging in terms of welfare (the cost per job is around \$6,330).

So grants to firms in disadvantaged areas can support local employment. The policy is not costless, however, as there appear to be no additional effects on productivity after controlling for investment effects. Since less productive plants receive more subsidies, this implies that the program lowers measured aggregate productivity because it increases the employment share of low productivity firms. [We also don't consider the negative effect of the taxes need to fund this investment]

Overall, then, our results are mixed news for advocates of firm level grants to turn around disadvantaged areas. While these policies can increase area level employment, they have no impact on productivity, leaving firms in this area vulnerable in the future (which may partly explain why firms and areas keep coming back for more support). As always with these types of policies, careful economic analysis suggests there is no free lunch – firm grants can raise employment, but at a cost in terms of productivity which goes beyond the purely financial implications of supporting investment in the first place.

[Further information: [Paper](#); [Press Release](#)]

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