in brief...
Can industrial policy boost jobs?

Business support policies aimed at revitalising economically disadvantaged regions can be effective at raising employment, according to a team of CEP researchers. But government subsidies, such as Britain's 'grant for business investment', only seem to work when targeted at smaller firms.

The Great Recession has brought industrial policy back into fashion. Governments around the world have given huge subsidies to private firms, most dramatically in financial services but also in other sectors such as the car industry.

But business support policies are not new. Most governments grant investment subsidies that claim to foster employment and productivity, particularly in disadvantaged areas. In 2010, European Union (EU) countries spent €61 billion on aid that was unrelated to the financial crisis; and the United States spends around $40-50 billion each year on local development policies.

Despite the ubiquity and cost of such schemes, rigorous evaluations of the effects of these 'industrial policies' on employment and productivity are rare. That is what we have done in an analysis of the impact of expenditure through Britain's 'regional selective assistance' (RSA) programme over a 20-year period.

We have examined every manufacturing plant in England, Wales and Scotland – over 2.3 million observations – comparing firms that did and did not get grants both before and after receiving government support.
Because EU law changed over this 20-year period, some parts of Britain became eligible for subsidies and others saw their grants disappear, which makes it possible for us to work out the impact of investment subsidies on firm performance.

Our research suggests that government grants to smaller firms in economically disadvantaged areas of Britain *can* increase employment, but that grants to larger firms have no effect. The positive impacts on smaller firms translate into wider area benefits, for example, reduced unemployment.

But 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 aggregate productivity by increasing the employment share of low productivity firms.

Our findings suggest a large effect of grants on small 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 that would otherwise perform badly.

So why are these positive employment effects confined to smaller firms, those with fewer than 150 workers? One possible explanation is that 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 to 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 are not just about shuffling jobs from nearby firms that do not receive financial support. In fact, the new jobs created appear to come mostly from the pool of unemployed workers in the area.

Grants to smaller firms can boost jobs but grants to larger firms are a waste of taxpayer money

Grants increase area-level employment but lower productivity, leaving firms potentially vulnerable in the future

So grants to firms in disadvantaged areas can support local employment. The policy is not costless, however, considering the negative effect on productivity.

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 lower productivity, leaving firms 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 that there is no 'free lunch': firm grants can raise employment, but at a cost in terms of productivity that goes beyond the purely financial implications of supporting investment in the first place.

This article summarises 'The Causal Effects of an Industrial Policy' by Chiara Criscuolo, Ralf Martin, Henry Overman and John Van Reenen, CEP Discussion Paper No. 1113 (http://cep.lse.ac.uk/pubs/download/dp1113.pdf).

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