Productive Economy Series: Part 1

Transitioning to high value sectors

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Paul Mac Flynn

Summary: One of the key policy considerations in building a more productive economy is how economic activity and employment are allocated to certain industries and sectors. This is because certain sectors produce less or more with the same inputs either by design or by choice. Economies that are overrepresented in certain low value sectors, will be less productive overall irrespective of the performance of individual firms. In many cases jobs in these sectors can be low paid, insecure and with little or no career progression. In many case the allocation of resources among sectors is not organic or random, but an outcome of policy decisions. We need to address these polices in the light of these outcomes and the trade-offs inherent within them.

Why does productivity matter?

At a very basic level, one of the key metrics by which we measure the performance of our economy is the degree to which it can deliver adequate living standards to those who live within it. An economy encompasses a broad range of economic activity across industries in production, services and construction. In a competitive economy, those firms will be in a position to provide wages that reflect how well the firm performs in the marketplace. Firms that are efficient and well run are then in a position to provide employment which contributes to a high standard of living for their employees. Obviously, this is a simplistic analysis, in reality well performing firms may seek to benefit from their performance through higher profits rather than wages. In the same way, firms that enjoy large market share may not be well run efficient companies either. In both these cases there are remedies. Strong unionisation and collective bargaining can tackle firms that seek excess profits and stronger enforcement of competition rules can prevent inefficient firms from dominating certain industries. But in a broad sense, the efficiency of firms is key to the delivery of living standards.

The relationship between efficiency and living standards can be examined in one particular industry or sector, but the same principle applies to the economy as whole. Just as for competitive marketplaces, in the competitive global economy, the living standards in any country will be largely determined by how well the firms in that economy perform compared with their peers. How efficient, or how 'productive', our economy is, is the main determinant of our national living standards. That is why so much of discussion about overall economic performance is about our 'productivity'.

However, even if all our firms matched the efficiency of their counterparts in other countries, the productivity of our economy may still be lower. This is because not all industries are alike. Irrespective of how efficient particular firms are at producing their goods or services, the value of what they produce is different. Whether driven by purely market forces or assigned a valuation by regulation, everything that we produce in the monetised economy has a value. There are therefore some industries that produce higher value output than others even if the resources used to produce them are the same.

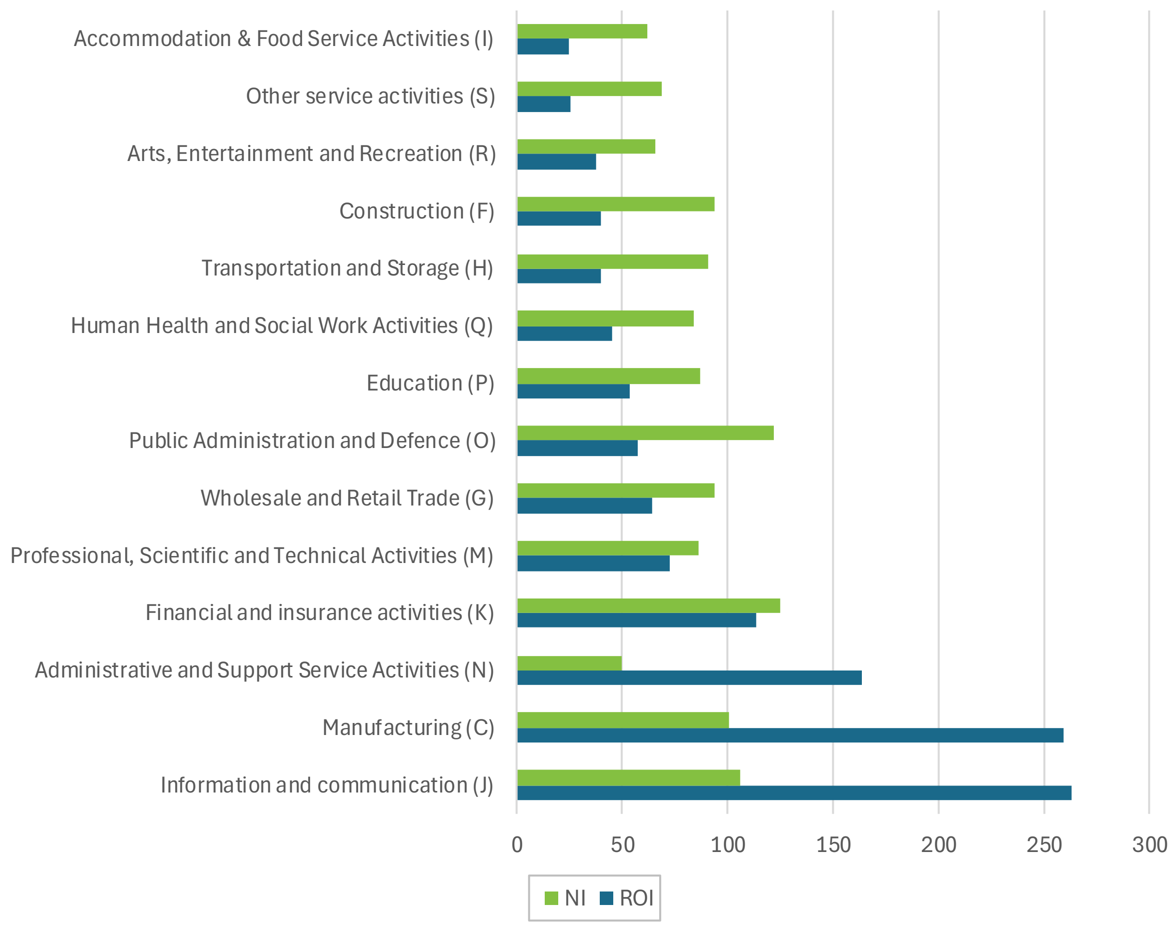
This means that it doesn't just matter how well a firm or a worker within it performs, the industry itself will also be key to determining what standard of living being employed in that job can provide. So, while we must focus on creating and promoting efficient and well-run firms, we must also pay close attention to the structure of our economy and whether we are putting our resources to the best possible use. Taken together, the mix of sectors or industries within an economy will determine the overall standard of living. This is not to say that we should abandon whole sectors of our economy because they are not highly valued by the market. It is to say that the balance of economic activity within an economy is crucial to determining the living standards that are possible within that economy.

How do sectors of the economy differ in productivity?

Chart 1 shows how much output (Gross Value Added) is produced by each economic sector for every hour of work undertaken in that sector as a percentage of the average for the economy as whole. Chart 1 shows that among the different sectors, there is wide variation in how much each sector can produce. Northern Ireland and the Republic of Ireland are very different economies and are at very different stages in their development. so, there is much greater variation in the productivity of sectors within the Republic of Ireland, and much less so in Northern Ireland.

Despite such differences in scale Chart 1 also shows that there are many commonalities between the performances of sectors both North and South. Finance and Insurance, Manufacturing and Information and Communication all appear among the top performing sectors in both economies. It is also true to say that these sectors are also among the highest paid sectors in both economies as well. At the other end of the chart, we can see that Arts, Entertainment and Recreation, Other services and Accommodation and Food are the least productive sectors in both regions, and these are also among the lowest paid sectors in both. It should be noted that while certain sectors may be at the bottom of the table for both productivity and wages, it does not necessarily follow that wages offered in that sector reflect the workers productivity. In many cases, low pay is a function of both low productivity and other factors such as a lack of bargaining power among workers.

Chart 1 Productivity by sector as a percentage of the national average in Northern Ireland and the Republic of Ireland 2019



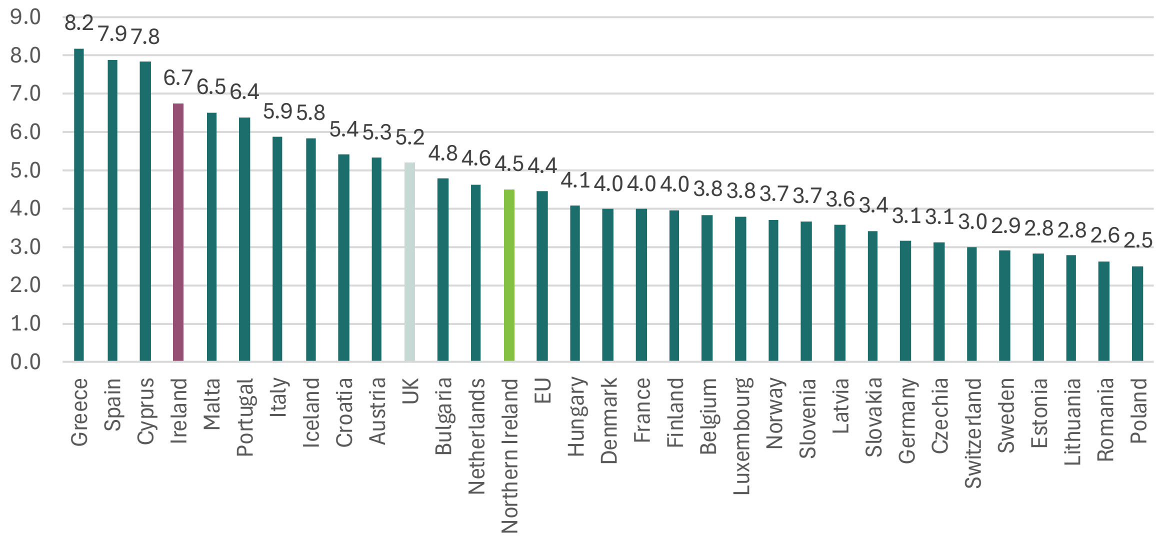
Source: CSO and ONS
Notes: National average applies to Northern Ireland regional productivity levels for NI sectors. ROI Manufacturing is affected by profit shifting and/or the presence of certain global firms

How do we allocate resources currently?

Having examined the differing productivity levels among sectors, it follows that we would examine how employment is spread across these sectors. The spread of employment tells us how we allocate resources across our economy. Where labour is deployed to one sector, it is necessarily not deployed to another, and such allocations have consequences for overall productivity. How employment is distributed across the sectors of the economy is something that should be viewed as an outcome of policy rather than a random allocation.

Chart 2 shows how labour is allocated to the Accommodation and Food sector across Ireland, Northern Ireland, the UK and other EU economies. What we can see is that both the Republic of Ireland and the UK are at the upper end of the distribution. While in Northern Ireland is just above EU average, in Ireland the Accommodation and Food sector is over 50% larger in employment terms than the European Union average. Indeed, many of the countries in the upper end of the distribution are not high-income countries and, In Ireland the Accommodation and Food sector is over double the size that it is in countries like Germany and Sweden.

Chart 2 Share of Employment in Accommodation and Food Sector in NI, GB and EU countries 2022



Source: NISRA, CSO and ONS

It could be argued that a greater share of employment in the Accommodation and Food sector means more firms operating in the sector and this leads to greater competition and thus lower prices. However, prices indices indicate that restaurant and hotels are in fact more expensive in Ireland than either Germany or Sweden, so any such consumer benefit seems unlikely. The question that naturally arises is why both the Republic of Ireland and Northern Ireland are in the position they are in. In particular, we need to examine the system of economic supports that we provide to firms and whether the outcomes of such policies are aligned to the goals that we have for national or regional productivity.

For instance, in the Republic of Ireland, the government has made regular use of reduced Value Added Tax (VAT) rates for the hospitality sector in order to protect employment in the sector. Such policies may have artificially boosted the share of employment in the hospitality sector beyond European norms. The policy was first initiated during a period of significant unemployment, and it could be argued that, at the time, labour resources were not being utilized and therefore they were not being diverted from other sectors. However, once the economy began to recover, the policy remained in place for a number of years meaning that a distortionary effect was likely. Similarly in Northern Ireland, support from Invest NI for the tourism sector over the past number of years may have contributed to increased hospitality employment levels.

This is not to say that we should just automatically shrink the Accommodation and Food sector. But we should ask questions about whether this is the appropriate allocation of economic resources. There may be opportunities to create more productive employment in other sectors that would create opportunities for higher wages. That means a re-examination of economic supports, including tax expenditures in order to align them with a plan to build a more productive economy.

Productivity is a key determinant of living standards and that is why policy should be concerned to achieve the most optimal balance of economic activity possible in this regard. However, productivity concerns should not be the sole impetus for policy decisions and it is perfectly reasonable for policy decisions that lead to an alternative balance of economic activity in order to achieve social, sustainable or even cultural objectives. All decisions in this area have trade-offs and our current economic model has made choices which involve such trade-offs.