

Box A: Is the UK public sector too large?

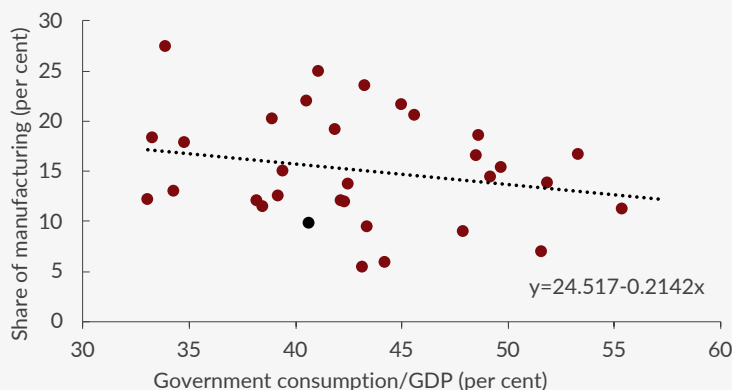
By Paul Mortimer-Lee

There is much debate about why Britain's economic performance in the last decade and a half has been so lacklustre. With slow growth, high inflation, strikes, and a high share of taxation in GDP, there is a strong aroma of the 1970s about present-day Britain. In this box, we look back at one of the reasons advanced for Britain's economic decline since the 1970s, which is that the public sector is too large. We find that figures for the share of public consumption in GDP do not support this argument. Nor at first sight do employment figures. However, the headline figure for public-sector jobs reported by the Office for National Statistics (ONS) drastically understates how many people depend on the public sector for employment due to contracting out and other organizational changes.

The main advocates of an excessive expansion of the public sector being behind Britain's relative economic malaise, which included the decline in the share of manufacturing in the economy, were Robert Bacon and Walter Eltis (1978, 1996). They argued that there were too few producers in the UK economy. This, they claimed, was due to an increasing share of non-marketed output in the total, i.e., that the size of the public sector had crowded out private-sector activity. Given manufacturing's continued slide – it accounts for only 9 per cent of output today, compared with double that in 1990 and 25 per cent in the mid- 1970s – it is worth re-examining Bacon and Eltis's arguments.

One of the objections to the Bacon and Eltis hypothesis is that other countries that have higher government current consumption as a share of GDP have not experienced the same problems with manufacturing as the United Kingdom. International data show that there is an inverse relationship between the share of government consumption and manufacturing – on average, a 1 percentage point higher share of government spending is associated with a 0.2 percentage point lower manufacturing share in GDP. While the relationship is weak, it does support the Bacon and Eltis hypothesis. However, the United Kingdom (in black) has a lower share of manufacturing than all but five countries (Luxembourg, Greece, Norway, Australia, and Iceland), and the share is significantly lower than in the other major industrial countries. The United Kingdom's actual share of manufacturing is six percentage points below what the average relationship in figure A1 would suggest. If we examine Italy, the share of government consumption in GDP is almost eight percentage points higher than the United Kingdom's, and yet the share of manufacturing in Italian GDP was 16.6 per cent in 2019, compared with 9.7 per cent in the United Kingdom.

Figure A1 Government expenditure and manufacturing shares of GDP



Source: OECD.

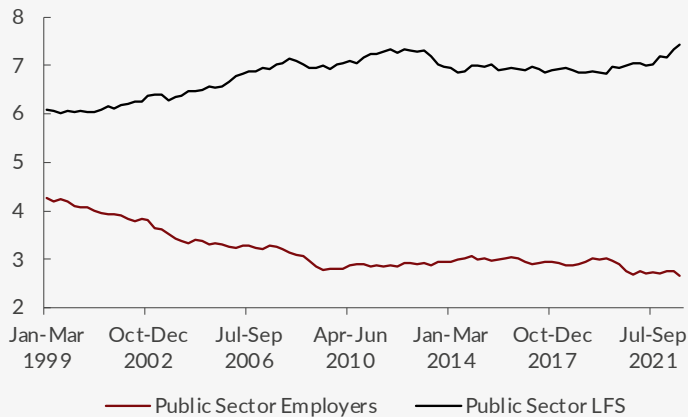
The share in GDP of government current consumption in volume terms shows a slight reduction since 1970 (figure 2), running counter to perceptions in some quarters of a rising share of the public sector. However, the stability of government consumption in GDP contrasts sharply with numbers that show a significant increase in the share of the population working in public administration, education and health and social services.

Figure A2 Share of government consumption in GDP (per cent)

Source: ONS.

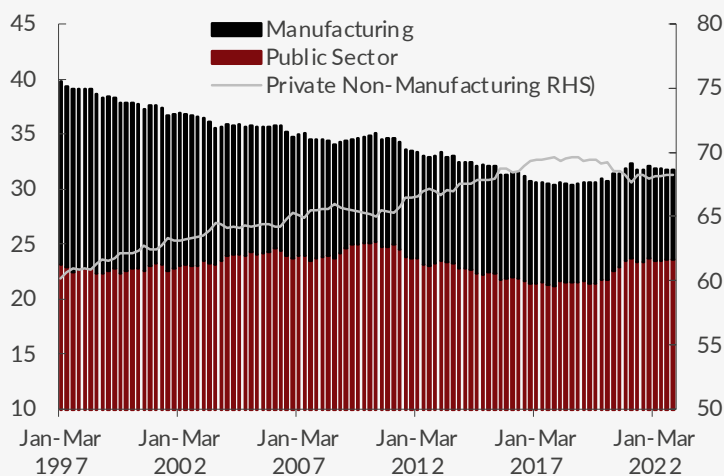
Bacon and Eltis believed that the increased size of the public sector in the 1960s and 1970s had diverted employment towards the public sector and away from manufacturing. Since the mid-1990s, the share of manufacturing in employment has halved. Measuring the employment of the public sector is more difficult than one might think, due to developments such as contracting out and the Private Finance Initiative (PFI). However, over the same period, according to the Labour Force Survey (LFS), public-sector employment has risen only slightly, from 23.1 per cent of total employment in early 1997 to 23.6 per cent at end-2022. Public-sector employment rose as a share of total employment after the Great Financial Crisis because private-sector employment is more cyclical than employment in public sector jobs. As the recovery progressed, the share of the public sector fell again.

Note that these figures are taken from the LFS and reflect employees' assessment of where they work. These employees include workers who are directly employed by private-sector firms but who work in public-sector establishments, for example, cleaners in the National Health Service (NHS). The number of workers employed directly by the public sector (based on employer returns which the ONS assess is a more reliable basis than the LFS-based data) is much smaller, currently 5.8 million, about two million less than recorded in the LFS. The former series shows a decline in the early 2000s (figure 3) reflecting an increase in outsourcing (Sasse et al., 2019), including under the PFI, affecting institutions including hospitals and prisons, as well as the expansion of social care, most of which is in the private sector. We believe that the LFS figures give a more accurate picture of employment tied to the public sector. However, Bacon and Eltis emphasized the importance of 'non-market' employment in the public sector, implicitly assuming that these employees were not available to work in manufacturing, presumably because their remuneration (including non-pecuniary advantages) exceeded that in the private sector. Outsourcing means that the number of employees in 'non-market' activities has declined, with the outsourced employees now in the market segment. This reduction in non-market employment runs against the Bacon and Eltis hypothesis that public sector expansion explains manufacturing's decline.

Figure A3 Alternative measures of public sector employment (millions)

Source: ONS.

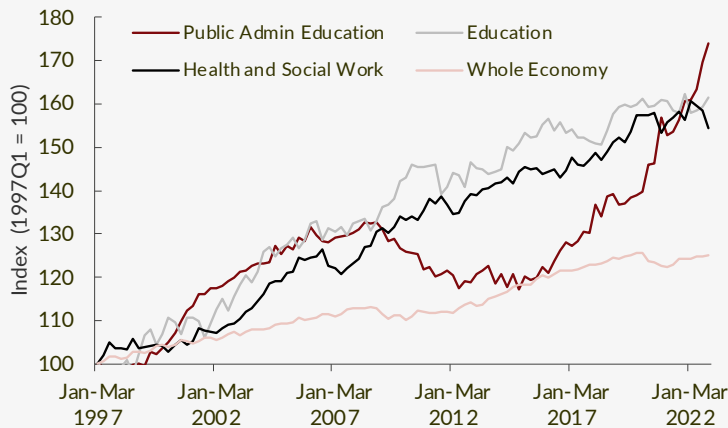
Public-sector employment on the narrow definition was 20 per cent of total employment in 1999, and 17.5 per cent in 2022. On the LFS measure, the increase from 1997 to 2022 was less than a percentage point to 23.5 per cent (figure 4). Thus, these figures suggest that the shrinkage in manufacturing employment was due to the expansion of the non-manufacturing private sector rather than due to an expansion of the public sector.

Figure A4 UK shares in total employment (per cent)

Source: ONS.

However, there remain serious doubts about the public-sector employment data. For example, if we compare the workforce jobs data¹ with the data in the ONS publication EMP13, we see that there are big differences in the employment numbers in sectors we would identify as public sector. The data reported for the third quarter of 2022 for public administration, defence, and compulsory social security is 1.6 million in the first and 2.6 million in the second. Education is shown as 3.1 million in the first and 3.4 million in the second. If we take the LFS measure of jobs in public administration, defence and social security and add it to the number in education and human health and social work, the total is 10.6 million jobs in the fourth quarter of 2022, compared with 7.8 million reported as in the public sector in the same publication (EMP13).

¹ JOBS02 <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/workforcejobsbyindustryjobs02>

Figure A5 Employment trends

Source: ONS.

Figure 5 shows that employment in sectors we would typically think of as ‘public sector’ has increased significantly more than in the economy as a whole. The rise in public administration numbers in recent years is particularly striking.

The differences between the three different measures of public employment can be summed up as follows:

1. Employer returns record about 5.7 million people working in the public sector (these are direct employees)
2. The LFS records 7.6 million people regarding themselves as working in the public sector (this includes direct employees and some of those employed producing public-sector output)
3. About 10.6 million people work in industries that are traditionally regarded as in the public sector

It can be argued that the third measure is a better reflection than the other two of the reality of the use of labour resources in the economy. It is not who employs the labour that matters for resource allocation, but what that labour produces. If labour produces services for the public sector, it should be classified as public-sector (e.g., self-employed speech and language therapists in schools, workers in PFI establishments, employees in care homes).

Taking this broad definition of public employment indicates an increase in the number of employees producing public output of four million from 1997 to 2022 (i.e., a rise of 60 per cent, with the number in public administration rising by almost three-quarters). Over this period, the share in total jobs rose from an average of a quarter in 1997 to a third in 2022. With the total number of employees rising by 6.5 million over the period, employment in public-sector-dominated sectors accounted for 60 per cent of this. It seems extremely difficult to argue that an expansion of 4 million jobs in industries supplying public-sector output did not affect the availability of labour to the manufacturing sector, which in 1997 had just over 4 million employees. In 1997, there were three times as many employees in manufacturing as in public administration. Now, the numbers are level pegging. In 1997, the manufacturing workforce was more than double that in education. Now, it is only 60 per cent as large as that in education. A shift in manufacturing’s share of the labour force would have been expected because the rate of productivity growth in manufacturing is higher than in services like education or public administration. However, the size of the shift is significantly larger than the productivity differential would suggest.

Conclusion

There is international evidence that supports the Bacon and Eltis argument that a higher share of public spending is associated with a lower share of manufacturing in total value added. However, the relationship is weak, and the United Kingdom has a far lower share of manufacturing – six percentage points lower

– than the average relationship suggests. A major explanation for manufacturing's lower share is that the United Kingdom has a comparative advantage in services, including financial services. A UK comparative advantage exists when the opportunity cost of an activity in the United Kingdom is lower than abroad. What this means is that the United Kingdom producing manufactures would cost more in foregone services output than it would cost abroad. Hence both the United Kingdom and foreign countries would be better off if the United Kingdom specialized relatively more in producing services and other countries concentrated more on manufactures. According to this explanation, the United Kingdom's shrinking share of manufacturing would be due to an increase in its comparative advantage in services. This might come from an increase in UK service productivity relative to abroad, or it might be because the United Kingdom has been losing its manufacturing edge – either development could give rise to the same reduction in share.

Regarding the question of whether the public sector excessively absorbs labour and leaves too little labour supply for manufacturing, the assessment is muddled by there being competing ways of measuring public-sector employment, each of which has drawbacks. However, there has been a massive expansion of employment in sectors that are usually regarded as within the public sector, which has absorbed almost two thirds of the increase in the labour force over the last quarter century. This will have severely limited labour supply to manufacturing. This also means that the United Kingdom has increasingly directed its labour supply towards sectors with low rates of productivity growth and away from manufacturing where productivity growth is higher.

References

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Sasse, T., Guerin, B., Nickson, S., O'Brien, M., Pope, T., & Davies, N. (2019). *Government Outsourcing: What has worked and what needs reform?* Institute for Government.