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Monetarism and the public sector problem: how important are these issues to the government of the UK?

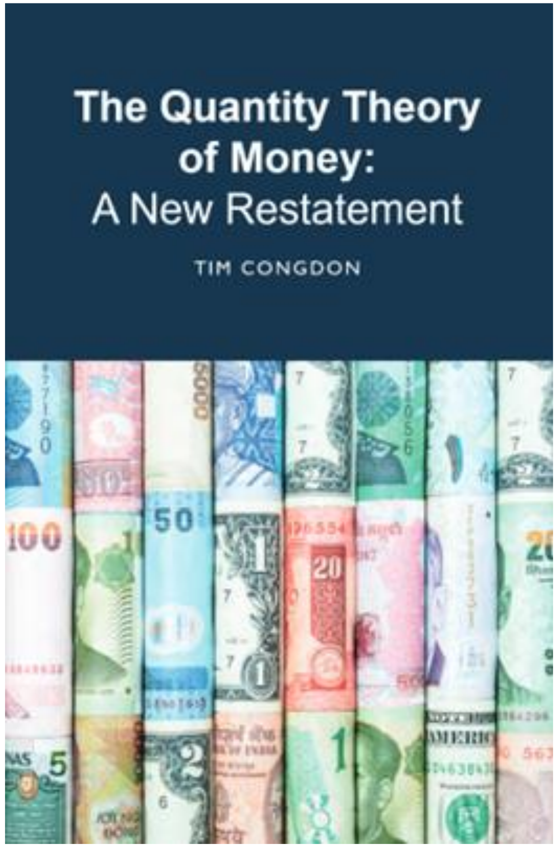
A presentation by Professor Tim Congdon CBE,

Chair of the Institute of International Monetary Research,

in September 2024

Monetary policy works in the private sector

- All private sector agents need a money balance to complete transactions. They can 'go bust' and hence have finite credit-worthiness.
- Monetary policy – to defeat inflation, or to boost the economy when it is depressed – works entirely in the private sector. A mixture of direct effects (from money to expenditure) and indirect effects (from money to asset markets and prices, and thence to expenditure) are at work, as explained in my recent short book for the Institute of Economic Affairs.



Monetary policy does *not* work in the public sector

- The government can extract resources from the economy – by taxation or by printing new money – without limit, at least in principle. Its credit-worthiness – ***inside the borders of the country in question*** – is therefore unimpeachable. Although public expenditure may be over 50% of GDP, the government's money balance at the central bank is in most countries trivial, only a fraction of the amount of tax paid each day.
- Monetary policy has no effect on the state's expenditure; the government's behaviour is not constrained by its money holdings at all.

'Monetarism is not enough' – *title of Keith Joseph's Stockton Lecture in 1976*

- Printed in a pamphlet from the Centre of Policy Studies, with a foreword by Margaret Thatcher,

- "The changed balance between the state and the private sector is crucial, both in itself – in the sense that it impinges on the kind of society we have as well as on economic efficiency – and because it reacts on the level of inflation…[The] public sector is relatively insensitive to economic conditions…in a state-dominated society, the state tends to set its stamp on nominally private institutions."

The nature and size of the public sector problem, e.g., in the UK

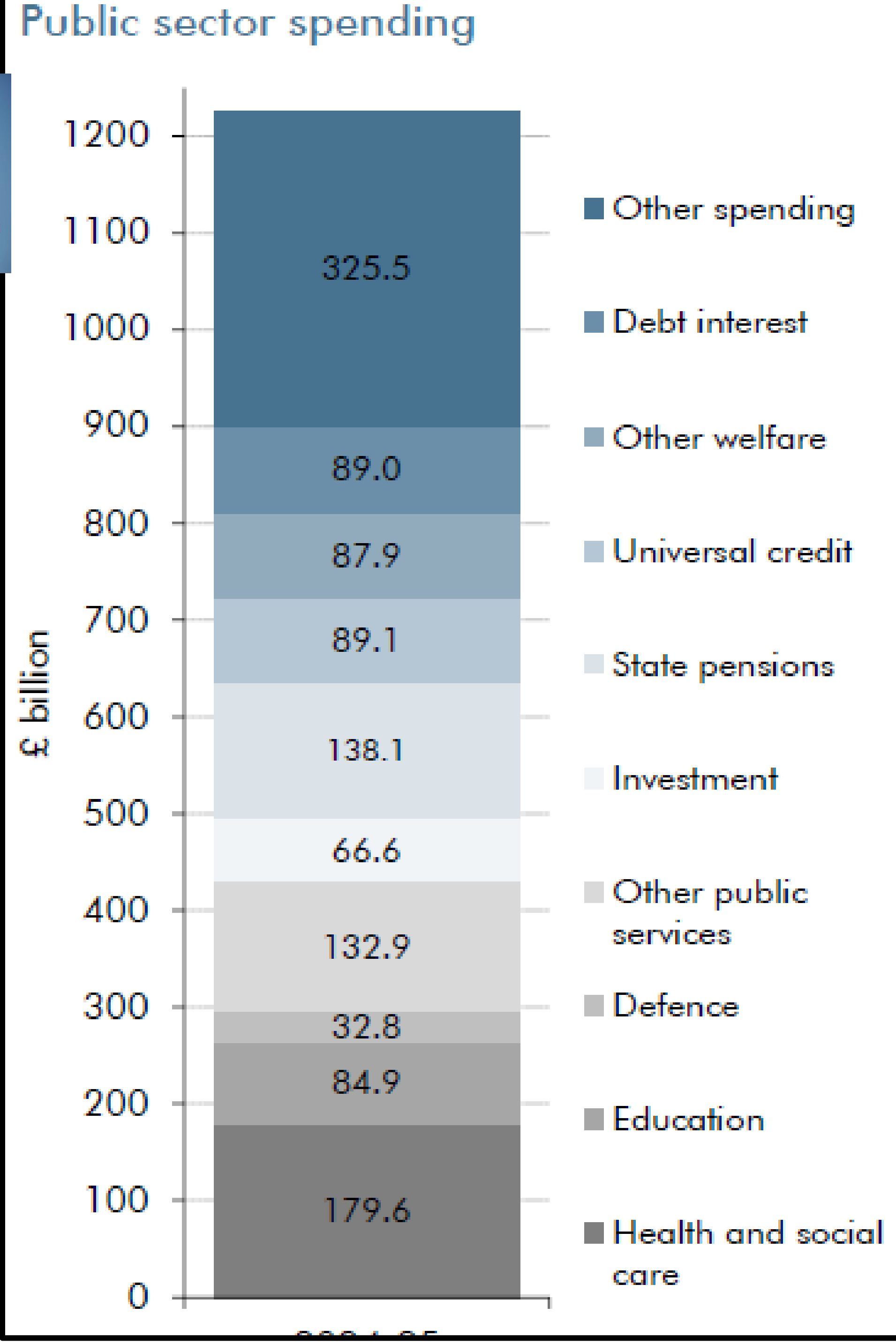
- For much of the public sector, notably state education and (in the UK) the National Health Service, **prices are not charged at delivery**. Wages are then not related to revenue generated in one part of the economy by an identifiable group of workers. There is no “market pricing” as such, while one employer (i.e., the government) employs all the workers who therefore tend to band together in a single trades union. **So there is one buyer and one seller.** The “market context” is described as “bilateral monopoly”, where much depends on bargaining or – technically – on “game theory”. **The state vs. the public sector unions.**
- In many countries, total public expenditure is over 40% of GDP. In the UK in the 2024/25 financial year the figure is expected to be **44% of GDP**.

The public sector problem: *the need to define the public sector properly*

- Public expenditure in many liberal democracies is over 40%, or even over 50%, of national income. **But this number overstates the importance of public expenditure in one important economic sense.**
- The government taxes citizens and companies in order partly to make payments to, well, citizens and companies, often the same citizens and companies. Much of its expenditure is therefore on so-called **“transfer payments”**.

Transfer payments in public expenditure

At least *four* categories in public sector spending in 2024/25 – debt interest, other welfare, universal credit and state pensions – are transfer payments. They amount to £404.1 billion, out of a total of £1,226 billion. **With subsidies to companies, payments to universities etc., transfer payments are probably well over £500 billion, approaching 50% of total public spending.**

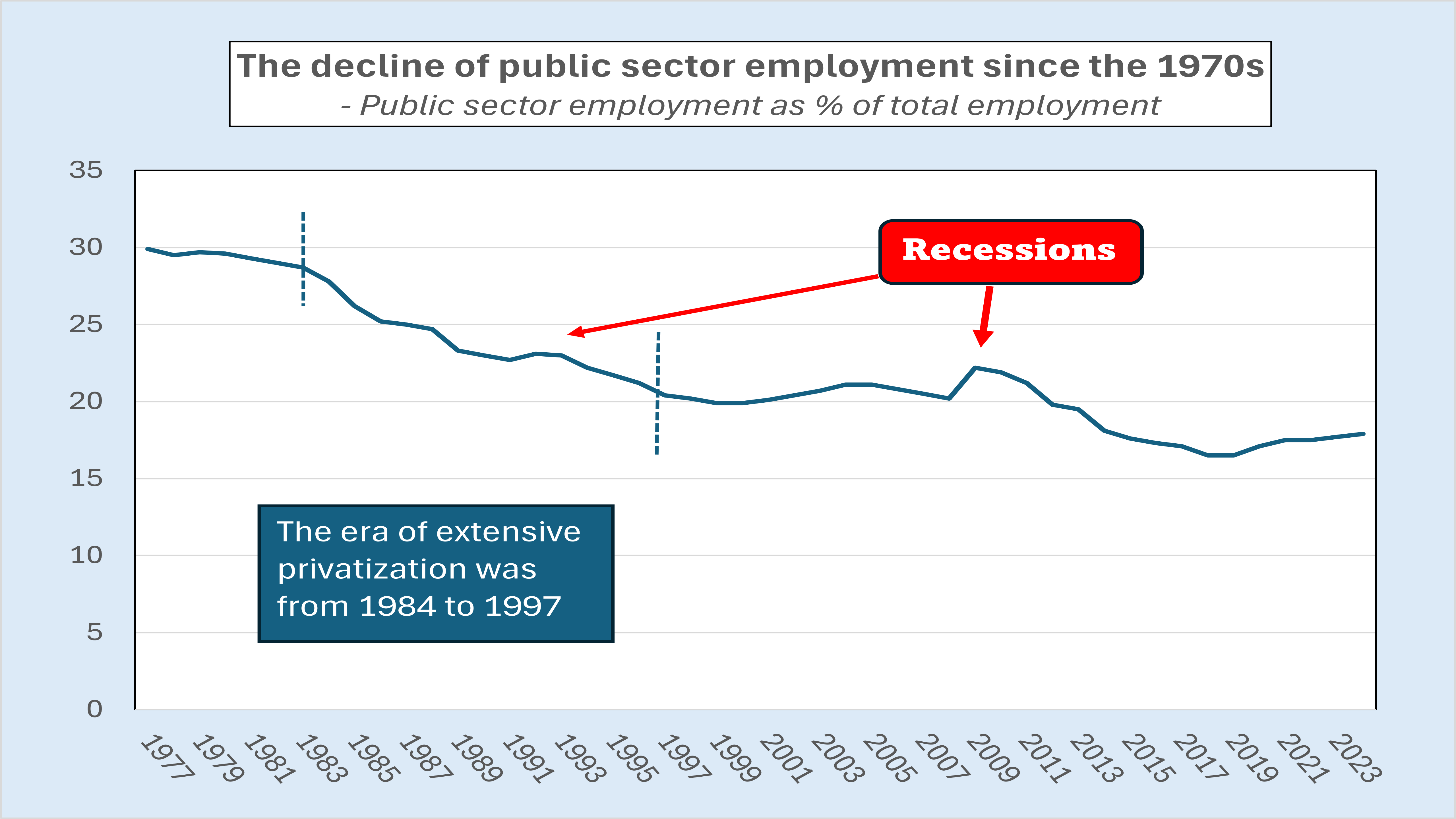


The public sector problem: *the need to define the public sector properly*

- **If we take it that transfer payments are about half of public expenditure, that cuts the public sector down to a bit more than 20% of the economy in the UK.**
- But – on top of that – much public expenditure is on goods and services supplied by the private sector. The government buys weapons from privately-owned defence contractors, books for schools and universities from privately-owned publishers, etc. Further, the bulk of public sector capital expenditure (e.g., in construction) is on private-sector suppliers.

The public sector problem: *the need to define the public sector properly*

- In most economies – even with total public expenditure at half or more of GDP – activity is predominantly in the private sector. Suppliers compete with each other, so that most markets have several or numerous competing suppliers and an anonymous mass of consumers/buyers. Crucially, the private sector – correctly defined – is large enough that monetary policy is effective.
- In modern liberal democracies, with mixed economies and mostly privatised utility and transport industries, **public sector employment is between 15% and 20% of the total workforce and public sector value added is similarly between 15% and 20% of national output. Here monetary policy doesn't work – or at least it doesn't work in the same way as in the private sector.**



The decline of public sector employment since the 1970s
- Public sector employment as % of total employment
35
30
25
20
15
10
5
0
Recessions
The era of extensive privatization was from 1984 to 1997
1977
1979
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015
2017
2019
2021
2023

Large decline in the importance of the public sector in the UK since the 1970s

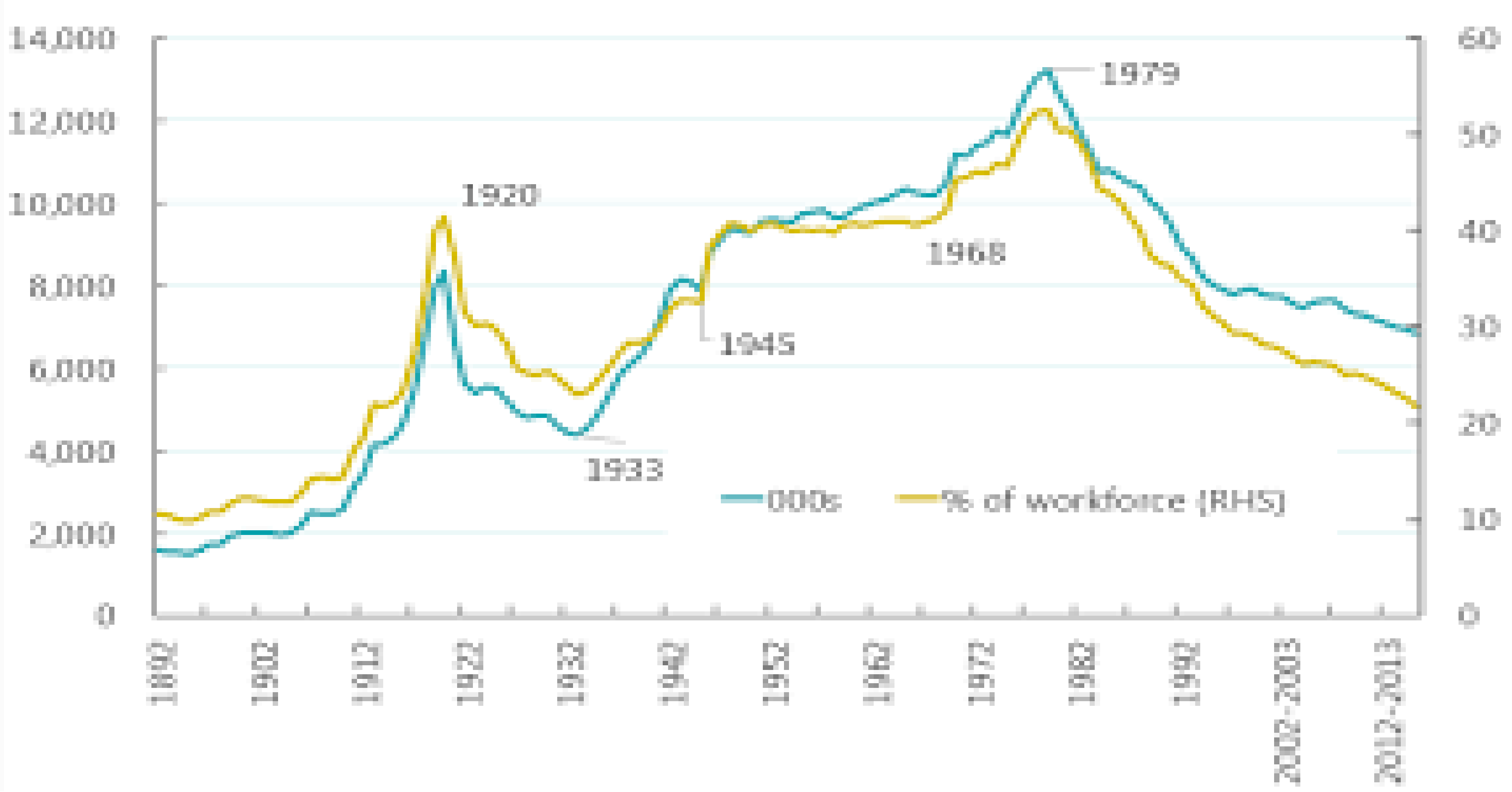
- In the 1970s public sector employment was, at its peak, about 30% of total employment in the UK. This was the heyday of the public sector unions and indeed of union power in the government of Britain. In 1979, when the Thatcher government was elected to power, just above 50% of the UK workforce were trade union members.
- Since then, three factors have reduced the power of the trade unions,

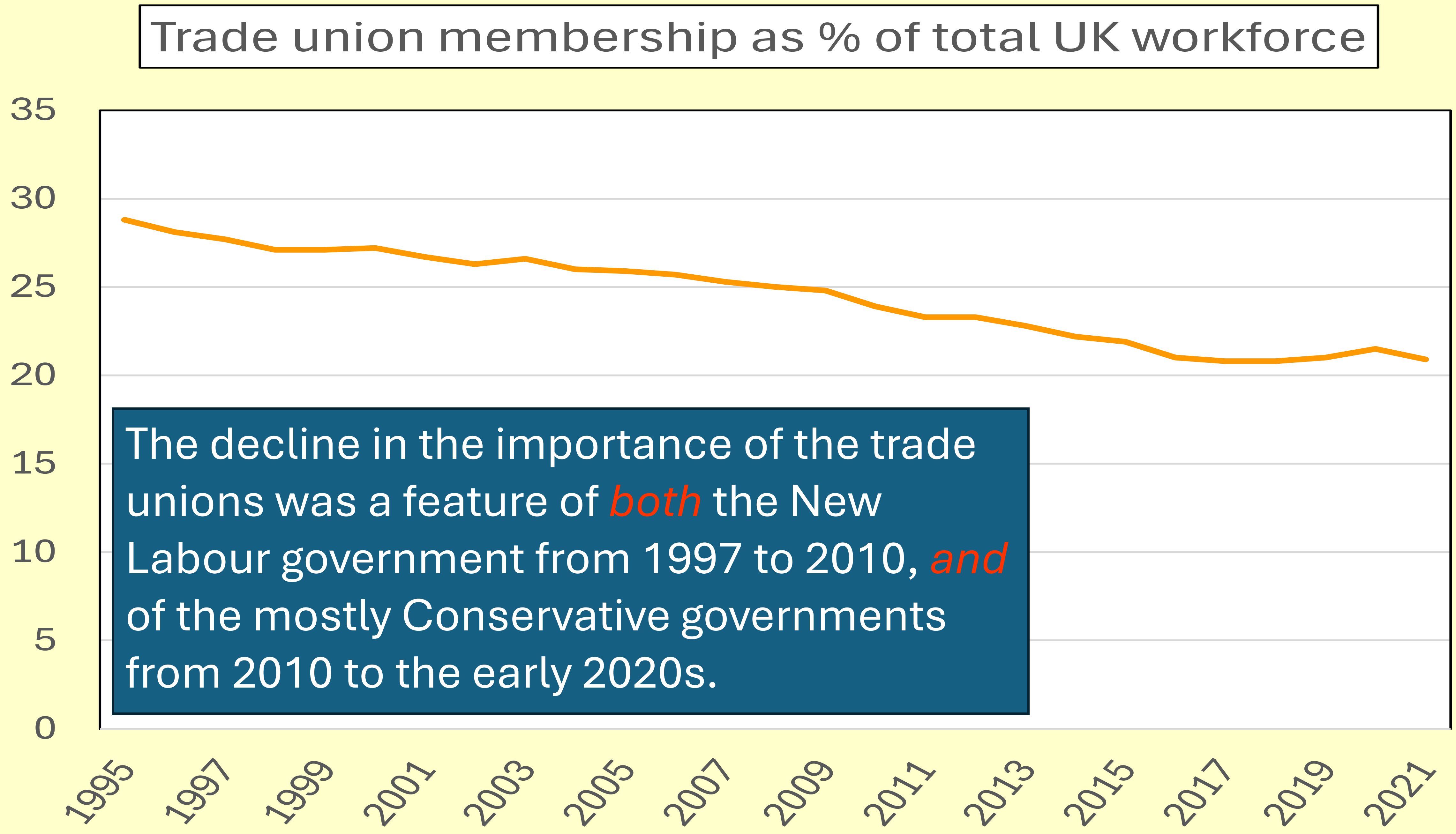
i. privatization, and marketization, of formerly nationalized utility, communications and transport companies in the 1980s and 1990s,

ii. growth of private sector employment in nursery education and social care, mostly for the elderly, much of it in the 2010s, and

iii. legislation to reduce trade union power.

In 1979 trade union members 50% of UK workforce



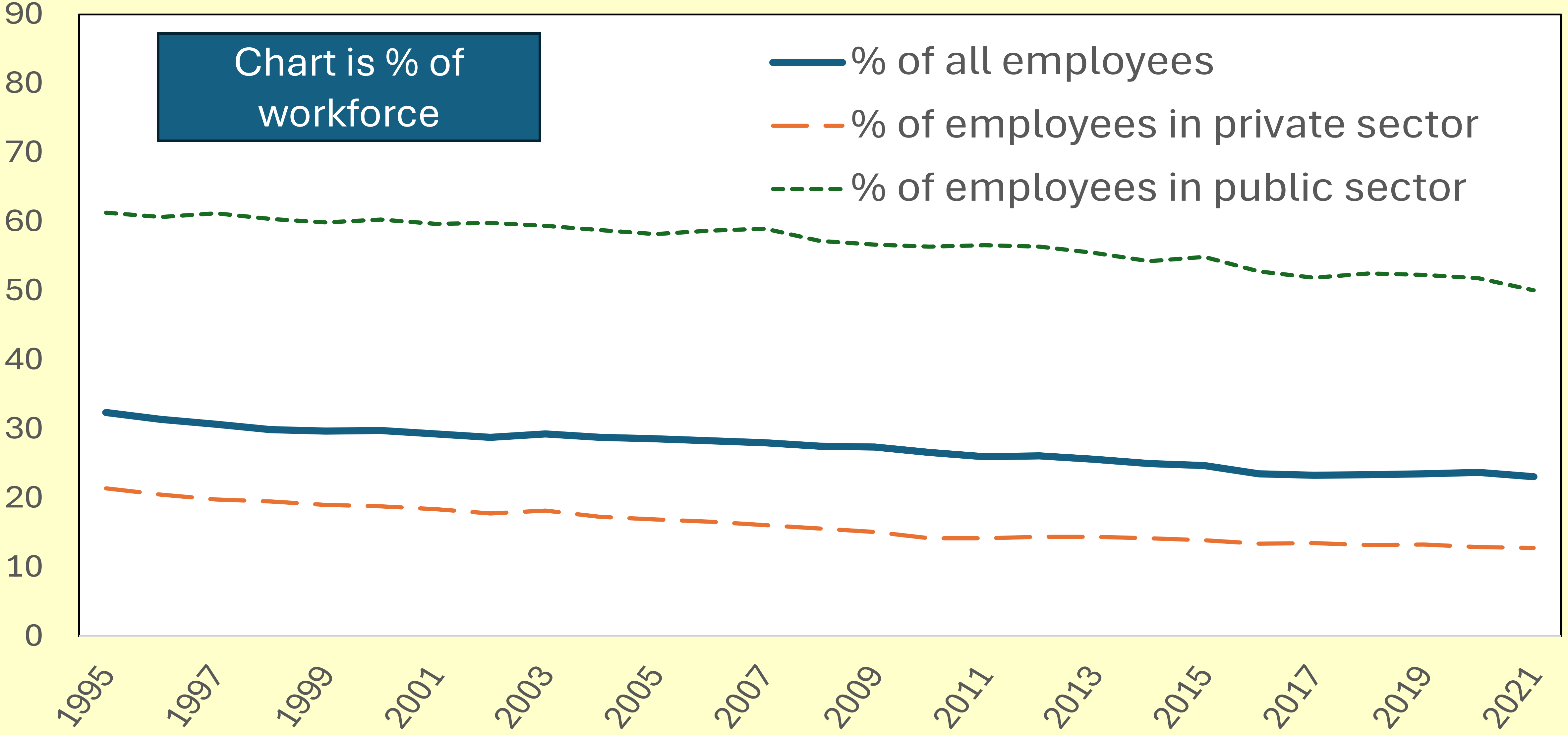

Trade union membership as % of total UK workforce
35
30
25
20
15
10
5
0
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015
2017
2019
2021
The decline in the importance of the trade unions was a feature of *both* the New Labour government from 1997 to 2010, *and* of the mostly Conservative governments from 2010 to the early 2020s.

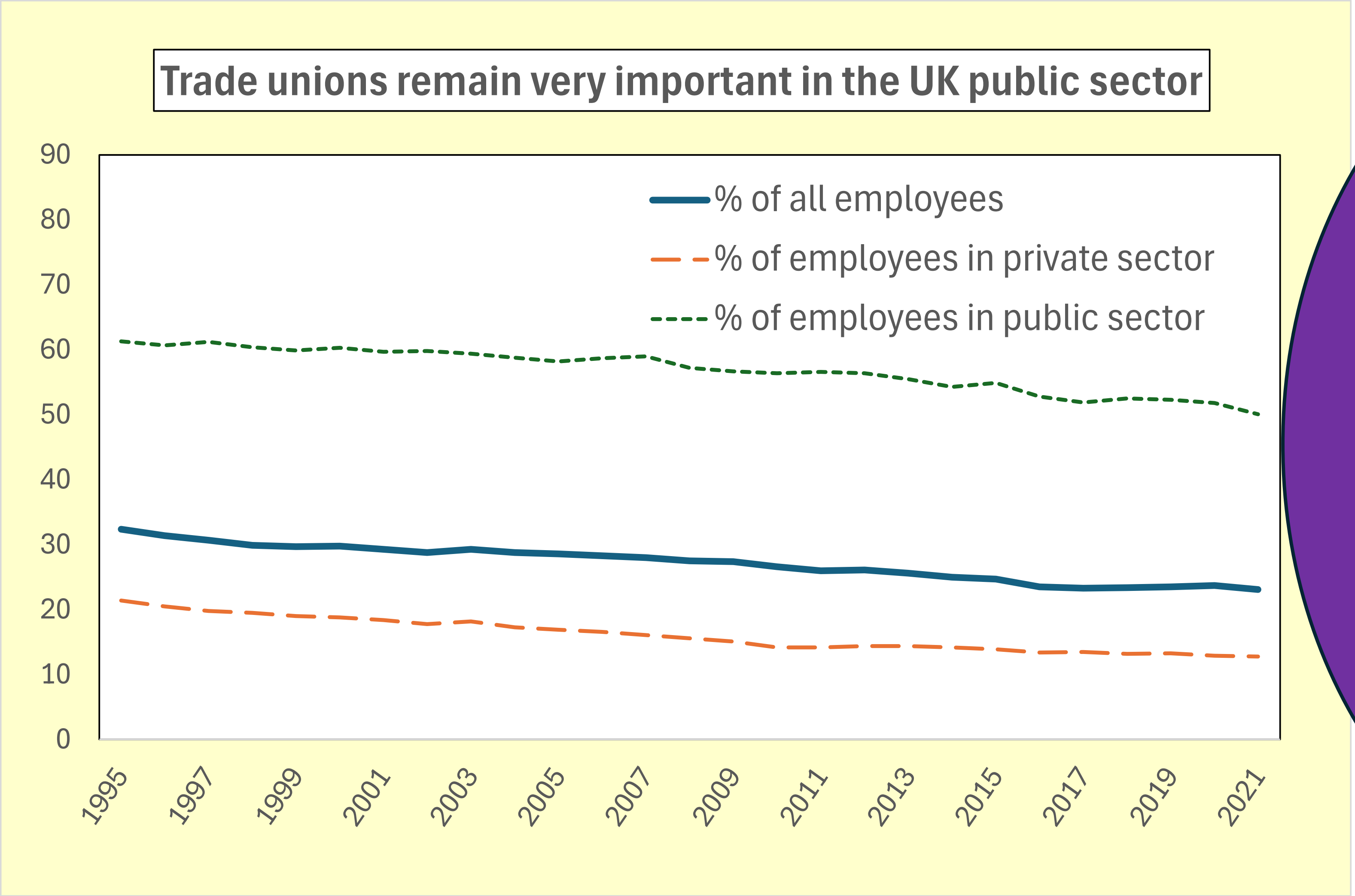
Morning Star
for Peace and Socialism

How Blair conned the unions

After a conciliatory promise to keep anti-strike laws but strengthen union recognition, Blair backtracked — and many accused him of colluding with big business. New evidence shows that indeed he was, reveals SOLOMON HUGHES

Trade unions remain very important in the UK public sector





In 2021, in the UK public sector, **half** of those employed belong to a trade union, compared with about **an eighth** in the private sector.

Could the UK's 'public sector problem' in the 1970s come back with the present Labour government?

- 1. Large pay awards, without strings attached, have been given to public sector workers at the start of the present Labour government. With the national minimum wage also increasing, *under the Conservatives*, much faster than general inflation, that makes it more difficult to hold back wage costs in the private sector.

- 2. A high proportion of Labour MPs receive financial support from trade unions. While Tony Blair was Prime Minister (1997 to 2007), the then Labour government tried to keep the unions at a distance. This may have changed. The present Labour government is already increasing "workers' rights".