

Replacing the State

Introduction

A distinguishing feature of the social and economic history of the twentieth century is the enormous rise in the role of the state throughout the Western world. Gradually, many of the functions which were previously the domain of the voluntary or private sectors have been embraced within the public sector. In the UK, for example, the most avowedly socialist government in our history was that of Clement Attlee from 1945 to 1951. Yet the share of the public sector in the economy as a whole under Attlee was less than it was during the government of Mrs Thatcher, renowned for her robust approach to the privatisation of state activities.

I describe in the first section of this paper the historical growth of the state over the past century and more. I then examine in the second whether there appears to be any relationship between the size of state activity and broad social democratic aims such as low unemployment. And I consider in the third how a much enhanced voluntary sector and the state might compete in the provision of services. In particular, the focus is on whether or not the existing public sector providers would inevitably be driven out, and the field left open to purely voluntary or private participation.

1. The growth of the state

The usual way in which the share of the public sector in GDP is presented is by taking the total spending of the public sector and dividing it by GDP. The current figure in the UK is just over 40 per cent.

However, public sector spending includes a large amount of transfer payments. In other words, taxes are raised from some individuals and are given out as benefits to other individuals. In the calculation of GDP, these are all subsumed together into the income of the personal sector. In other words, although the 40 per cent figure tells us about the overall tax burden, from an economic point of view it is not comparing like with like in terms of measuring the size of the public sector.

To illustrate the point, we can imagine an economy in which the state performs no functions at all. In other words, there is no defence, no state education, no state spending on infrastructure, or whatever. However, the rate of tax is 100 per cent on all income, which is deducted automatically at source, and then credited back in exactly the same amount as a benefit. In this economy, by definition the total spending of the public sector is equivalent to the entire economy. The total value of benefits paid out by the state is 100 per cent of GDP. But, in contrast, no-one is employed by the public sector, which provides no services to the population.

Obviously, this is a purely hypothetical case which uses a deliberately extreme example. But it shows quite clearly that the usual way of looking at the share of the public sector in the economy, by taking total public spending and dividing it by GDP, can give a quite misleading picture of the role of the state.

It is important to emphasise again that this figure does convey valuable information. It tells us about the size of the tax burden in the economy. But it does not necessarily give us an informative picture of the importance of public sector activity in the economy.

A more accurate picture on the claims on resources of the public sector is given by its current expenditure in national accounts terms as a percentage of GDP. As a simplification, this tells us how many people are employed in the sector relative to employment as a whole, and how much they are paid, again relative to overall pay. The various creative accounting activities of recent years have somewhat confused the issue. But this percentage is still a good indicator of the scale of state activity in the provision of services.

Here is the picture over a long period of time.

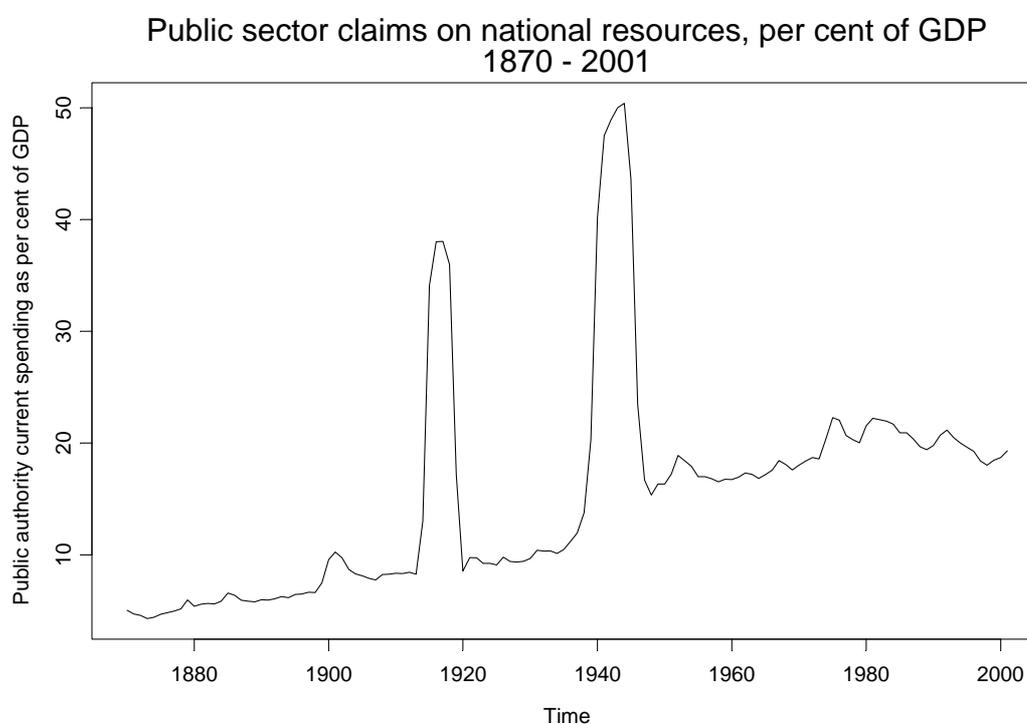


Figure 1 Source: C.H. Feinstein *National Income, Expenditure and Output in the UK*, Cambridge University Press, 1972 for data 1870-1965, and *Economic Trends Annual Supplement*, HMSO, for 1966-2001.

The huge increases in the wars are obvious in the chart. Millions of people either volunteered for or were conscripted into the armed forces, for example, which increased the claims of the state on the economy very sharply.

The most striking general feature of the chart is the steady rise in the importance of the public sector in the economy as a whole over the 1870-2001 period. In the late 19th century, public sector claims on resources averaged just over 5 per cent of GDP. In the late 20th century, this figure has been around 20 per cent.

We can translate these rather abstract percentages into cash terms. At present, 1 per cent of the UK GDP amounts to some £10 billion. So each year, in the late 20th century the state is making a claim on national resources which is around £150 billion more than it would have been if the late 19th century claim as a percentage of GDP had continued to hold.

A considerable proportion of the increase appears to be warranted in the following sense. A distinguishing feature of societies is that as they get richer, the demand for services such as health and education grows more quickly than the economy as a whole. My grandfather, for example, born at the end of the 19th century, went to school for half the day at the age of 12 and to work for the other half. The following year he had left school completely. His experience was entirely typical of his generation. Now, even the least qualified young person is in education until 16, most are in the system until 18, and an increasing proportion do not leave until they are 21.

In other words, there has been a massive increase in the amount of education which is provided. There is no immutable law which has required this expansion to be provided by the state. But whether it had taken place under public or private sector auspices, a large rise in the proportion of GDP spent on education would have happened regardless.

Without in any way wishing to provide an exhaustive list of similar examples, it is worth considering briefly the question of the elderly. The cost of old age is becoming more marked. Old people live longer and they cost more to keep. This is well known.

There are, however, two implications of this which are conceptually quite distinct. First, the cost of pension provision has risen sharply. However, this is financed by transfers of income – from taxpayers to pensioners, for example – which affects the *total* amount of public spending and hence the size of the tax burden, but does not alter the claims on resources. Second, there is the increased technical ability to provide health care for the old plus additional bureaucratic costs involved in administering these provisions. These latter costs *are* an additional claim on resources, and as such feature in our chart in Figure 1.

We can put the data in Figure 1 under the microscope and look in more detail at the post-war years. This is both instructive in itself, and gives rise to examples of additional public sector claims on resources which are not so obviously justified.

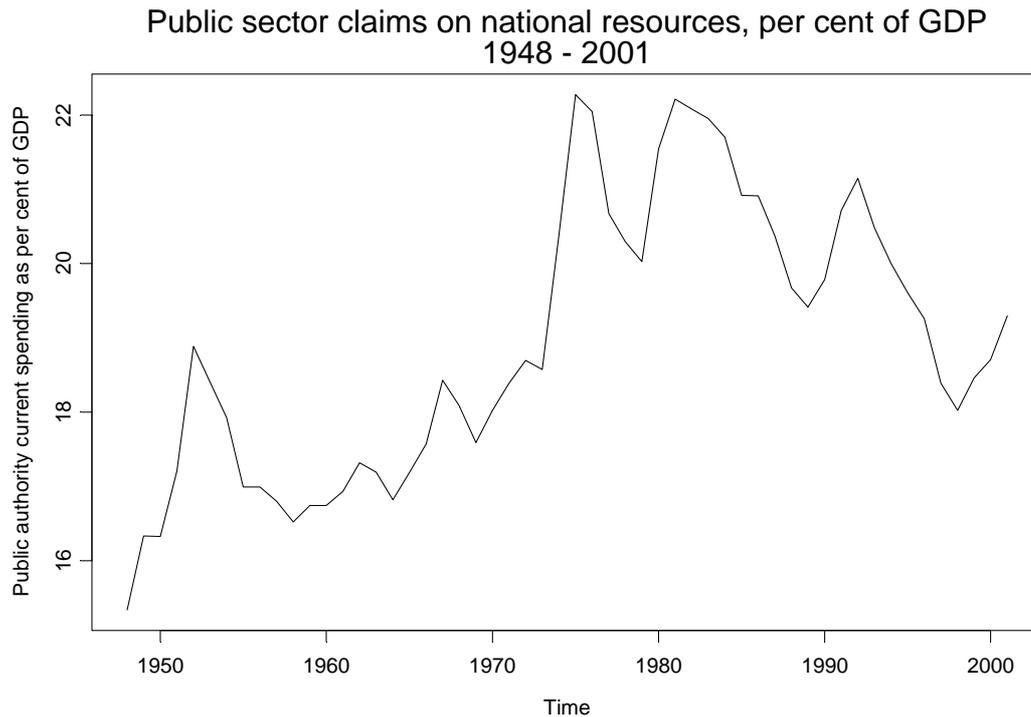


Figure 2

Figure 2 illustrates the point that for almost the whole of the Conservative period 1979-97, the state was making a bigger claim on resources than it did under Attlee (1945-1951).

The chart shows that there was a sharp rise in the size of the state in the late 1960s to mid-1970s, which has proved to be very hard to reverse. At the very far right hand side of the chart, the renewed increase in the size of the public sector under New Labour is beginning to show, a rise which will be even more distinct once data for 2002 and 2003 are available.

The increase over the past thirty-odd years coincides with the rise in a new, or at least vastly expanded, set of middle class professions. So, for example, we have a greatly expanded Health and Safety Executive, long after the major killing jobs - mines, ships, heavy industry- have all but disappeared. Similar arguments apply to Social Services

3. *The state and wider social objectives*

Peter Mandelson is the chairman of Policy Network, a left of centre grouping which brings together prominent centre-left leaders from all over the world. In a recent article, he cast doubt upon the concept that a larger state sector is a necessary condition for the achievement of wider social objectives:

‘The issue at stake is not bigger or smaller government. Nations are viable with very different shares of public spending and GDP. It is the capacity of the state to act as an agent of greater prosperity and social justice that is key, and that requires continuous and far-reaching reform.’ (*Guardian* newspaper, 7 July 2003)

His insight has possibly even more empirical backing than he imagined. We can take the data in Figure 1, and examine the relationship between the size of the public sector in the UK over a long period of time, and on the rate of unemployment.

Of course, the government may rely upon short-term changes in policy instruments such as interest rates or tax cuts to try to modulate fluctuations in unemployment. But there is a large literature which shows that such efforts are in general rather futile. It is not the purpose of this paper to go into detail on this topic, but there are two rather fundamental defects with conventional short-term intervention to try to control unemployment. First, the ability to predict the future course of the economy, even in the short-term, is very seriously limited¹. Second, the various models of the economy which purport to quantify the impact of policy changes disagree wildly about the effect of any such measures.² So governments lack the ability to make consistently accurate predictions about where the economy might be in the absence of policy change, and have a highly imperfect understanding of the impact of short-term changes in policy variables such as interest rates or tax cuts.

We might, however, expect to find a relationship over the longer term between the size of the public sector in the economy and the rate of unemployment. A larger public sector might cushion the economy more effectively from the various shocks to which it is subjected from time to time, and help preserve the level of employment in difficult times.

Figure 3 plots this relationship, and shows the rate of unemployment and the claims of the public sector as a percentage of GDP over the 1870-2001 period.

¹ see, for example, C.Mellis and R.Whittaker, (1998), 'The Treasury forecasting record: some new results', *National Institute Economic Review*, 164, pp.65-79 and P.Ormerod and C.Mounfield, (2000), 'Random Matrix Theory and the Failure of Macro-economic Forecasting', *Physica A*, 280, 497-504

² see, for example, J.Bray, S.Hall, A.Kuleshov, J.Nixon and P.Westaway (1995), 'The Interfaces between Policy Makers, Markets and Modellers', *Economic Journal*, vol.105, pp.989-1000

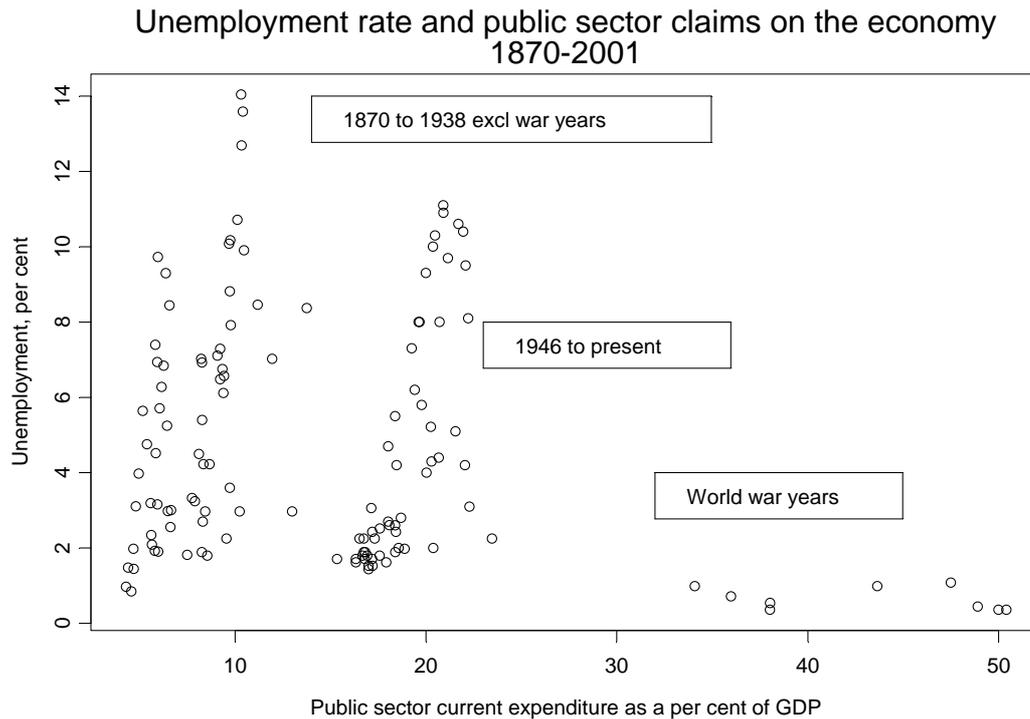


Figure 3 Source: as Figure 1

Each point in the chart corresponds to a particular year. Reading onto the left hand axis from any point, we can see the rate of unemployment in that year, and reading down to the bottom axis we see public sector current expenditure as a percentage of GDP in the same year.

The striking feature of Figure 3 is the way the data organises itself into three more or less separate clusters. The left hand collection of points relates to years when public spending was low, at around 10 per cent of GDP. With the exception of 1915-18, all these points are from the period 1870-1938. The second cluster relates to all the years from 1946 onwards, and the final small group at the far right of the chart are for the world war years.

Comparing the periods before and after the Second World War, we see that public spending has been much higher in the latter than the former, at approximately 20 per cent of GDP to approximately 10 per cent. But this doubling of public expenditure in its share of GDP appears to have very little connection with the average rate of unemployment over these two periods. Table 1 gives the relevant numbers.

Table 1 Unemployment rate and current public spending as a percent of GDP

Period	Public spending average, per cent	Unemployment		
		average	minimum	maximum
1870-1938 (Excl WW1)	7.9	4.9	0.4	14.0
1946 onwards	19.0	4.5	1.4	11.1

Source: calculated from Feinstein and ETAS

So the more precise calculation shows that comparing the two periods, the relative importance of the public sector more than doubled. Yet to all intents and purposes, the average rate of unemployment was the same in both periods, 4.5 per cent after World War 2 compared to 4.9 before. The fluctuations were slightly large before the Second World War, with unemployment ranging from 0.4 to 14 per cent, compared to 1.4 to 11.1 per cent after.

In other words, British economic history presents us with two distinct examples of policy regime as far as the size of the state is concerned. In one, it is fairly high, and in the other, very much lower. Yet the two are very similar in terms of their experience of unemployment. The data show very clearly that the size of the public sector *per se* over a period of time has no connection with the rate of unemployment.

4 *Specific social aims and the potential impact of the voluntary sector*

The growth of the public sector does not appear to have removed general social and economic problems. Of course, a great deal of such expenditure has specific as well as general aims. For example, we provide an education service through the state, in the hope of educating the population. The health service aims to cope with a wide range of issues connected with the physical and mental well-being of the population.

Opinions differ widely about the extent to which the state has succeeded in meeting its specific social aims. I address in this section of the paper the question as to what might happen if services which are already provided by the public sector were opened up to competition on a much larger scale than has previously been attempted.

A smaller state sector as such need not necessarily compromise the achievement of broader social and economic goals, as we have seen. But there is an understandable reluctance amongst many people to entrust the provision of services such as health and education purely to the impersonal workings of the market and the profit motive.

The example of NGOs in places like Afghanistan and Iraq is instructive. The UK government already uses voluntary organisations like Christian Aid or Oxfam or Save the Children on a substantial scale. They seem to be trusted more than governmental organisations because they work with not at people, and they cannot afford the kind of

numbing bureaucracy which often pervades government programmes, no matter how well motivated.

It is useful to remind ourselves that before the Second World War, a considerable amount of services which are now dominated by the state were then provided by the not-for-profit voluntary sector. The overall level of provision was much lower than it is now in terms of monetary expenditure, even after allowing for the effect of inflation.

But, to a large part, this is because Britain is now a much richer society than it was even 60 or 70 years ago. Since the late 1930s, average living standards have increased by some 360 per cent, and by 180 per cent since the early 1900s. In other words, we are almost five times better off than we were in the 1930s, and three times better off than 1950. So we can afford much more lavish provision of all kinds of goods and services, be they health and education or cars and foreign holidays. In other words, the fact that health care, say, was not as good in the 1930s as it is now is primarily due to our ability to spend so much more on health in real terms in the 21st century. The difference in the level of provision over such a long time scale does not in itself tell us anything about the desirability of any particular form of organisation structure.

The specific details of how a very much larger voluntary sector might function are not the immediate concern of this paper, although it would surely have to operate on the principle of allowing consumers very much more choice than they have at present. We might think of foundation hospitals as an important step in this direction. The government can set a framework and guard against gross failure or corruption, but let local communities/NGOs do delivery.

It might seem that an insuperable problem in trying to think about what might happen in such circumstances is the fact that we have no empirical evidence on which to base a judgment. In other words, it has never happened before. We have not seen the opening up of state services to competition from the voluntary sector on a large scale.

The way around this difficulty is a standard one in the social sciences. We can set up a theoretical model, based upon plausible rules of behaviour, which gives a framework for improving our understanding of the issues.

We can usefully think of a model as a map. In a geographical context, the most accurate map of an area replicates reality in every single detail. But such a map would be wholly impractical to use. Instead, mapmakers make dramatic simplifications. The key to whether a map is a good one or not is whether the simplifications are chosen well. A one page map of the principal roads of Britain would be of little use to someone trying to locate a particular street in, say, Manchester, but would be helpful for someone looking for a route between, for example, Southampton and Newcastle.

In the same way, a large amount of simplification is needed in order to construct a successful model. Ideally, it is one which contains sufficient of the important relevant detail to improve our understanding of the world, yet at the same time is not so complicated as to become too hard to understand completely.

The model described here³ is a rather general one, which considers how a market opened up to competition might evolve, and the factors which drive its development. It is not intended to illustrate any particular market, but to set up a general framework which could be modified to take account of any information which is specific to any given example.

Another helpful way of considering models such as this is to see them as a game. Each has a description of how the game is set up, and its own rules of behaviour as to how it can develop during the course of the game. In chess, for example, the starting positions of each of the 32 pieces on the board are specified. Each type of piece has specific rules about how it can move about the board, how it can capture other pieces, and so on. Overall, the number of rules about behaviour is very small, with perhaps no more than a dozen in total. Yet this limited number of rules is able to generate a game of immense complexity.

To begin with, we imagine a service which only the public sector provides. Apart from defence, in practice it is hard to find an example where the state supplies 100 per cent of the market, but in areas such as health and education, the figure is 90 per cent or more. Before the privatisations of the 1980s, there were more examples of where the share was effectively 100 per cent, in the case of telecommunications, gas and electricity, say. But to keep matters simple – and there is always a strong incentive to follow the principle of Occam’s razor - the public sector initially supplies the entire market in this model.

The service is supplied to a large number of consumers. We can make an heroic simplification and assume that each consumer is able to perceive the qualities of this service accurately. Further, we assume that there are just two features of the service which define its overall quality completely. In reality, there may be considerable confusion about what the true qualities of a service actually are, leaving aside the question as to whether the properties of a complex service such as health, say, can be measured in a straightforward way.

From a policymaking perspective, of course, huge simplifications are made every day in terms of how things are measured. The entire output of an economy, its GDP, is summarised in a single number. At present, this is around £1,000 billion at an annual rate for the UK. We are so used to this concept that it is easy to forget that the number is an amalgam of millions of widely different goods and services, and there has been an ongoing debate for many years about factors which should or should not be included in the measure. Yet the GDP figure is not without meaning. GDP per head across the world, for example, correlates strongly but not perfectly with desirable things such as life expectancy, literacy rates, and so on.

So the assumption that the quality of the service in the model can be measured by just two factors is a perfectly normal one to make. We could think of these as being, say, price and quality, or quality and reliability, or whatever. Suppose we imagine them to be price and overall quality.

³ A more technical paper setting out a similar kind of model is available at <http://www.paulormerod.com/research.html> under the heading ‘Competition and market structure’

We now have the straightforward conditions in which the game starts. To get the game moving, we need some rules of behaviour under three separate headings. First, how new players, or suppliers of the service as they are, enter the market and what the price and quality of their offer is. Second, how consumers respond to these new offers. Third, how existing players in the market, including the incumbent monopolist, respond to the new entrants.

The not-for-profit voluntary sector is not driven by the same set of motivations as a private company, but it still needs to be very much aware of financial reality. So it seems reasonable to assume that a voluntary competitor to the state will only try to enter a market if it can cover its costs. The best way to deal with this in terms of the rules of the game may seem indirect, but it captures the essential feature.

In reality, whether it is the commercial or voluntary sector, it is hard, indeed often impossible, to discover the price at which an organisation can deliver a service of a given quality, or the quality which it can provide for a given price. Such information tends to reside solely within the confines of the organisation. In other words, specific information is very hard to come by. However, we can get round this problem by assuming that a potential entrant into the market will make its decision on the basis of the price and quality of the offers already in the market. The higher the existing price, the more likely the potential entrant is to try its luck, and the higher the existing quality, the less likely. We express this as a probability of actually entering the market in a given period, which depends as described on the levels of price and quality already out there in the market.

Once an organisation decides to enter a market with its own offer, it faces two problems. First, will people actually take it up, given the mix of price and quality? Second, and even more importantly, how many customers will actually know that this particular offer is available? This problem tends to be skirted over in economics, where the assumption that consumers have ready access to large amounts of information dies hard. It is, however, of fundamental concern to marketing departments whenever a new product is launched.

The privatisation of utilities in the UK has given us many examples. In both gas and electricity, say, a household now faces a quite bewildering choice of suppliers, each claiming advantages for its particular offer. I have tested a seminar room full of economists, many of whom insisted fervently that consumers acted as if they had full information, how many of them could name even a complete list of companies involved in the domestic supply of gas and electricity, let alone the details of their offers. Not surprisingly, none could. The rather baffling choice of numbers now available to replace the old 192 directory enquiry line is but the latest example.

So we make the realistic assumption that only a certain proportion of consumers become aware of the existence of a new entrant. The old adage 'Half my advertising expenditure is wasted, but I don't know which half' is uncomfortably close to the truth. In practice, new entrant into a market might plan to achieve a high level of awareness, but actually obtain a much lower one. There are many factors which determine the actual outcome, which even after the event can be hard to identify and disentangle. We therefore choose the proportion of consumers who become aware of

a new offer at random. Some organisations will be lucky and get a high awareness, whilst others will not.

The next issue to consider is how consumers respond to the various offers as they appear. We do not have to believe in the whole apparatus of free market economics to realise that consumers respond to incentives. They will tend to switch to offers which can give them a better overall mix of price and quality. But there are constraints on the extent to which they will do this.

The first step is to assign each consumer a unique preference between price and quality. Some will attach great importance to price, others to quality, and most will be interested in various mixtures of the two. Given these tastes, a consumer may switch from his or her existing supplier to a new one which offers a better price/quality mix as far as he or she is concerned. But consumers can only switch to an offer of which they are aware. An organisation may have a very attractive mixture of price and quality, but have only a low awareness amongst consumers. Finally, we assume that each consumer has a propensity to switch.

In other words, it is not certain that a consumer will switch to a new supplier, even though objectively the price/quality mix of the new offer is better for the consumer in question. This seems realistic. There may be costs, for example, of switching to a new supplier. Taking a child out of one school putting her into another is by no means costless. Leaving aside any monetary considerations (e.g. new uniform, cost of travel), there is the emotional costs of transfer. Even more importantly, there is uncertainty surrounding both these costs themselves, and the actual quality of the new supplier. The only way to find out whether the offer is as good as it seems is to try it, yet there is comfort in the devil one knows. For example, there was a company called Ionica which entered the residential telecoms market. The offer was very good. Indeed almost too good to be true. So good, in fact that Ionica went bust leaving a lot of customers out of pocket and looking for another supplier. So there is real risk to customers looking to switch.

Finally, we give organisations in the market a behaviour which allows them to adjust to new offers which are made. The basic rule is that each organisation tries, in each period, to match the best price and quality offer available in the market. This need not burden us with the full panoply of calculus and profit-maximising behaviour of the economics textbooks. All we need assume is that organisations are motivated to stay in business. And the best way to do this is to ensure that the offer is competitive.

But in practice there will be constraints on the ability of the organisation to do this. The management may not be of sufficient quality, the cost structure may be too high, or whatever. The organisation may fail to match the best offer in the market. Again, in the model we handle this by giving each organisation a probability of being able to match the best offer.

A distinguishing feature of the not-for-profit sector is its sheer diversity. Different organisations will not only have different capacities to deliver any particular level of service, but may differ in their views as to what constitutes the service which they provide. They will also differ in their ability to adapt to competitive pressures. We do not need to know in advance – indeed it might not be possible to predict – which

organisations will prove to be better suited to deliver the service once a state monopoly is opened up to competition. This will only emerge during the process of competition itself. But it is precisely the differences, the divergences between the organisations in the not for profit sector which is its strength. The public sector monopolist may be able to provide from the outset a better service at a lower price than some of its potential not for profit competitors. Yet, amongst the diversity, it is almost certain that some will be found who can do it better.

This completes the set of rules to study how this hypothetical market might evolve over time. It is important to note that we have not biased the direction of the results by making the classic economics assumption of maximising behaviour. If consumers always take up the best offer which exists for them, if firms are always able to match the offer of their most effective competitor, the results of the model are obvious.

Opening up a market to competition under these assumptions about behaviour will increase quality, reduce price, and lead to a market in which many firms survive, in contrast to the initial conditions when there is an incumbent monopolist. It is not too much of a simplification to say that it is a simple model of this kind which underpinned the case for the various commercial privatisations which we have seen.

The model based on a stereotype of Economic Man is not completely divorced from reality. Compared to the old nationalised industry days, services in general *are* of better quality⁴ and prices more competitive than they used to be. The one major disconnection between the predictions of the model and reality is that the original incumbent monopolist has tended to retain a large market share⁵. A share, in fact, which is considered by economists in the various competition authorities to give *prima facie* reasons for believing that the market is not competitive. Yet, transparently, the market in, say, telecoms is highly competitive. Quality has improved dramatically and prices have fallen (in real terms, and sometimes even in absolute terms).

The rules of behaviour in our model mean that consumers and firms do tend to follow their own best interests, but they do so under many constraints. They either do not or cannot always follow the 'best' course of action, whatever that might be.

Nevertheless, when we simulate the behaviour of this market on the computer, we still find that:

- price is reduced from the level charged initially by the monopolist
- quality is improved from that offered initially by the monopolist

Importantly, however:

- the monopolist tends to be able to retain a large market share

⁴ the possible exception to this is rail, but even here there were distinct signs of improvement before the catastrophic interventions of Stephen Byers.

⁵ this has been true even of British Airways, despite the best efforts of 'Cool Britannia' Bob Ayling and Lord Marshall. If they had not had the endowment of slots at Heathrow, then BA could have succumbed to competition.

In other words, the model produces results which are more in accordance to what we have actually seen when state monopolies are opened up to competition. The market does have competitive properties in that the price/quality mix to the consumer is improved. But in general the original public sector provider retains a large market share.

Each individual solution of the model is unique, and differs from every other. This is because consumers and the organisations supplying the service do not act deterministically. In other words, they do always take the same decision when faced by identical circumstances, but will choose between alternatives on a probabilistic basis. This gives a *range* of results which can be obtained from the model. We might, indeed can, find examples where the original state monopolist is driven out of the market entirely, At the other extreme, it may be able to see off competitive threats and retain a monopoly.

The crucial feature which influences – although by no means determines completely – the market share of the public sector provider is its ability to respond to the new competition. If it is slow and unwieldy, the chances are that its share of the market will collapse. In this sense, the present government is quite correct in its belief that fundamental changes are required in how the public sector operates, although its ability to deliver on this perception has been rather more questionable.

But there is a very important implication for voluntary organisations in all of this. We have set up a hypothetical model, based on realistic rules of behaviour, in which a state monopoly is opened up to competition from new providers. In areas such as health and education, many people are understandably wary of profit-oriented firms, so the voluntary sector in principle would have a great opportunity to extend its scope and enter these markets.

Yet any organisation which does so faces considerable risks. In the model, as in reality, most new entrants in to the market fail. The reasons vary from case to case, but success is by no means easy. Incumbency, both in economics and biology, is a very strong card to hold. Dominant species are hard to shift from their niches. And monopolists usually retain a large market share even when they are opened up to competition.

The good news is that the overall quality of the offer to the consumer will almost certainly improve over time. This result is obtained despite the fact that we do not incorporate the ‘rational’ maximising behaviour of Economic Man into our model. In principle, it would be advantageous to open up to the offers of the voluntary sector services over which the state at present has a near monopoly. But attempts to enter such markets by the voluntary sector carry a distinct risk of failure for any individual would-be player in the game.

