

# The economic contribution of the private sector

Australian Institute of  
Company Directors

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## Headline findings

### The analysis presented in this report demonstrates that the private sector:

- generates **85%** of aggregate gross value added in the Australian economy, equivalent to **\$982 billion** in 2010-11
  - of this, an estimated 5.3% is contributed by the not-for-profit sector,<sup>1</sup>
  - and 94.7% is contributed by for-profit businesses—equivalent to \$930 billion in 2010-11
- directly pays around **87%** of income tax, equivalent to **\$244 billion** in 2010-11
- contributes around **91%** of Commonwealth non-financial public sector revenue, equal to **\$268 billion** in 2010-11
- employs **83%** of Australian wage and salary earners, equivalent to **9.5 million Australians** as at June 2011
  - about 8% of total employment is estimated to derive from the not-for-profit sector,<sup>2</sup>
  - based on this estimate, for-profit businesses employ around three-quarters of Australian wage earners—roughly equal to 8.6 million Australians.

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<sup>1</sup> Productivity Commission (2010) 'Contribution of the not-for-profit sector', research report, February.

<sup>2</sup> *ibid*

## The economic contribution of the private sector

In a modern “mixed” economy such as Australia’s, the primary role of the private sector is to create income while the primary role of the public sector is to re-distribute it. Viewed another way, the private sector produces goods and services that can be sold in the marketplace whereas the public sector redistributes goods and services produced in the private sector, including towards the production of “public goods”, i.e., goods and services which the market economy, for various reasons, cannot or will not supply (e.g. national defence).

There is a small overlap where governments own and operate business enterprises (e.g., AustraliaPost and Medibank Private). In such cases, public entities sell goods and services on a market and generate income in the process. In recent years, the trend has been for governments to divest such enterprises to the private sector and focus on the core business of government—income redistribution and the provision/funding of public goods.

Income is created when “factors of production” (i.e., land, labour, capital and entrepreneurship) are combined to produce goods and services which can be sold at prices at least equal to their cost of production. In short, if buyers will pay at least as much as it costs to produce a good or service, then the production of that good or service makes both buyer and seller better off and creates income in the process.

The “value added” created in this way is returned to the owners of the factors of production as rent, wages, interest and profit—in other words, as income. There is no income without value added—these are two sides of the same coin. While the public sector creates value added when it employs factors of production to redistribute income or produce public goods, because there is no market for such goods and services, they can never add more value than their cost of production (i.e., there can be no profit).

Profit is the unique preserve of the private sector (or government business enterprises where they exist). Profit is the reward for risk-taking and private enterprise is generally better placed to assess and manage commercial risk than the public sector. Taking commercial risks, on average, brings reward and the risk-taking entrepreneurship of the private sector drives value added above the cost of wages, interest and rent to create profit.

The public sector in its core activities is neither designed nor intended to assume commercial risk. It therefore cannot generate profit. Without a private sector, economies tend to deliver much lower standards of living (e.g., North Korea) because they have no means of generating profit. The prospect of profit drives efficiency, productivity and ultimately economic growth from which rising material living standards then flow.

This short paper presents three simple measures of the private sector’s contribution to the national economy:

1. the private sector’s share of aggregate value added in the Australian economy;
2. the private sector’s contribution to the costs of public sector activity; and
3. the private sector’s share of national employment.

## Value added

Gross Domestic Product (GDP), as measured by the final value of all goods and services produced within a country, is the basic measure of a nation's economic output.

Disaggregated into its components, GDP is the sum of the value of private sector consumption and investment goods (C+I), public sector consumption and investment goods (G) and net exports (X – M):

$$Y = C + G + I + X - M$$

GDP can be measured using three approaches: income, expenditure and production. The production approach aggregates the gross value added of each industry at 'basic' prices, that is, market prices adjusted downwards for taxes and upwards for subsidies.<sup>3</sup> This method isolates value added in the economy as follows:<sup>4</sup>

$$\textit{Total Gross Value Added} = \textit{GDP} + \textit{Subsidies on products} - \textit{Taxes on products}$$

In 2010-11, the private sector's share of gross value added is estimated at 85% (Chart 1.1).<sup>5</sup> Of this, around 5.3% is contributed by not-for-profit organisations, and the balance is contributed by for-profit businesses.<sup>6</sup>

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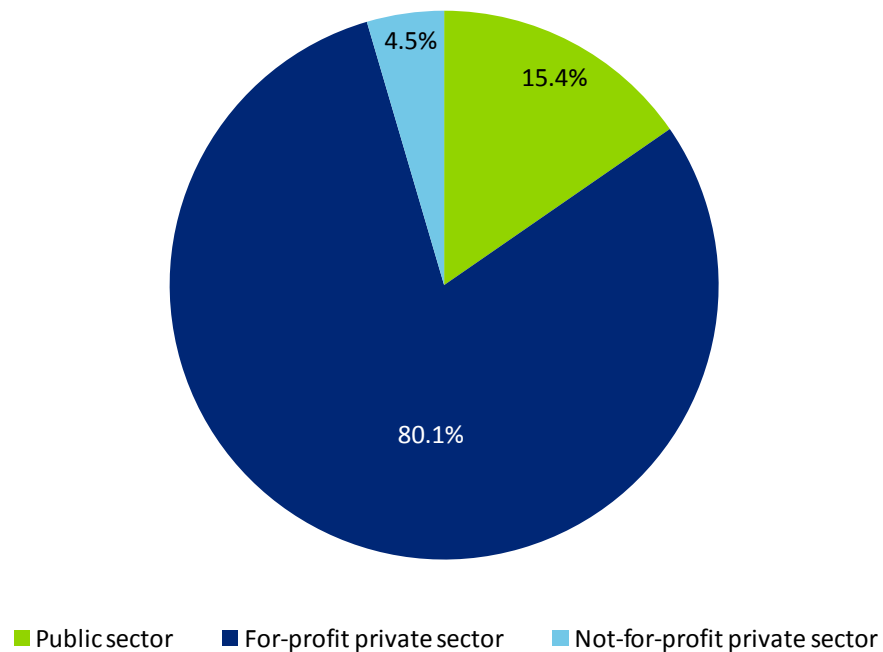
<sup>3</sup> 'Basic' prices represent the amounts received by producers (i.e. the market price) plus the value of any subsidies and minus any taxes.

<sup>4</sup> In aggregate and over time, all taxes and subsidies cancel each other out, but one or the other might be positive in any given time period. So they must be subtracted from GDP to calculate the value created by the economy.

<sup>5</sup> The public sector's contribution to employment is estimated as a weighted proportion of total compensation of employment in each industry, weighted by the relative size of employment and the relative average wages in each sector. The public sector's contribution to employment is estimated to comprise around 82% of the total public sector gross value added within an industry.

<sup>6</sup> Gross value added of economically significant not-for-profit organisations.

**Chart 1.1: Contribution of public and private sectors to gross value added, 2010-11<sup>7</sup>**



Source: ABS

Value added can be broken down into income derived from employment and income derived from all other factors of production (i.e. gross operating surplus plus gross mixed income). The private sector is responsible for 93%<sup>8</sup> of the gross operating surplus plus mixed income in Australia and around 78%<sup>9</sup> of the total contribution of employment to value added.

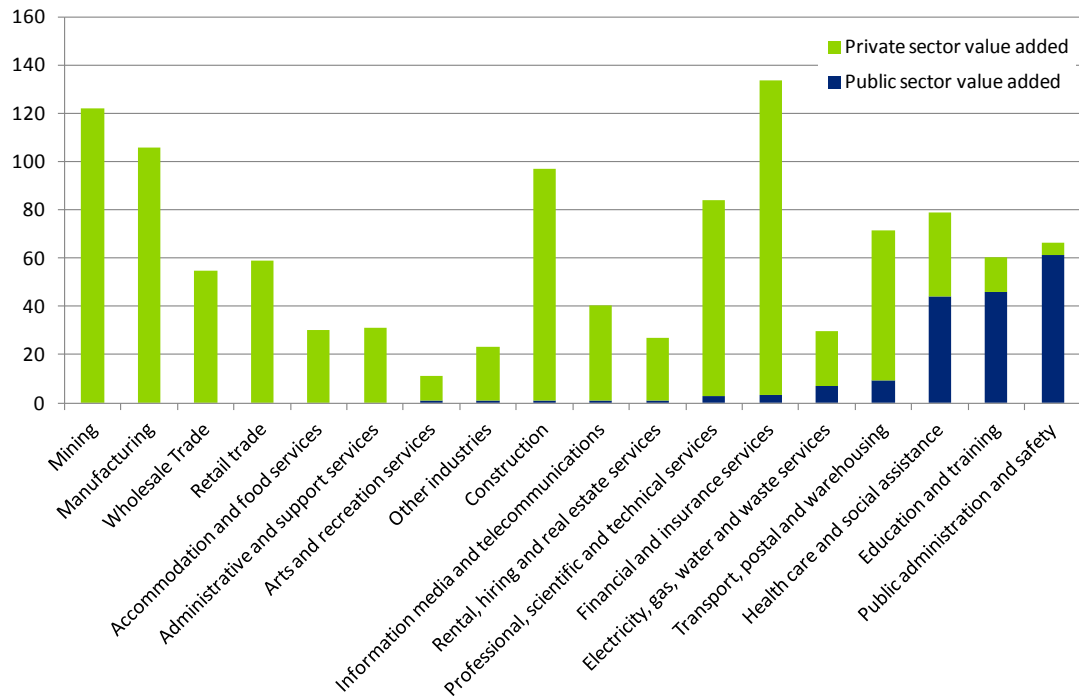
Naturally, the public sector has more of a presence in some industries than others. The contribution of the public sector is most pronounced in Public Administration and Safety, followed by Education and Training and Health care (Chart 1.2). However, almost all of the value added across all other industries derives from the private sector.

<sup>7</sup> In 2010-11, these shares equated to \$930 billion gross value added in the for-profit private sector, \$53 billion in the not-for-profit private sector and \$178 billion in the public sector.

<sup>8</sup> Equal to around \$434.4 billion in 2010-11 (total GOS is \$466.6 billion).

<sup>9</sup> Equal to around \$512.7 billion in 2010-11 (total compensation of employment is \$691.2 billion).

**Chart 1.2: Gross value added by sector and industry, \$ billion, 2010-11**



Source: ABS

## Taxation revenue

Except where the government generates revenue through government business enterprises<sup>10</sup> or earns interest on investments held overseas, all revenue required to fund public sector activity is transferred from the private sector. About 91%<sup>11</sup> of all Commonwealth activity (including that undertaken through the States) is funded from revenue raised by taxing the private sector, including 94% of “general government” activity (i.e., activity relating to core government functions) (Australian Government Budget Papers, 2010-11).

Some (around 70%)<sup>12</sup> of Commonwealth government taxation revenue is raised directly and some (around 30%)<sup>13</sup> is raised indirectly. Company tax and personal income tax are paid directly whereas GST, excise and customs duties are collected indirectly through the prices paid for taxable goods and services.

Around 87%<sup>14</sup> of revenue raised through direct taxation is paid by individuals and companies in the private sector (Chart 1.3). All of this revenue, including that paid by

<sup>10</sup> The government generates revenue through GBEs from corporate income taxation (0.08% of taxation revenue) and profit distribution (about 2% of total government revenue).

<sup>11</sup> \$267.8 billion in 2010-11.

<sup>12</sup> \$199.6 billion in 2010-11.

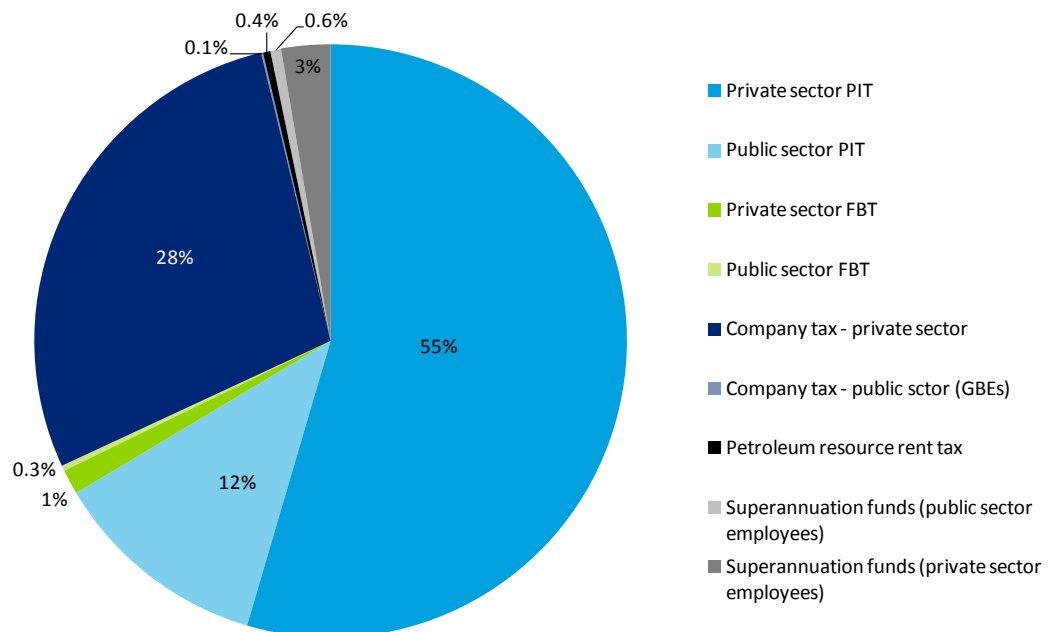
<sup>13</sup> \$81.2 billion in 2010-11.

<sup>14</sup> \$174.1 billion in 2010-11.

individuals, derives from business activity (i.e. business activity funds salaries and (sometimes) dividends which are then taxed).

Almost all of the balance of direct tax revenue is paid by public sector employees, with Commonwealth public corporations contributing 0.1% in the form of company tax. However, even the taxes paid by public sector employees in the general government sector are effectively raised from the private sector, since these wages and salaries are funded from revenue raised from taxes on private sector business activity. Effectively, therefore, almost 100% of the revenue allocated to the general government sector is raised from the private sector.

**Chart 1.3: Private and public sector shares of direct tax revenue**



Source: Australian Government budget outcome 2010-11

The public sector’s shares of fringe benefits tax (FBT) and personal income tax (PIT) are estimated using the public sector employment share and the average wage differential between the public and the private sector. Other factors will affect share of tax paid (such as the fact that fringe benefits are more heavily weighted towards the public sector), but these are not accounted for here.

## Employment

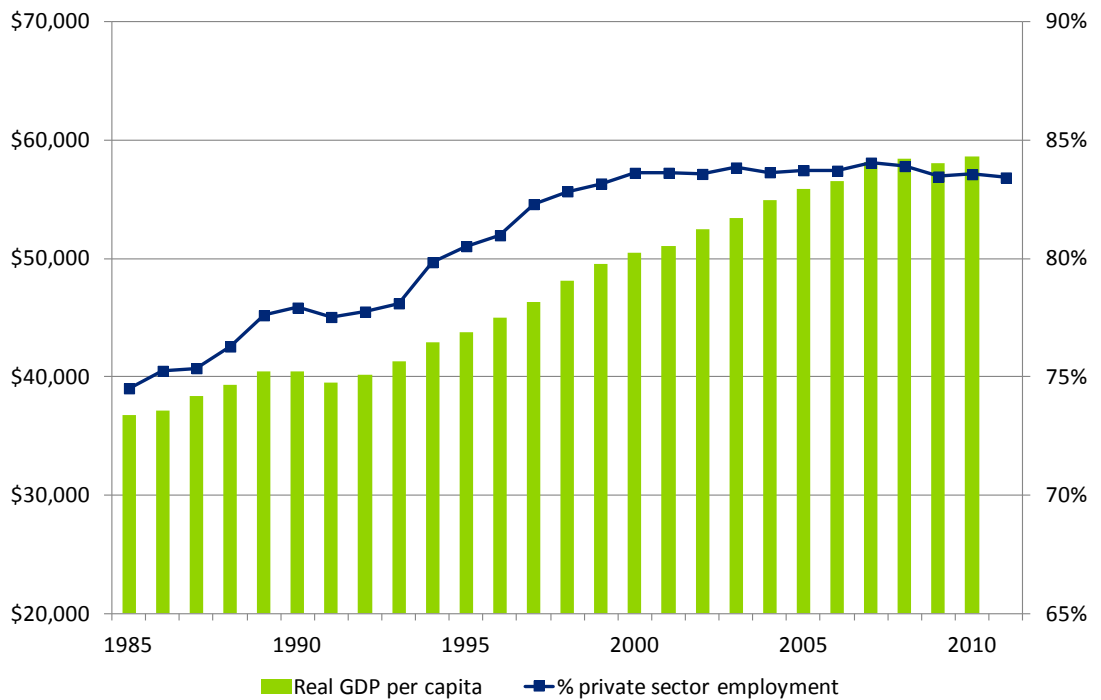
Labour is a key factor of production, responsible for just under half of aggregate value added. The great majority of wage and salary earners are employed in the private sector—over 83% of all employed persons in Australia in 2011<sup>15</sup>. Around 8% of employment is

<sup>15</sup> As at June 2011, over 9.5 million Australians were employed in the private sector.



estimated to derive from the not-for-profit sector.<sup>16</sup> Based on this estimate, for-profit businesses employ around three-quarters of Australian wage earners—equal to 8.6 million Australians at June 2011.

**Chart 1.4: Share of private sector employment, % (RHS), and real GDP per capita, \$ (LHS), 1985-2011**



Source: ABS

The share of private sector employment has steadily increased from under 75% in the mid-1980s. This shift in employment from the public to the private sector has been associated with a steady rise in per capita GDP over the same period (Chart 1.4). This is consistent with the view that the private sector generates higher labour productivity than the public sector which in turn drives improvements in general living standards over time.

<sup>16</sup> Based on Productivity Commission estimates of employment in economically significant NFP organisations (not including volunteers).

# Limitation of our work

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