Effective Governance Forum

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The Productivity Opportunity for the UK Government

If public sector productivity had matched that of to the country as a whole, government borrowings would be lower by over £100 billion year

Contents

Summary

- Over the last 25 years the UK has been transformed from one of Europe's lowest public debt, lowest tax and strongest private sector economies into a high public spending, high debt and increasingly highly taxed economy. As a result, the economy is stagnating.
  - Net public sector debt has increased from £347bn in 1997 to over £2600bn now, the equivalent to over £88,000 per household.
  - This is an unprecedented rate of increase in peace time.
  - Public spending, now £1,222bn (£43,000 per household) has also increased over the same period, from 35.5% of GDP to 46%.
  - Social protection (welfare, pensions etc), health and debt interest represent over half of all spending.

- Other European countries have not followed the same path as the UK.
  - Only Cyprus and Greece have raised their tax take more quickly than the UK.
  - Public debt in the UK has grown from 32% of GDP in 1997 (half the European average) to 97.1% of GDP, the seventh highest rate of 28 countries.
  - While UK growth has been similar to that in other EU countries since 1997, it has fallen far behind that in other Western economies.

- In terms of the ONS's own definition of productivity, the performance of the public sector has been poor.
  - Between 1997 and 2022, labour productivity across the whole economy rose by 27% while public sector labour productivity fell by 8% over the same period.
  - At a time of enormous technological change such a weak performance is counter-intuitive.
  - Other sectors of the economy have rapidly increased labour productivity: for example, productivity in the Information and technology sector is, according the ONS, over eight times higher than it was in 1997.
  - We estimate about half of government spending – pensions and debt interest payments for example – is outside the scope of productivity improvements.
  - In those other areas where productivity can potentially be improved, it is estimated that each 1% of improvement could result in savings of over £4bn.
  - If public sector productivity could, for example, be increased by 20% – not an unrealistic target given the gap between private sector and public sector productivity – then £85bn of efficiency gains would be realised.

- Public services are extremely expensive primarily because of low productivity in the state sector. However, examining the ONS productivity data, between 1997 and 2022, if the public sector's increase in productivity had matched the increases of the labour productivity of an equal weighted basket of financial services, professional services and administration and support labour productivity public sector labour productivity would be some 32% higher today. As a result, government expenditure would have been in the order of £120bn to £140 billion lower in 2023. Given the fiscal deficit for 2023/4 was £120.7bn we can see that such savings, if achieved, would result in modest fiscal surplus, not substantial deficit.

- Public sector productivity is intrinsically difficult to measure accurately. However, its poor recent performance is supported by opinion polling which finds increasing levels of public dissatisfaction with the quality of public services. For example, YouGov reported in October 2023 that:
  - 86% describe the NHS as being in a bad state, including almost half of those considering it to be in a "very bad" state.
  - Trains (70%), 69% police (69%), prisons (67%), schools (63%) and the courts/justice system (57%) are all considered to be in a bad state (57%).

- There are of course plenty of external reasons why the UK is in such a poor economic situation: the Global Financial Crisis, Brexit and the subsequent failure to exploit its opportunity, the Covid-19 pandemic and global instability are the most obvious examples. But in addition to these, there is the question as to why the quality of the UK's public services – whether this is measured by the government's own metrics of public sector productivity or by public attitudes to those services – has not taken advantage of the same opportunities as the private sector.

- The consequences of the spending and debt explosion over the last 25 years are that the UK risks a debt crisis and is already at the mercy of global bond markets.
  - Debt interest payment between 1997 and 2021 were relatively stable at between £30bn and £50n a year.
  - Net interest payments for the UK government as a proportion of tax receipts are now, with Italy, the highest in the G7.
  - Debt interest payments are now over £100bn a year. They are set to increase further as both debt and the cost of borrowing are projected to grow.

- Whichever party is in power, after the next election, will therefore have to deal with a dilemma: an economic situation which is unstable and public services which have signally failed to respond to the recent significant increase in spending.

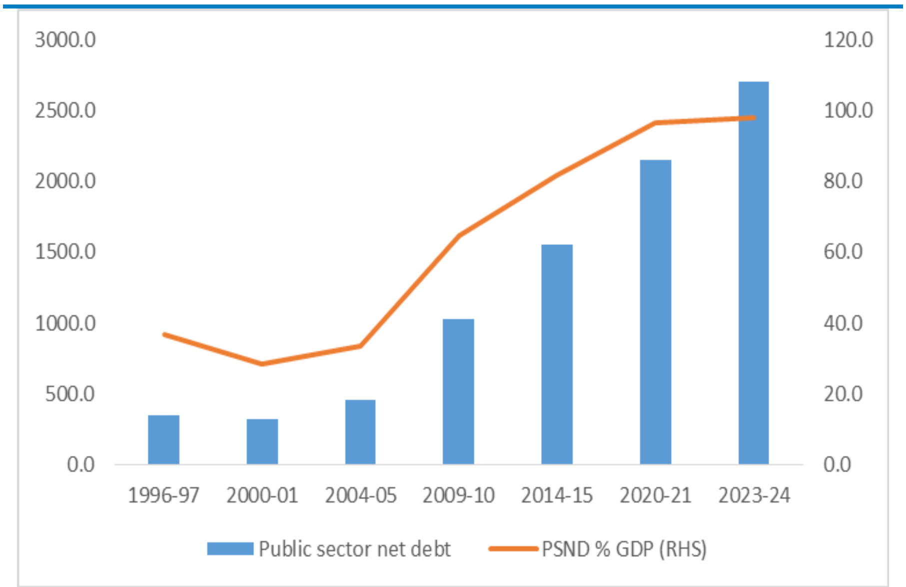
- Transforming the productivity performance and the quality of management in the public services is therefore both essential and potentially transformative for the economy.

The UK's public sector debt explosion

Britain's outstanding public debt has gradually accumulated over the last couple of hundred years or so.

- When Tony Blair was elected in 1997 net public sector debt stood at £347bn.
- By the eve of the Global Financial Crisis (GFC), in 2008, this had increased to £567bn.
- By 2010 and the election of David Cameron, the national debt breached £1000bn.
- In 2020, at the beginning of Boris Johnson's premiership, it was £1800bn.
- Today it exceeds £2600bn – the equivalent to over £88,000 per household. The OBR estimates that public sector debt will reach £3000bn in 2027. Without a change of strategy, even this extraordinary outcome could be too optimistic.

UK Public Sector Net Debt £bn and % GDP



Source OBR, Public finance databank, March 2024

In other words, government debt has increased more than seven-fold over the last 25 years. This is unprecedented in peace time.

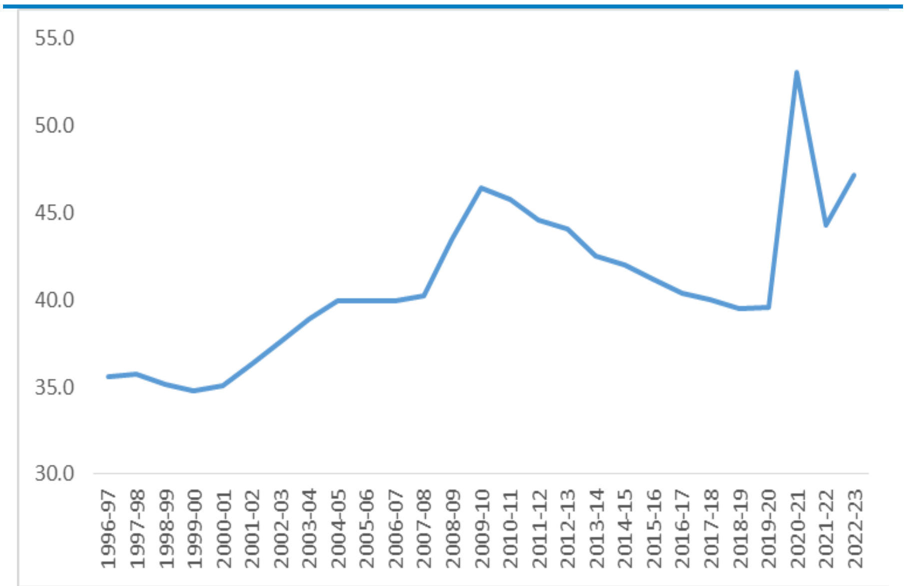
Previous increases in debt have coincided with existential wars. And this debt explosion is unique in a European context. This is not normal.

The spending explosion

This explosion in public debt is also mirrored by significant increases in public spending relative to GBP.

- Public spending accounted for 35.6% of GDP in 1996-7.
- New Labour steadily increased the state's share to just over 40% by 2007-8.
- The GFC embedded state spending further peaking at 46.5% of GDP in 2009-10.
- The Cameron-Osborne years saw public spending rise in real terms in each and every year but as a proportion of GDP, by 2019-20, public spending's share of the economy had edged back to the still historically high figure of 40% of GDP, a level similar to the pre GFC peak.
- Then comes the Boris Johnson government, Covid-19 and the response to it. Public expenditure peaked at 53.1% of GDP in 2020-21. Today, almost two years after the end of Covid-19 restrictions state spending remains embedded at 46% of GDP.

UK public spending as proportion of GDP 1996-7 to date



Source OBR, Public finance databank, March 2024

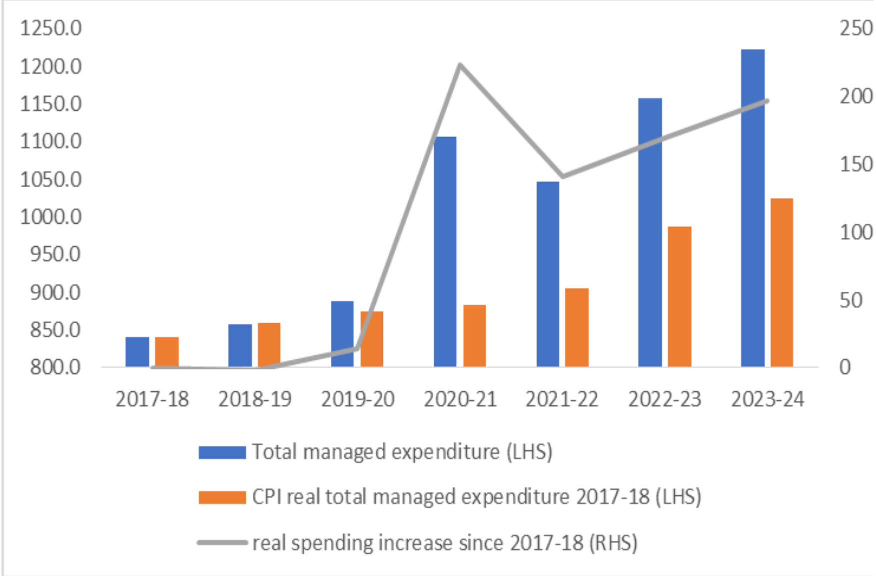
The Covid-19 effect should not be under-estimated. On the eve of lockdown total managed expenditure (TME) stood at £881bn.[1] This increased to £1106bn a year later. However, as is

[1] TME covers all current and capital spending carried out by the public sector (i.e. not just by central Government departments). It comprises the sum of Departmental Expenditure Limits (DELs) and Annually Managed Expenditure (AME), less depreciation.

outlined by the chart below, most of the additional Covid-19 expenditure has become embedded after normality resumed.

The OBR estimates public spending in 2023-4 will be £1222.3bn in 2023-4 (equivalent to £43,000 per household). That is £197bn more in real terms than it was in 2017-18.

UK total managed expenditure, CPI adjusted total managed expenditure and real spending increase since base year 2017-18 £bn

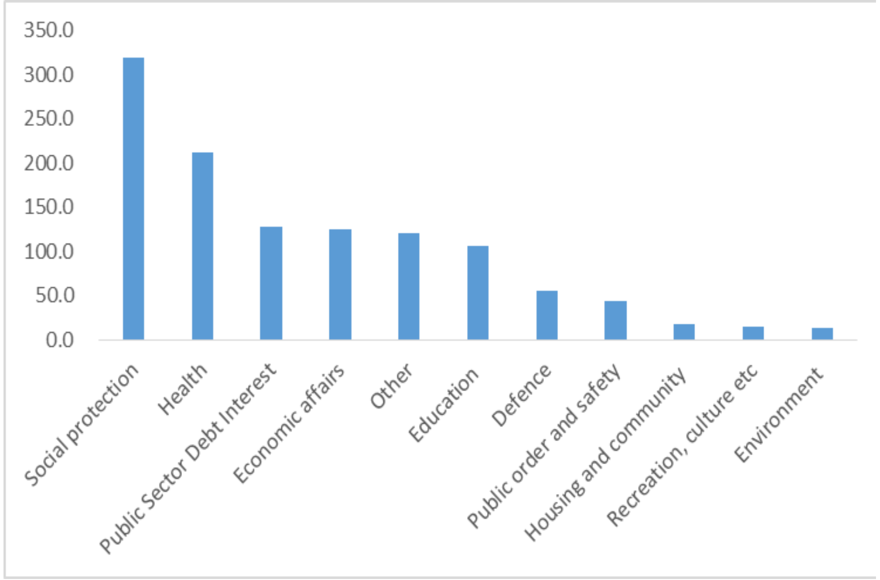


Source OBR, Public finance databank, March 2024 and ONS

Where the money goes

Of the £1154bn of public spending in 2022-3, two departments account for almost half the budget: social protection and health. Debt interest is next in magnitude. Of the social protection budget broadly half relates to the state pension, which currently is subject to the so-called 'triple lock' and thus has grown in excess of CPI in recent years. The remainder relates to a range of benefits including housing, out of work, disability and the like.

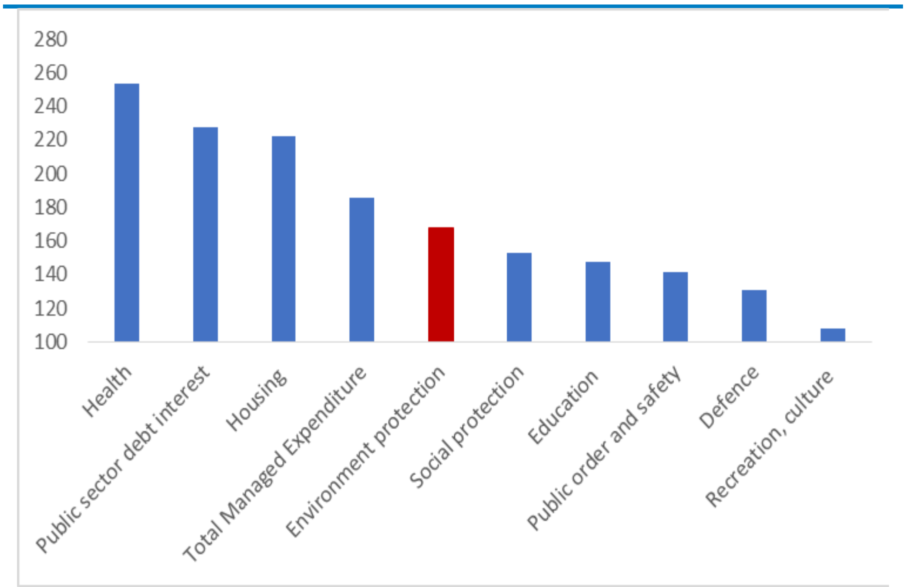
UK public spending by department £bn 2022-3



Source ONS, PESA 2023 Chapter 4

Total managed expenditure has increased by 85% in real terms since 1999-2000. However, this average mask a wide variance of spending increases with the health budget in particular up by over 150% over the period.

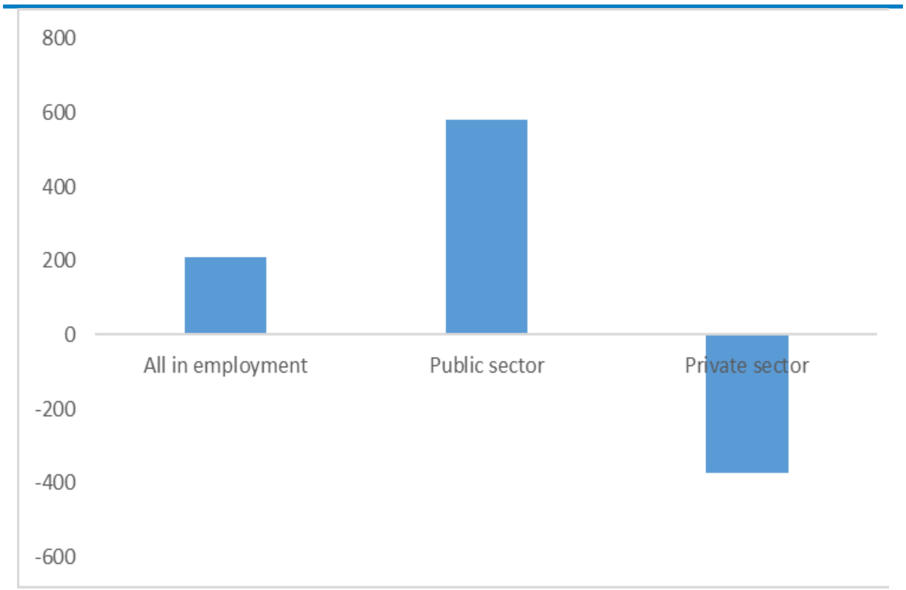
UK public spending by department real growth in spending since 1999-2000 to date % change



Source ONS, PESA 2023 Chapter 4

Public sector employment has grown in line with the increases in public spending: since 2019, it has increased by 581,000 while the private sector has shed 373,000 jobs

UK employment change since Dec 19 to current; public and private sectors

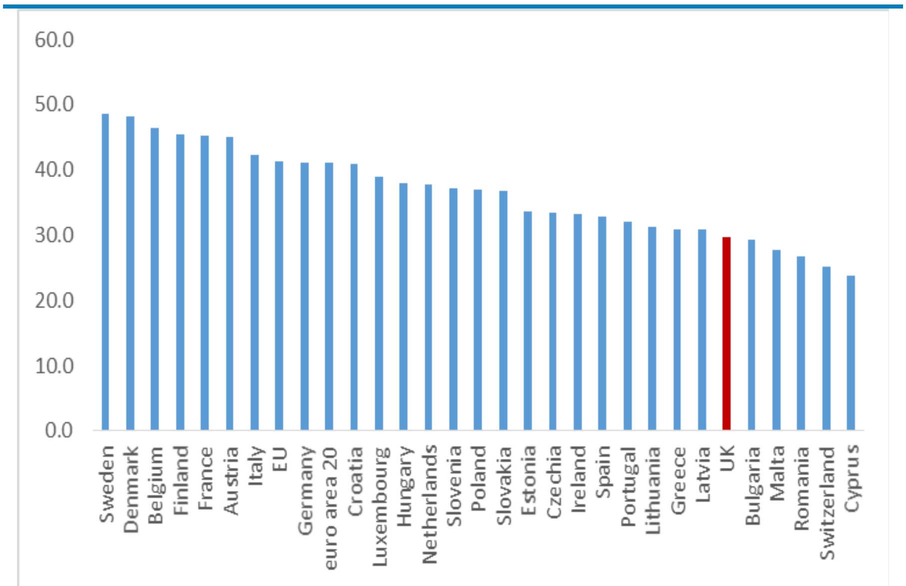


Source ONS, All in employment by industry: People (not seasonally adjusted)

The UK in a European context

While the UK has sharply increased its national debt and spending, other major European economies have reduced debt, tax and spending. The UK is the outlier, not the norm. Firstly, in terms of tax revenue as a percentage of GDP, the UK was in 1997 highly tax competitive, being in the low tax top quartile overall.

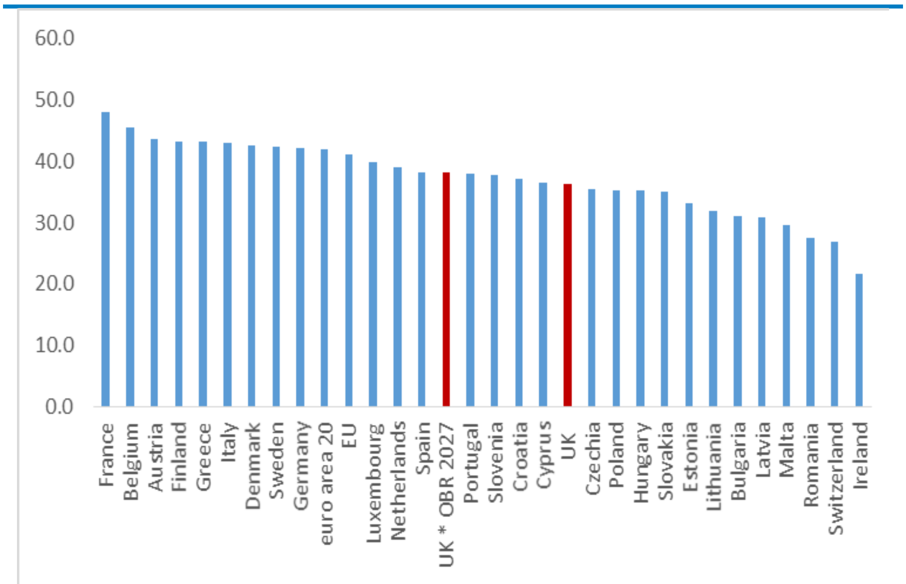
Tax revenue to GDP % 1997 EU, Switzerland and UK



Source Eurostat, National Tax Lists

Today, it is clear that the UK has lost its tax advantage relative to the EU.

Tax revenue to GDP % 2022 EU, Switzerland, UK (+ OBR to 2027)



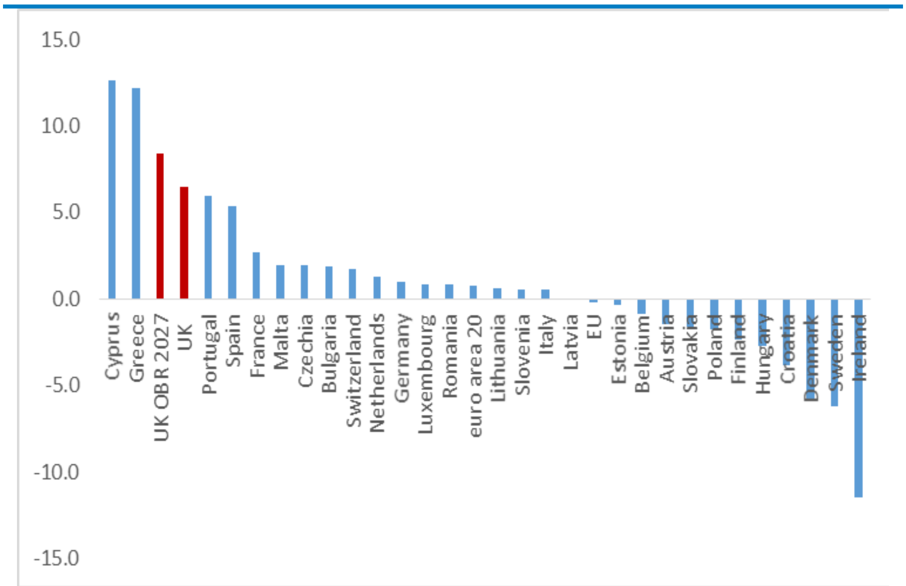
Source Eurostat, National Tax Lists

Moreover, over the last 25 years, no country (except Greece and Cyprus) has increased taxation as much as the UK.

Indeed, over that period, according to the EU Statistical agency Eurostat, the average rate of EU wide tax actually fell marginally by 0.2% with 13 EU countries cutting aggregate tax over that period led by Ireland, Sweden and Denmark's significant cuts.

Tax increases are thus not inevitable. Most EU countries have cut taxes over the last quarter century just as the UK adopts the opposite strategy.

Change in tax revenue to GDP % from 1997 to 2022 EU, Switzerland, UK (+ OBR to 2027)

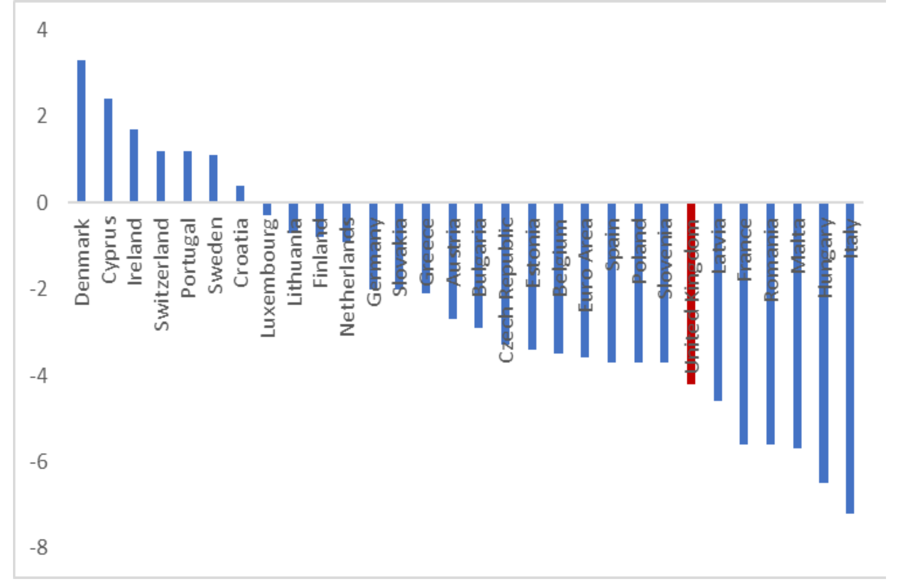


Source Eurostat, National Tax Lists

Not only have UK taxes risen sharply but the UK Government currently runs one of the highest fiscal deficits in Europe as outlined by the chart below.

- The UK's fiscal deficit in 2022 was 5% contrasting with an EU average of 3.3%
- Only six European countries are running larger deficits.
- Five European countries run surpluses and a further six are very close to balance.

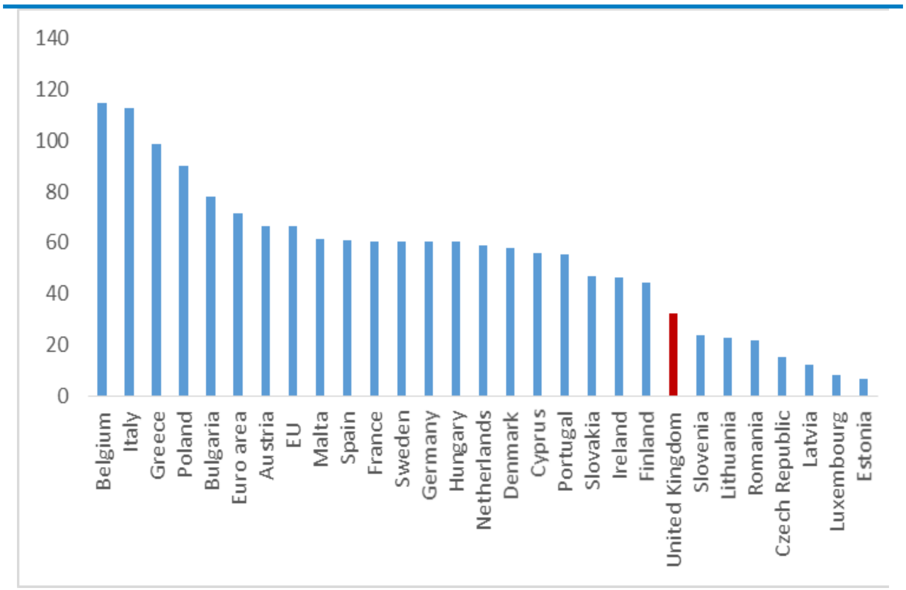
EU and UK annual fiscal deficit 2023 % GDP



Source Trading Economics, Budget Deficits

25 years ago, the UK had one of the strongest fiscal positions in Europe as outlined by the chart below with public debt to GDP of just 32%, less than half the EU average.

EU and UK Public Sector Net debt 1997 % GDP

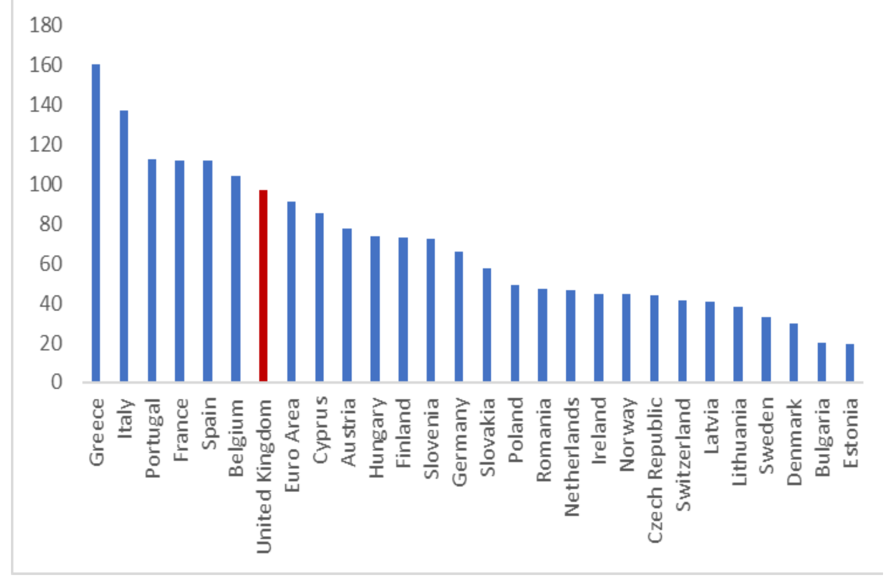


Source Trading Economics, Budget Deficits

In contrast, UK public debt to GDP currently stands at 97.1%.

The UK over 22 years has thus moved from being in the top quartile in terms of its public sector balance sheet to being firmly in the bottom quartile.

EU and UK Public Sector Net Debt 2023 % GDP

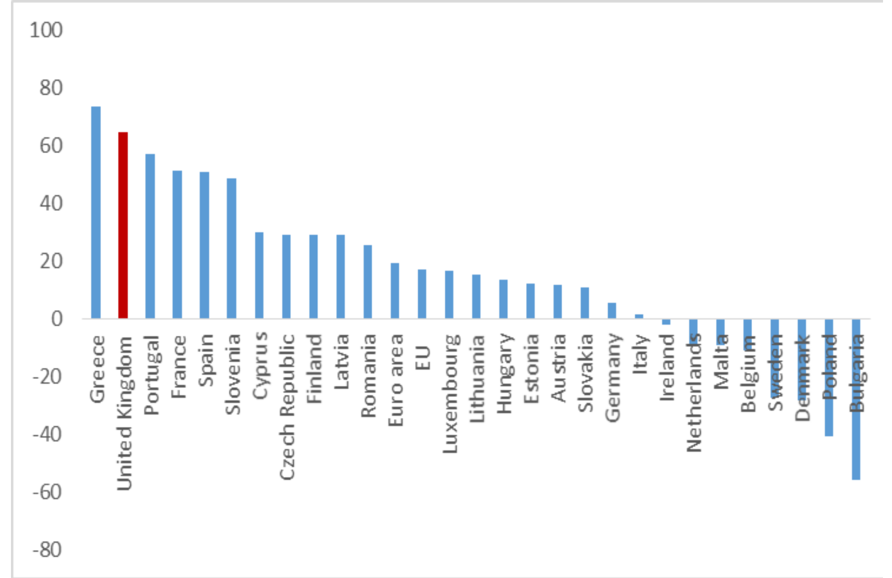


Source Trading Economics, Budget Deficits

In terms of the rate of change in public debt over the last 25 years, outlined by the chart below, only Greece has seen a greater deterioration, relative to GDP, than the UK. Further the rate of increase in UK public debt has been three times the EU average increase.

It should also be noted that while most countries have weakened their public sector balance sheets this has not universally been the case with eight countries reducing their relative level of indebtedness. Sweden, Denmark and Poland are perhaps the most notable cases.

% change in public debt to GDP 1997 to 2023



Source Trading Economics, Budget Deficits

Thus, the UK is a European outlier running substantial current deficits, increasing taxation by more than almost any other European nation while also weakening its national balance sheet by more than any country other than Greece. This contrasts with a number of European countries that have both reduced taxation and improved their fiscal position.

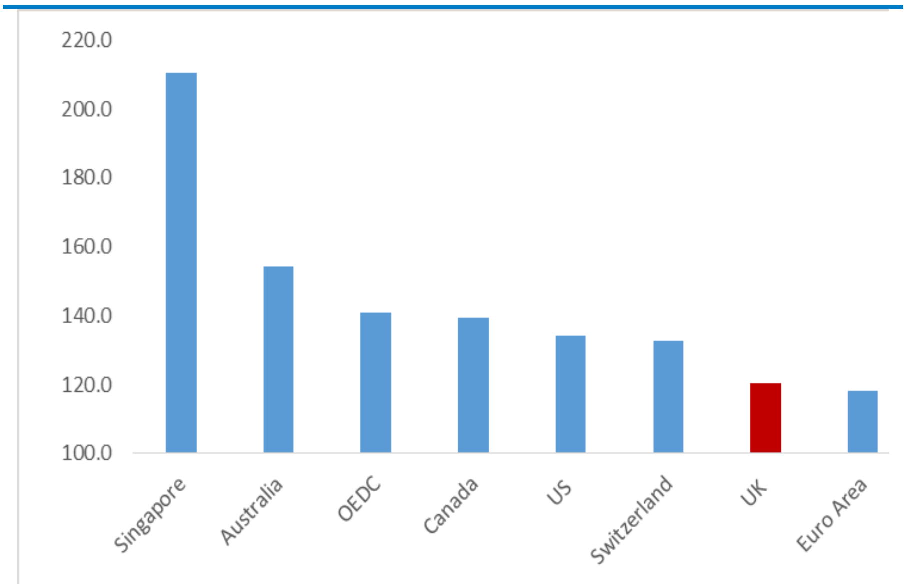
But we're doing well relative to the EU?

Some may argue that the UK's economic performance is superior to our major European competitors. In terms of growth rates, this may be broadly true. But while the UK may have grown marginally faster than the Euro area as a whole since 2005, the continent of Europe has underperformed every other major economic region in the world.

The chart below shows that the UK and EU have managed 20.3% and 18.1% growth respectively between 2005 and 2023. This however contrasts with Swiss GDP increasing by 32.5%, the US by 34.5%, Canada by 39%, the OECD by 40.9% and Australia by 54% over the same period.

As a reference if the UK had grown at the same rate as the US since 2005 current UK GDP would have been some £380bn higher today, or £13,000 per household. Decline is thus not inevitable, but it is an inevitable consequence of poor policy choice and delivery.

Major developed nation GDP growth indexed to 2023 2005=100

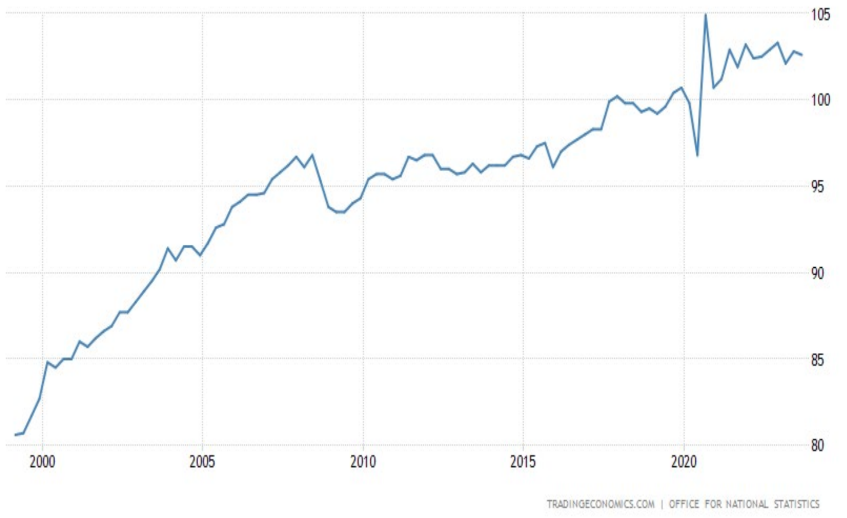


Source World Bank

An examination of UK productivity

It is well documented that, according to the ONS statistics, productivity in the public sector has stalled. In an age of enormous technological change such a stalling is counter-intuitive. Recent technological advance has been so rapid, especially in digitisation and AI fields, that productivity in all public services should have improved, not the opposite.

UK productivity since 1997



Source Trading Economics, ONS

A word of warning: the ONS measurement of productivity is imperfect

Firstly, a word of warning. While the ONS provides detailed economy and sector wide productivity data, it is widely accepted that there remains difficulty in computing accurate figures. Quantifying manufacturing productivity may, with caveats, be relatively straightforward to measure: there are often clear inputs and outputs.

But when it comes to the service economy, output is more subjective particularly where some sectors, for example the police or armed forces, are not subject to classical market pressures and pricing. In some cases, the ONS simply assumes inputs equal outputs. Thus, a constant productive factor of 100% is assumed i.e. these sectors extraordinarily can never have productivity growth. Clearly such a methodology is imperfect.

Further, many public service outputs are difficult to quantify reasonably. Is a teacher who taught children in a class of 30 necessarily more productive than one where the class size was just 20? Similarly, is a higher number of anti-biotic prescriptions a sign of higher productivity (more activity by doctors) or a sign of lower productivity (worse public health)?

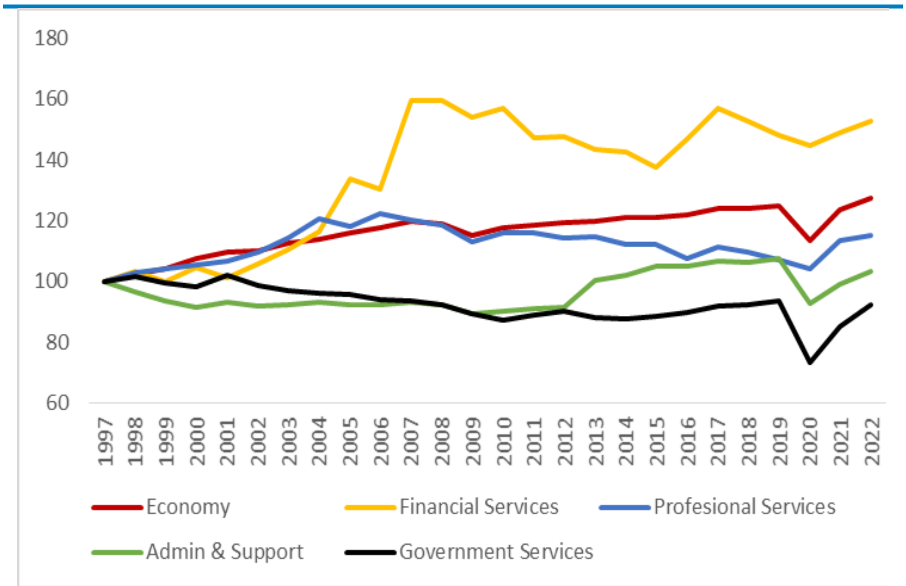
Thus, the data needs to be treated with great care. But they are the official data which the ONS has done its best to adjust over the years in order to give what it considers to be the most accurate analysis.

What do the ONS data suggest?

The chart below, outlines the hugely differing performance in labour productivity by sector of the economy. While the data can only be indicative, as discussed above, the gap between the performance of Government services and similar private sector activities is stark.

Between 1997 and 2022 economy wide labour productivity increased by 27%. However, the ONS estimates that public sector labour productivity actually declined by 8% over that same period. Even with the caveats above, this is extraordinary, given the digitalisation of the economy.

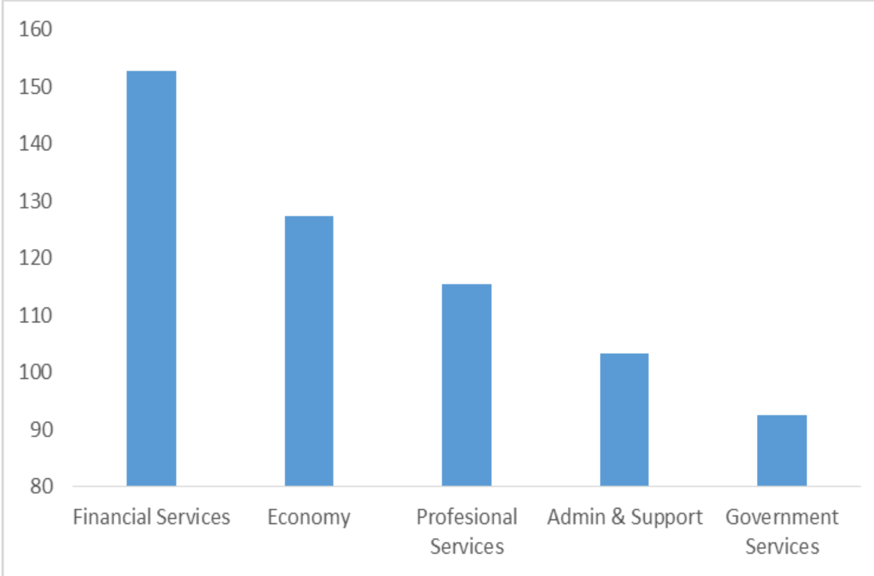
UK productivity. Output per worker economy and key sector 1997=100



Source ONS

The chart below examines the ONS estimates of productivity improvements in key sectors of the economy since 1997.

UK productivity. Output per job economy and key sector Indexed change since 1997



Source ONS

It is striking that the two productivity stars of information and communications and manufacturing have seen indexed gains of over eight-fold and two and a half times.

According to the ONS since 1997 the gap between the economy as a whole and Government Services has widened by 37%. Against an arguably fairer comparison, of an equal weighted basket of financial services, professional services and administration and support the gap is still 32%.

The productivity opportunity

When examining the public sector productivity gap relative to economy as a whole, it clearly is not as simple of suggesting Government spends £x and productivity has lagged the economy by y% and thus the gap is £x multiplied by y%. For there are some areas – such as interest payments on the national debt and most welfare payments – which are clearly not subject to productivity improvements. There will be other legal obligations and contingent liabilities which should also be excluded.

Calculating how much of current government spending is liable to productivity improvement is therefore more of an art than a science. The figures in the following pages are based on the following assumptions:

- Debt interest payments and the social protection budget are both assumed to be outside the scope productivity improvement.
- A further £250bn of cost are also not factors of production (this would include, for example, accrued public sector workers pensions or other contractual obligations).
- Thus, of the total £1155bn of total managed expenditure in 2022-23, only around half is theoretically addressable to productivity improvement.

The table below outlines for each department the scope within each departmental budget that can potentially be addressable with productivity improvements; and the potential gains from 1%, 10% and 20% productivity improvements.

UK productivity opportunity – savings potential £bn

	£ billion 2022-23 outturn	% potentially addressable	Estimated saving Productivity gain % saving £bn 1%	10%	20%
General public services	163.7				
of which: public and common services	*26.8*	80%	0.2	2.1	4.3
of which: international services	*8.5*	10%	0.0	0.1	0.2
of which: public sector debt interest	*128.4*	0	0.0	0.0	0.0
Defence	55.5	80%	0.4	4.4	8.9
Public order and safety	43.9	80%	0.4	3.5	7.0
Economic affairs	125.0		0.0	0.0	0.0
of which: economic development	*63.8*	50%	0.3	3.2	6.4
of which: science and technology	*7.2*	80%	0.1	0.6	1.2
of which: employment policies	*3.8*	80%	0.0	0.3	0.6
of which: agriculture	*6.7*	25%	0.0	0.2	0.3
of which: transport	*43.6*	25%	0.1	1.1	2.2
Environment protection	13.9	25%	0.0	0.3	0.7
Housing and community amenities	17.8	25%	0.0	0.4	0.9
Health	211.6	80%	1.7	16.9	33.9
Recreation, culture and religion	14.0	85%	0.1	1.2	2.4
Education	105.5	80%	0.8	8.4	16.9
Social protection	318.8	0%	0.0	0.0	0.0
Accounting adjustments	87.4		0.0	0.0	0.0
Total Managed Expenditure	1154.9		4.3	42.9	85.7

Source ONS, PESA 2023 Chapter 4 and EGF calculations

The table suggests that, using the ONS approach to productivity, each 1% productivity gain from the addressable portion of public spending could yield £4bn of efficiency savings.

This therefore indicates that the potential for efficiency gains is immense: after all, the ONS estimates that public sector productivity is 8% lower today than it was in 1997, while productivity across the whole economy over the same period grew by 27%.

A 20% improvement in productivity could, from this top-down analysis yield approximately £85bn of efficiency gains and would still, on the ONS measure, leave the public sector still somewhat less productive than the private equivalent.

Some may argue that £80bn of efficiency gains is over-ambitious. But they might also consider that from 2017-18 to 2023-4 real spending will have increased by £197bn, or almost 20% of the entire budget. In this context, saving £80bn should be considered as quickly achievable.

Attitudes to public services

Even given the difficulty of measurement, public sector productivity is poor. This is confirmed by opinion polling which finds increasing levels of public dissatisfaction with the quality of public services. For example, YouGov reported in October 2023 that:[2]

> "YouGov asked Britons about 12 key public services, with a majority thinking that most are in a bad state. At 86%, the NHS is the service people are most likely to describe as being in a bad state, including almost half of the public considering it to be in a "very bad" state.
>
> Given this, it's hardly surprising that the more specific health services are judged to be performing similarly poorly – 81% for hospitals, 78% for social care and the same number for GPs.
>
> Seven in ten say that trains (70%) and police (69%) are likewise in a bad way, with two thirds saying the same of prisons (67%). Around six in ten consider schools (63%) and the courts/justice system to also be in a bad state (57%)."

Moreover, the same survey found that those who had interacted with crime-related public services – police, prisons, and courts and the justice system – in the last 12 months are particularly likely to say those services are in a bad shape compared to the wider public:

> "Fully 81% of those who have interacted with the prisons system say they found the system to be performing poorly, 14pts higher than the wider public. Likewise, 72% of people who have used or interacted with courts/justice system in the last 12 months say the service is in bad shape, 15pts higher than the wider public. For those who have had to deal with the police, that gap is seven points higher, at 76%...
>
> Social care is also looking more rickety to those who have dealt with it in the last 12 months, at 88%, ten points higher than the wider public."

A separate survey by Savanta has found that most people are aware of the need for reform in the public services: 87% believe that the NHS is in need of reform, 82% believe that social care and policing are in need of reform and 78% for education. These are not results that reflect well on productivity in public services.

[2] https://yougov.co.uk/politics/articles/47473-public-services-are-in-bad-shape-across-the-board-say-britons

The consequences

The consequences of the debt-and-tax explosion and the continuing failure of the public services are many. They include issues such as:

- The potential difficulty in attracting further inward investment, due to deteriorating tax competitiveness, particularly dangerous for an open trading nation such as the UK.

- The ability of the country to absorb unknown future shocks (war, pandemic, technological or financial crisis or whatever), as a result of a greatly weakened public sector balance sheet.

- The risk of the low productivity public sector crowding out the private sector with the resultant damage to long-term growth prospects.

- The increase in state dependency (according to the ONS, 54% of UK households now receive more in benefits, including benefits-in-kind, than they pay in taxes).

In addition to these risks the final pages however cover an additional risk: the vulnerability of the economy to interest rates.

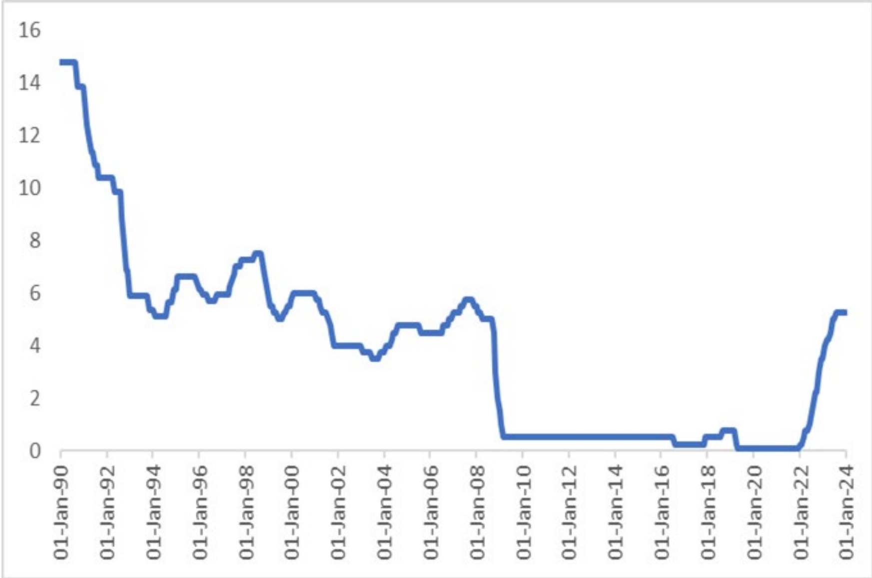
The importance of interest rates

It has been argued by some that the increase in public debt did not matter much because the cost of borrowing was so low. Clearly if the re-financing cost of an extra £100bn of debt is 0.1%, as was the case until recently, there was some immediate logic to that claim.

What this assumed however, was that both the yield curve and base rates would remain close to zero in near perpetuity. This was always a bold assumption as the experience of near zero interest rates over the last decade was unprecedented in the three hundred years of the UK central bank.

As is well documented interest rates started to rise in early 2022 and have moved up from 0.1% then to a current 5.25% as outlined by the chart below.

UK base rate Jan 1990 to date %

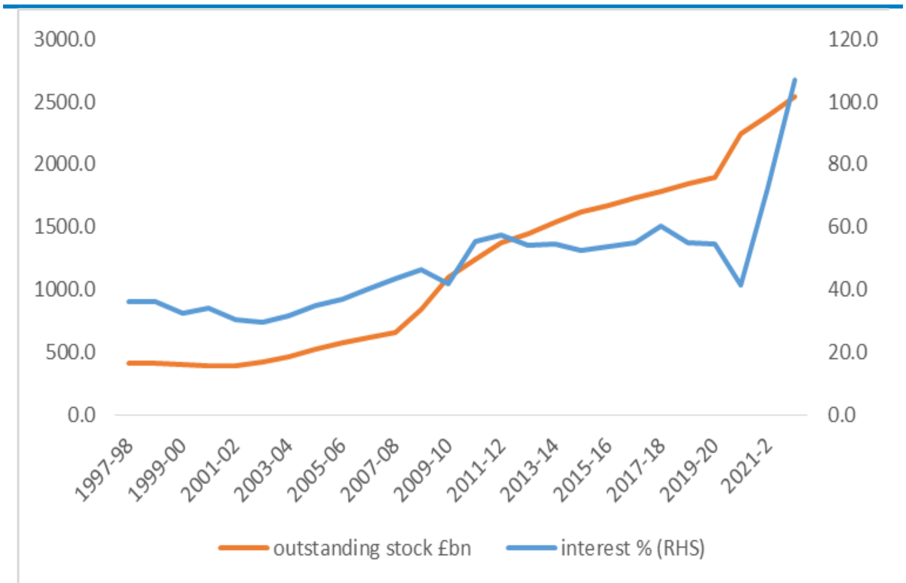


Source Bank of England

With public debt having increased seven-fold since 1997 or by almost four times in real terms, the vulnerability of the public purse to interest rate shocks has become much greater.

The chart below shows that, until 2021, debt interest payments stayed fairly stable in the £30bn to £50bn pa range. But as inflation and interest rates have both rapidly increased over the last couple of years so have debt interest payments risen from the £30bn to £50bn range to over £100bn last year.

UK Public Sector Net debt (LHS) and annual central Government debt interest cost (RHS) £bn



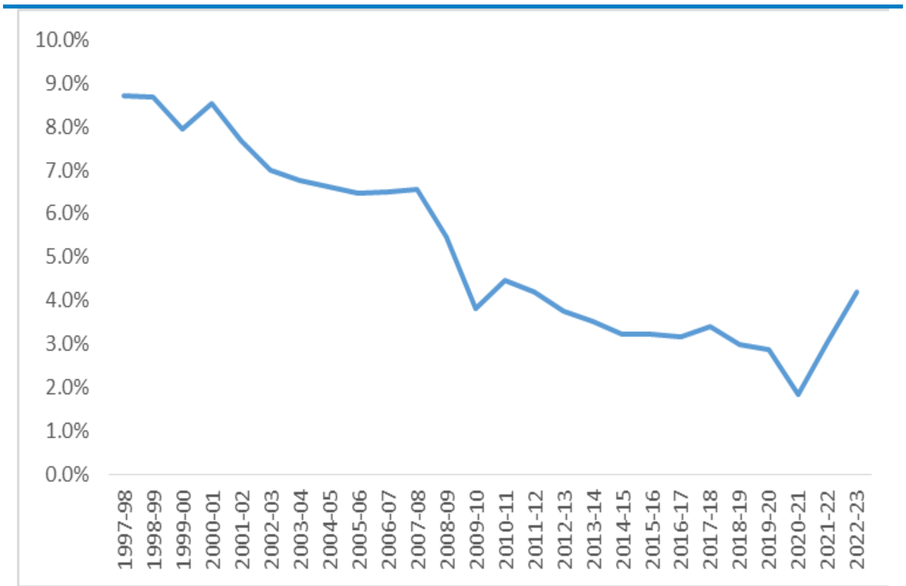
Source OBR, Public finance databank, March 2024 and ONS

While, due to the debt maturity profile of much public debt, there is some short-term protection and flexibility, ultimately the current higher cost of borrowing feeds through to permanently higher interest repayment costs assuming the cost of capital remains at current levels.

The monetary conditions that existed between 2009 and 2022 were the exception and the only time money has effectively been free in the 300 years history of the Bank of England. It would be highly imprudent to rely on such an event occurring again.

The OBR estimates that the outstanding stock of sovereign debt will exceed £3000bn by 2027-28. In time, each additional 1% increase in the cost of borrowing would ultimately add £30bn to HMG's costs. It is a slow ratchet as cheap debt is ultimately re-financed by higher costing new debt gradually over time.

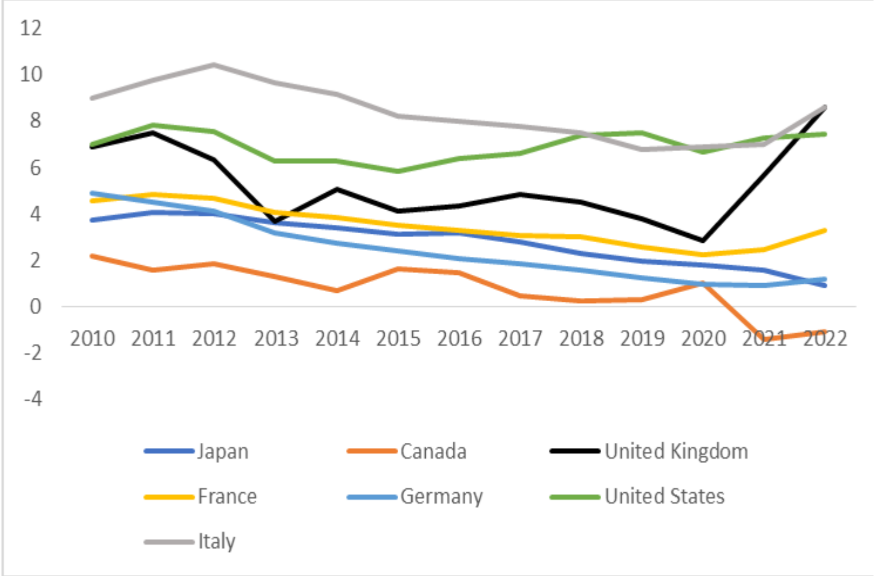
UK Public Sector Net Debt - implied average cost of debt funding %



Source OBR, Public finance databank, March 2024 and ONS

As indicated by the chart below, net interest payments for the UK Government as a proportion of tax receipts are now, along with Italy, the highest in the G7. Deficit reduction is the only way to reduce the sensitivity of the UK to further interest rate increases – and the only way to achieve that is through ensuring better value for money in the public services.

G7 economies net interest payments as a percentage of receipts



Source OBR

Moreover, the UK's substantial fiscal deficits and re-financing can only be met with continuing investor and global confidence in the UK. A loss of confidence would have devastating consequences for the yield curve, cost of debt serving and the overall wealth and security of the nation.

The substantial expansion of the UK state, resulting in increased debt, higher taxes and a reduced private sector does greatly matter. It reduces growth and opportunity while increasing debt and taxation, but ultimately it risks the very foundation of what it seeks to protect, public service, through a weak and stagnant economy poorly able to cope should external shocks occur.

The Effective Governance Forum

The role and complexity of government has changed substantially since the Northcote-Trevelyan Report was published in 1854 but the mechanics of managing government have remained virtually unchanged.

The objective of the Effective Governance Forum is to demonstrate how UK government should be structured, using modern management practice and radical decentralisation, to significantly improve public services at substantially reduced cost.