

Lord Bridges of Headley
House of Lords

09 April 2024

Richard Hughes
Chair

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obr.uk

Dear Lord Bridges,

The role of productivity growth in sustainable public finances

To assist with the inquiry into the national debt currently being undertaken by the Economic Affairs committee, you requested a short note on the extent to which higher productivity growth could help keep public sector expenditure close to current levels.

Please find attached a short explanation of why this is a very complex question analytically. We intend to return to the role of productivity in this summer's *Fiscal risks and sustainability report*.

Sincerely,



Richard Hughes
Chair
Office for Budget Responsibility

"In your evidence session you noted that the rates of productivity and GDP growth were important variables in your scenarios projecting government expenditure as a % GDP in 2072/73. Could you please confirm what rate of productivity and GDP growth is assumed in the projection published in your July 2023 report which showed government expenditure reaching 64% of GDP in 2072/73, and in addition provide us with your calculation of what higher productivity growth would be needed to enable government expenditure under the same assumptions to account for 40% of GDP in 2072/73? It would be helpful if you could also highlight any other changes in key assumptions, for example productivity growth in public sector services, which might lead to the 40% GDP outcome. If you have revised the 64% estimate since July 2023 could you please also provide these calculations on the revised basis."

There is no simple answer to the question of how much productivity growth is needed to stabilise the public finances. As explained below this is in part because spending policy has in many cases been set more in terms of the levels of inputs rather than outputs and so our modelling largely assumes this continues in future. It is also because changes to productivity growth in the whole economy will have consequences for the costs of providing public services which are not straightforward to analyse. We intend to return to this question in our upcoming *Fiscal risks and sustainability report* due in summer 2024.

The rate of productivity growth is the main determinant of growth in GDP-per-person and so of increases in the average standard of living. In the long-term projections detailed in our July 2023 *Fiscal risks and sustainability report (FRS)* we assume that potential labour productivity growth would settle at 1.5 per cent a year.¹ Combined with assumptions about changes in the size of the workforce, our projections are for real GDP growth to be slightly higher at 1.6 per cent a year on average.

Our long-term fiscal projections assume that public sector expenditure changes in line with long-term economic determinants on the basis of constant government policy. On this basis we estimated, in our July 2023 *FRS*, that total public sector spending would rise from 43.4 per cent of GDP in 2027-28 to 64.1 per cent in 2072-73. This 20.7 percentage point increase comes from increases to 'primary' spending (that is excluding debt interest payments) of 10.8 per cent and to debt interest of 9.9 per cent. As a matter of arithmetic, with receipts changing relatively little, a smaller increase in primary spending would therefore reduce the accumulation of debt and attenuate the rise in debt interest (all as shares

¹ *Long-term economic determinants – March 2023 Economic and fiscal outlook*, OBR, June 2023

of GDP). So one way of viewing this question is to ask whether there is some level of increased productivity growth such that the projected increase in primary spending could be lower and still deliver the same amount of public services as expected in our projections.

Spending is projected to increase in the long term primarily as a result of the ageing population and 'other cost pressures' in the health service which have caused health spending to rise faster than demography alone would dictate.² For most public services there are no defined long-term plans so our projections of constant policy require us to make some assumptions. In many cases we note that (for non-welfare expenditure) government policy is usually described in terms of inputs (that is the level of expenditure) rather than outputs (the volume of services delivered) and that the level of inputs is broadly stable as a share of GDP over quite long periods. So we primarily model constant policy as either being a constant share of GDP or, for those services influenced by the composition of the population, a share of GDP that varies as the population ages (e.g. state pension spending rises as a share of GDP). Under these assumptions, higher or lower productivity growth would not, by itself, generate smaller or larger public spending expressed as a share of GDP (although it would lead to changes in the actual level of public sector output).

In order for higher productivity to reduce spending as a share of the economy we would need to make different assumptions about government policy. One could define this as being the delivery of a certain level of services. Under these conditions, and assuming no changes to the costs of delivering these services, higher productivity could mean that delivering these outputs would require a lower share of GDP. But this approach runs into two main difficulties.

The first is that government policy for the provision of some public services is explicitly framed in terms of shares of GDP. The clearest case is for defence where spending is anchored on a NATO commitment for spending of 2 per cent of GDP. The second, and wider problem, is that the costs of delivering services are not independent of productivity increases in the wider economy. Most public services are labour intensive and so a large portion of spending is on wages and salaries. And we would expect higher whole-economy productivity to be (eventually) reflected in higher wages. Over the long term, in order to recruit and retain staff the public sector would need to broadly keep pace with whole-economy pay rises.

² *Working paper No. 9: Fiscal sustainability and public spending on health*, OBR, September 2016

This would increase the input costs of producing public services and therefore require the productivity of the public sector to also increase to generate an improvement in the quantity and quality of public services (this is ‘Baumol’s cost disease’ in the economics jargon).

In conclusion, the consequences of an increase in whole-economy productivity growth for the growth of public spending as a share of GDP is not straightforward. It could reduce growth in the size of the state, but without accompanying increases in public sector productivity, the quality and quantity of public services would be very different. We intend to cover these in more detail in our next *Fiscal risks and sustainability report* to be published in the summer.