Public Sector Productivity – managing the Baumol cost disease

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CHAPTER EIGHT

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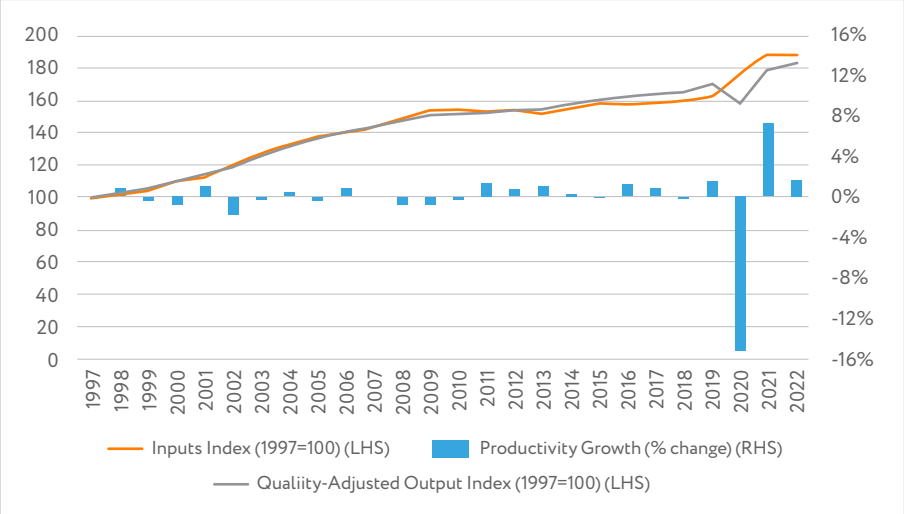
The public sector plays a critical role in the economy, providing essential services as well as creating an enabling environment for private sector growth. These functions have direct and indirect impacts on the economy and society, using taxpayers' money.

In the UK annual government expenditure has averaged at least 40% of GDP since 2008, two thirds of which is spent on public service provision. In the fiscal year 2019-20, the public sector accounted for 22.5% of GDP, or £7,600 per capita at that year's prices.[1] The UK public sector also employs around 17% of the UK workforce.[2]

Over the past decade, efforts to increase public sector productivity have focused primarily on cost-cutting measures. This approach has been effective in the short-term, but further efficiency gains through this route will be harder to achieve in the face of increased demand for public services and rising costs.

Instead, a focus on organisational productivity and effectiveness is required, with a clear understanding of the delivery chain for different types of public services. Public sector organisations need the administrative and legal capacity to adopt new technologies and innovate, adapt organisational structures, and develop an agile workforce and management.

Figure 1: UK public sector quality-adjusted output and inputs (1997=100) and total factor productivity (annual % change)



Source: Office for National Statistics (2023)

Government review

Public sector productivity has received renewed attention following Chancellor Jeremy Hunt's announcement in June 2023 of a cross-government review. In his accompanying speech, he described the review as the "most ambitious" ever undertaken and that a primary motivation was to "look at what it would take to deliver that additional 0.5% [public sector productivity growth] every year that would stop the state growing ever bigger as a proportion of our output".[3]

Adding 0.5 per cent per year to public sector productivity growth will not be an easy task to accomplish. Over the past 25 years, successive governments have already achieved a meaningful improvement in public sector performance. For instance, the New Labour administration from 1997 to 2010 markedly increased the quality of public sector outputs by funding major new programmes (grey line in Figure 1). The subsequent coalition and Conservative administrations also had notable success in reducing the cost of services without severely reducing the quality (orange line in Figure 1).

Overall, productivity in the public sector was broadly flat between 1997 and 2007, fell during the financial crisis in 2008 and 2009, and then increased by 0.7% a year from 2010-2019 (blue bars in Figure 1).[4] During the latter period the public sector enjoyed a better productivity performance than the private sector.

However, the approaches taken during past decades to raise public sector performance are unlikely to produce further gains. The public finances are under unprecedented strain, and many public sector organisations are already struggling to meet the demand placed on their services.

Apart from the dramatic impact of the COVID-19 pandemic - from which public sector productivity has not fully recovered[5] - there are significant long-term challenges to be faced. Demographic pressures from an aging population, increased need for spending on international security, commitments to regional development ('levelling up'), and adaptation to climate change are putting an increased burden on government to deliver services effectively while keeping spending under control.

Focus on efficiency

The current cross-government review emphasises a 'rigorous focus on efficiency'. However, focusing exclusively on efficiency and cost savings has not always worked in the past, since it carries risks such as poor service quality, low staff retention and underinvestment in innovation.

Indeed, this was the case following the Gershon Efficiency Review (2003/4) which was criticised for leading to a decline in some services, notably through the loss of skills and expertise.[6] One of the best-known examples is the loss of staff at the Office for National Statistics, most of whom were unwilling to follow the relocation from London to Newport in Wales.

In the healthcare sector, a recent report by the Health Foundation claims that productivity gains from budget cuts are not sustainable in the long run.[7] A report by the Chartered Institute of Public Finance and Accounting (CIPFA) and the Institute for Government (2019)[8] also argues that limiting staff pay increases and prompting workers to be more productive is "approaching – or has already reached – its limit".

Policy agenda

The need to improve public sector productivity does regularly appear on the policy agenda, but discussion is often limited in scope and does not consider value for money along the whole delivery chain. Instead, policymakers focus on an easily observable variable that gets public attention (e.g. more policemen on the beat, reduce the length of the waiting list, faster processing of visa applications) and attempt to cut costs or squeeze more out of the same budget. However, these interventions can only produce one-off increases in productivity, and so it cannot deal with the long-term economic and demographic trends that are placing strain on the public sector.

"Baumol's cost disease implies that the value for money approach will not achieve sustainable growth in public sector productivity unless taxes, or government borrowing, continue to rise."

Demand for public services will cause ever-increasing costs because of the brutal logic of 'Baumol's cost disease' which implies that the value for money approach will not achieve sustainable growth in public sector productivity unless taxes (or government borrowing) continue to rise.

New paradigm

It is therefore imperative to find a new paradigm for improving the performance of the public sector that can produce sustainable increases in productivity which are strategic and focus on overall organisational productivity and effectiveness.

Fortunately, the thinking about productivity and its outcomes in the public sector has evolved significantly in recent years.[9] There is a greater understanding of the key drivers of productivity, and there are more signals of purposeful improvements at a practical level in public sector organisations.[10 & 11]

But there is still a lot to do. For example, a major review of public sector performance by Barber (2019)[12] concluded that a long-term strategy for continuously improving efficiency and productivity through both disruptive and incremental innovation was still largely missing.

Outline

In this chapter we therefore first discuss why the rising demand for public services, in combination with Baumol's cost disease hypothesis, means raising public sector productivity faces significant headwinds. This requires a broader focus on the purpose and role of productivity.

We then describe how productivity needs to be managed across the delivery chain from budget to inputs, to outputs, and then to outcomes. Next, we discuss the three drivers of public service sector productivity, namely the development of an adaptive business organisation, the development of a process of continuous innovation largely driven by digital transformation, and the creation of an agile workforce. We conclude with a summary of the implications for pro-productivity policies in the public sector.

The pressures on the public sector: managing the Baumol cost disease

The importance of the public sector will increase further. Firstly, the demand for some public services, in particular for healthcare and climate change mitigation and adaptation, is rising. In education, the demand for primary or secondary schools may diminish as the population growth slows, but demand for adult training and education will increase.

Secondly, even without increased demand, the share of the public sector in the economy will rise because of Baumol's cost disease hypothesis. This states that the services sector, and in particular labour-intensive services such as those provided by the public sector, experience continually rising costs while productivity remains stagnant.[13] The main mechanism is that wages tend to follow those in the private sector, whose productivity growth is usually faster.

Measurement

The observed stagnation in public sector productivity is partly the result of how productivity is measured. Even today, official productivity statistics assume a zero-productivity growth rate for just over 40 per cent of public sector services, using the so-called "output-equals-inputs" convention. In his June 2023 announcement, the Chancellor also announced a review of ways to improve measurement.

Constant pressure

The combination of increased demand for services and rising cost pressures means that public services are under constant funding pressure. This can easily lead to a fatalistic view that cutting budgets is the only viable policy instrument. Policymakers either conclude that the only way to keep expenditure under control is by squeezing more out of remaining resources, or that the only way to meet demand is by spending more without much hope of a productivity gain.[14]

In other words, service performance can only be improved by increasing spending,[15] consolidation of operations,[16] reduced quality,[16] or axing 'non-essential' functions.[17]

Mitigating the impact

However, while the logic of Baumol's cost disease is inescapable, the impact can be mitigated if productivity has more potential to be increased than assumed.

Lagging productivity growth in public sector services is in part a direct consequence of negligence by politicians, government officials, and managers in the public sector regarding the functioning of public bodies.[14]

According to Blank, Baumol's cost disease consists of three separate illnesses. Firstly, the lack of well-functioning markets making public sector organisations dependent on good intentions or on perverse incentives as they try to spend their way out of the problem. Secondly, the assumption that there is an inherent trade-off between quality improvements and productivity. And thirdly, a belief that 'big is always better' leading to an upscaling of public sector organisations well beyond the point where their productivity peaks.

To manage Baumol's cost disease, and so not fall victim to spending more to stay still or spending less to cut costs (and quality), public sector productivity must move away from the narrow focus on cost efficiency. A broader consideration of organisational productivity and effectiveness is imperative.

The focus should be on defining desired outcomes, linking those to outputs, and investing in capabilities to turn inputs into outputs while managing budgets efficiently. This defines the public sector delivery chain.

"The combination of increased demand for services and rising cost pressures means that public services are under constant funding pressure."

The delivery chain in the public sector

Public service provision is complex and dynamic due to the interdependent units involved.[18 & 19] As a result, defining public sector productivity is not straightforward.

It can be assessed in multiple ways, considering factors like accountability, accessibility, responsiveness, reliability, competence, and safety. What constitutes productivity depends on which parts of the service delivery chain policymakers and managers focus on, i.e. whether they aim for better outcomes, quality and user satisfaction, improving the technical efficiency by which inputs are transformed into outputs, or achieving budget savings (see below).[16]

The delivery chain is a map of the budgets, inputs, and output activities that are controlled by an organisation, linked to the desired outcomes (Figure 2). The aim of mapping the delivery chain is to understand the relationship between these components, the effectiveness of transformations along the chain, and where improvements should be targeted to ensure the greatest increase in overall productivity.

Components

Public sector productivity can be split into three components:

Budgetary efficiency is the productivity by which budgets are transformed into the inputs that are needed for the organisation

Organisational productivity is the way by which input resources are transformed into the output activities that the organisation performs

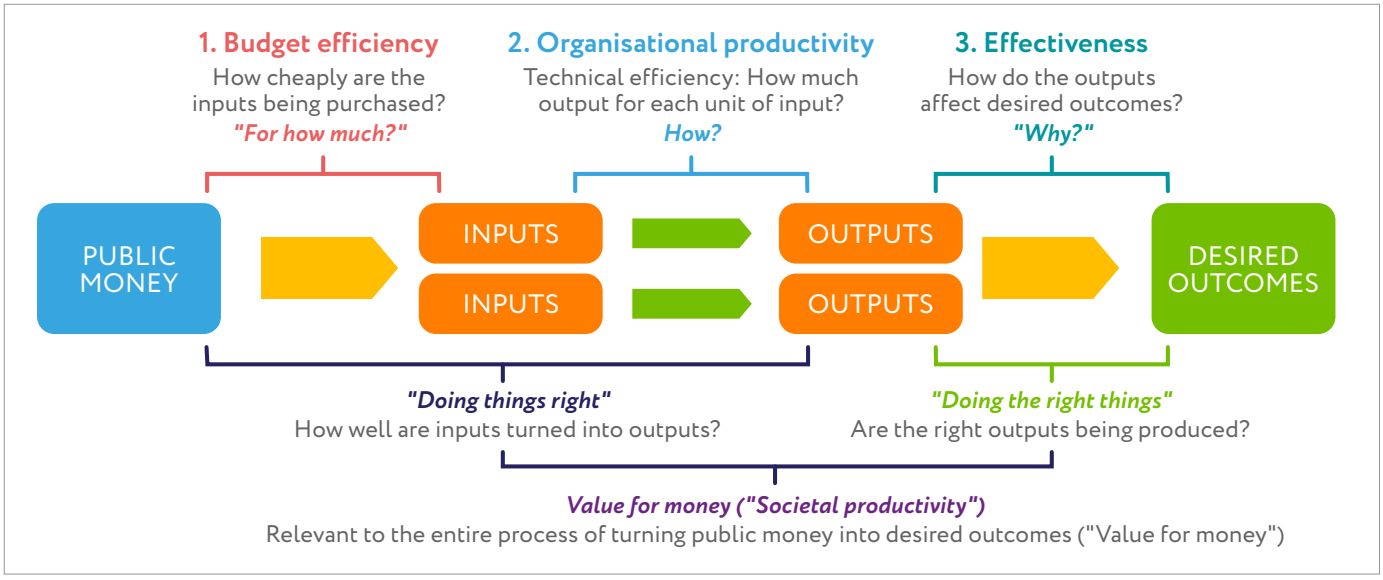
Effectiveness corresponds to the productivity with which output activities contribute to the ultimate beneficial outcome for the community and society.[16]

Drucker (1963)[20] expresses the difference between efficiency and effectiveness as 'doing things right' versus 'doing the right things'. For example, a surgical procedure in a hospital is an output, and the typical outcome is that the patient will enjoy a healthier and longer life. The Department of Work and Pensions (DWP) produces outputs in terms of the number of benefits paid or the amount of employment advice given, while the desired outcome is a reduction in long-term unemployment.

Mapping the delivery chain is more than an academic exercise. At their core, misunderstandings and misconceptions of public sector productivity are often due to a failure to adequately map it and identify the key bottlenecks where there is scope for improvement.

The mapping of these chains can be tailored to any organisation in the public sector. Many often have multiple delivery chains, or aim for one outcome that is achieved by producing a variety of outputs, which can all be mapped separately.

Figure 2: The public sector delivery chain. A simplified model of how public money is turned into inputs, outputs and outcomes



Source: Adapted from Aldridge, S., Hawkins, A., & Xuereb, C. (2016). Improving Public Sector Efficiency to Deliver a Smarter State. (https://quarterly.blog.gov.uk/2016/01/25/improving-public-sector-efficiencyto-deliver-a-smarter-state/)

The delivery chain can alter, particularly in response to social and technological developments, and the mapping needs to be flexible enough to accommodate such changes and make corresponding organisational changes as required.

Priorities

An understanding of the delivery chain, and how productive its component stages are, can help managers to understand priorities for improvement.[16] For example, if a policymaker or manager in a public sector organisation is trying to measure the impact of an intervention on productivity, there may be a time lag between the implementation of the policy and the outcome for social well-being.[21] In this case it may not be feasible to use the effectiveness definition if the time window is not sufficiently wide to capture long-term impacts.

Another issue is that effectiveness may be affected by factors outside the public sector's control, such as general economic conditions, making it a potentially misleading way of assessing a public sector organisation's performance.[11]

All three components of the service delivery chain are key to generating value for money. But for it to be a useful tool, it requires a breakdown and prioritisation of its components. The key test of a strong productivity narrative in a public sector organisation is whether it can explain how budget efficiency, organisational productivity, and effectiveness collectively contribute to its overall objectives and outcomes.

Drivers

There is an extensive literature on productivity drivers in the public sector and on the similarities and differences compared to the private sector.[8, 9, 10 & 11] We distinguish three main areas on which pro-productivity policies in the public sector can be focused: adaptive organisation design; continuous innovation; and an agile workforce.

Organisational learning

An important principle behind all three productivity drivers is the concept of organisational learning. These are the processes by which an organisation is constantly looking for, and able to exploit, opportunities to sustain and increase productivity. Creating an adaptive approach to business design requires time to be given to strategic thinking, a culture focused on continuous improvement, and attention to speed and flexibility in the decision-making process.

ADAPTIVE ORGANISATIONAL DESIGN

This lies at the core of any high productivity organisation. By being adaptive, an organisation is able to better respond to the rapid or unexpected changes that occur in its environment by changing (often deep-seated) internal behaviours. By using the service delivery chain concept, public sector organisations can strengthen their adaptivity.

One of the key issues related to adaptivity is the need for a better balance between hard budget constraints and spending flexibility. Government often provides budgets shortly before a new fiscal year which prevents flexibility in using budgets across years. This can damage prospects for sustained productivity improvements. Annual budgets should be determined as part of long-term spending, investment and delivery plans.

Effects of scaling

An adaptive organisation should also continuously look to balance productivity gains from centralisation, as has happened in healthcare, education and other government services, against diseconomies of scale. Working at a larger scale strengthens the specialisation of human and organisational capital and the use of larger and more efficient capital equipment.

However, scaling public services can also result in reduced access due to greater geographical distances for the user, increased marginal costs from management processes, and a failure to meet the specific needs of some groups. This, in turn, leads to a loss in quality or effectiveness.

Adaptive organisations, even when centralised, need to be able to respond to context specific needs, especially regional or local requirements. Many public services have strong complementarities (training and business support, or health services and social care), which can only be realised in local or regional contexts.

Finally, organisations need to be agile and responsive to crises, such as natural disasters, or sudden peaks in demand, such as for healthcare during a pandemic. The ability to manage spare capacity, or the resilience to relocate resources quickly, may matter more for productivity and effective outcomes than a budget-efficiency approach.

"Organisations need to be agile and responsive to crises, such as natural disasters, or sudden peaks in demand such as for healthcare during a pandemic."

TECHNOLOGY AND CONTINUOUS INNOVATION

Technology and innovation are often seen as a way to improve public sector productivity. Firstly, technological improvement can accelerate the ability to carry out existing tasks. For example, the West Midlands police introduced an AI-based system for identifying at-risk children, augmenting the existing risk assessment procedure to help officers make better decisions about where to target resources.[22]

Technology can also create opportunities for expanded activities. For example, drone technology has made aerial surveillance much cheaper for the police, and so can be employed in far more situations like search and rescue, crime investigation, and pursuit of assailants.[23]

As well as leading to one-off improvements in productivity growth, technologies can also support continuous innovation by streamlining decision-making processes and improving access to information.[16]

Digital transformation

In the UK, digital transformation initiatives have been used to streamline processes and expedite public service delivery. By establishing digital workflows, governments can automate certain components of the service delivery value chain, freeing up more time for public sector employees to focus on more complex and human-facing tasks.[24]

For example, the NHS Digital Initiative includes a federated data platform for patient management, care coordination, and supply chain management, as well as the adoption of telecare services. While evidence on the success of this initiative so far has been mixed, policymakers believe it holds the potential to transform the UK's healthcare delivery in the long-run.[25]

Benefits

Take-up of new technology may also generate indirect benefits via reorganisation of the delivery chain, generating further productivity gains via greater specialisation or by freeing up labour for other tasks.[26]

Such organisational restructuring may also be necessary to yield benefits from new technology in the first place. A study by Garicano and Heaton (2010)[27] of US police departments, for example, found that the adoption of information technology (IT) alone is not associated with enhanced crimefighting effectiveness, but is when complemented with specific new management practices.

Challenges

New technology can also create new challenges. Generative AI systems may be able to falsify evidence, produce targeted fraud material, and manipulate markets.[28] Or drone technology can be used to transport illicit goods, provide surveillance for criminals, or disrupt air traffic. Hence organisations need to continuously monitor the effects of new initiatives and be able to develop and adapt their delivery chain to respond to the problems.

"As well as leading to one-off improvements in productivity growth, technologies can also support continuous innovation by streamlining decision-making processes."

AN AGILE WORKFORCE

Any technological or organisational transformation requires a reset of skills and competencies of the workforce. This is a particular area for concern because investment in human capital is comparatively low in the public sector. The CIPD (2015)[29] found that the median per-employee training budget is 37% lower in the public sector than the private sector.

Some of the latest digital technologies pose challenges in requiring new skills and competencies. For example, using big data analytics and artificial intelligence does not only require STEM (science, technology, engineering and mathematics) skills. Continuous improvement and understanding of customer needs and experiences resulting from these new technologies also require softer skills, such as collaboration, creativity, adaptability, flexibility, and conflict management.

People can be partly trained in some of these core soft skills, but generally they are acquired through experience in organisations that are committed to innovation. As a result, the successful integration of new digital technology necessitates not only the proficiency of individuals but also a well-functioning information technology infrastructure and the elimination of structural and systemic obstacles to new ways of working in the organisation.

Potential

Both STEM and softer skills are key to creating an agile workforce – one with maximum flexibility and minimum constraints using the full potential of all its people. While an agile workforce tends to generate greater employee satisfaction and higher morale, it also needs to be preceded by strong consultative processes and ownership of new working arrangements by those most involved in delivery to ensure high employee engagement.

Given the highly competitive landscape for talent, and the need to attract people with valuable skills, professional talent management in the public sector is important. This involves a comprehensive reassessment of how human resources are managed, including redesigning job characteristics, recognising outside expertise, refining candidate selection processes, and improving onboarding protocols. Synchronizing these phases is critical to hiring of suitably qualified candidates. The context of current labour market dynamics underscores the important link between innovative hiring practices and the overall goal of increasing productivity in the public sector, particularly when – as now – public sector pay has fallen behind comparable private sector levels.

Management

Awareness of modern management techniques is also critical to improving organisational performance by ensuring more efficient coordination, strategic decision-making, and optimal resource utilisation. Cross-national research has shown that modern management techniques, such as the use of performance management practices (goal setting, incentives, monitoring), can be successfully applied in hospitals and schools.[30]

Performance management serves four main purposes. First, it helps define clear tasks, goals, and objectives and facilitates communication within the organisation. Second, it enables policymakers and public administrators to transparently communicate the use of public funds by measuring performance against these goals.[31] Third, it allows public sector organisations to learn and improve their performance over time. And finally, performance measurement can serve as a basis for evaluating and rewarding public servants and ensuring that their incentives are aligned with societal interests.[32]

Interpersonal skills

The development of managers' interpersonal skills can also increase productivity by substantially lowering staff turnover. These skills are particularly important in retaining staff with high levels of human capital.[33] Indeed, Hoffman and Tadelis (2021)[33] findings suggest that good managers primarily have a positive effect on productivity by virtue of their ability to help workers to enjoy their jobs.

However, the inherent complexity of the public sector, vague goals, uncertain cause-and-effect relationships, and diverse stakeholder perspectives, make the application of performance management challenging.

Policy makers frequently use language like 'improving' or 'declining' performance, ignoring the trade-off that attempts to enhance performance in one area may have adverse effects in another. For example cost-cutting measures can make budgetary efficiency look better, but will adversely affect long-term impacts and thus reduce the overall value for money in the long-run.

Policy implications

In order to unleash productivity, the public sector needs to invest in its drivers at all steps in the delivery chain. Here we set out a number of policy objective than can help achieve this.

Both public sector managers and government policy makers have important and distinct roles to play in delivering public sector productivity growth. Firstly, strategic management within public sector organisations is vital for optimising the existing delivery chain – identifying bottlenecks, identifying and implementing new opportunities, and utilising the drivers of productivity growth.

Secondly, central government can support productivity growth by ensuring that public sector organisations have the analytical, financial, and lawful capacity to do so. The delivery chain may need to be adapted, and in this case it is central government that has the licence to bring about a substantial transformation.

These imply the following principles for pro-productivity policies in the public sector:

Enable a long-term focus

Long-term planning and strategic thinking are important for public sector managers and policymakers to improve responses to even short-term challenges. This involves strategic planning to respond to anticipated changes in demand, and the delivery of long-term objectives, while also being able to deploy resources to solve immediate problems.

Forecasting and scenario planning are important aspects of this capability.[34] If a public sector organisation can adopt a long-term perspective in its decision-making, it will be able to improve budgetary efficiency over time.

For instance, advanced technology and training programmes might require high initial investments and take a long time to begin producing results, but these projects can be entirely justifiable when considering the substantial benefits that will be incurred in the long-run. Yet government budgeting practices make this kind of investment extremely difficult.

Space for experimentation is also important. This is vital, not just for testing the value of different policies, but also for building a deeper knowledge of the relationships within the delivery chain. However, this requires some level of tolerance from policymakers and politicians for the inherent risk of failure of innovative projects, resulting in some projects not delivering value for money, even if the overall programme does.

Centralised scale and localised operations

All public sector organisations face the challenge of striking a balance between centralised scale and localised operations. Economies of scale from centralisation might appear to reduce overall costs, but might also struggle to address specific needs and lack local context in various local communities, thereby achieving worse outcomes. Conversely, a highly localised approach could be costly due to duplicated efforts and lack of resource sharing and creates inconsistency of service.

Overall, devolution can improve productivity through four mechanisms: tailoring to local needs; innovative dynamism as each unit can conduct experiments; easier collaboration with the local private sector; and the development of local civic participation.

Management driven by measurement

A well-functioning measurement regime is essential for effective project management, process evaluation, and resource allocation. Public sector organisations are often rich in data due to their statutory requirements for performance and data transparency.

Big data analytics and AI techniques open new opportunities to filter relevant knowledge from massive databases and to share insights more widely. Organisations can leverage these opportunities by developing a data strategy - working out what role data will play in their organisation - and by establishing what organisation-wide processes need to be in place to enable this role. Such a strategic approach will also inform which investments need to be made to deliver the intended data processing capabilities.[16]

The challenge is that many inputs, outputs, and outcomes within the delivery chain have a qualitative component that is highly subjective in nature to users, and survey data can enrich quantitative measures. To be successful, the approach to quality adjustment should be evidence-based in that practitioners are willing to experiment in order to find better measures.

It must also be inclusive, in that for the measures to be regarded as legitimate they must reflect the perspectives of as many citizens as possible. The approach to quality enrichment also needs to be collaborative, in that for the intended users to regard the measures as useful they should be included in designing and implementing the adjustment procedure.

Better project management

Projects in the UK regularly suffer from serious cost overruns and time delays, from major national projects like HS2, to local IT programmes such as the upgrade to Birmingham City Council's ERP system. It is important to understand the underlying dynamics that cause a high risk of failure for project

management.[35] Among these are the need for procurement officials and project managers to have the technical skills that allow them to act as an intelligent customer and to implement project governance approaches that allow them to manage the inherent risks in the project. There is also a need for procedures that ensure the deliverables integrate well with the existing organisational processes and other upgrade projects. In addition, changes in scope or leadership of a project will have a substantial deleterious effect on its likelihood of success.

Strengthening public trust

Improving productivity in the public sector should also help to increase citizens' trust in government. If citizens see that taxes are being used efficiently and that public services are being delivered effectively, they are more likely to trust and support government. Indeed, numerous studies have shown a positive correlation between quality delivery of public service and citizens' trust in government.[36, 37 & 38]

This relationship between citizens' trust and public sector performance is bidirectional. While many studies have argued that citizens' level of trust in government is a product of the quality of public service delivery, Van de Walle and Bouckaert (2003) argue that poor level of trust in government itself could produce negative perceptions of public sector performance.

In this sense, subjective trust or distrust in government's capacity to implement public services could influence citizens' willingness to pay for a particular service, or to make other contributions that could contribute to the success of such service delivery.[39] Increased trust between citizens and public sector officials is an important step in boosting public sector productivity, especially at the local level.

Conclusions

Over the past decade, efforts to increase public sector productivity have focused primarily on cost-cutting measures. This approach has been effective in the short-term, but further efficiency gains through this route will be harder to achieve as public sector wages have declined relative to the private sector. The combination of an increased demand for public services and the logic of Baumol's cost disease point to an unprecedented burden on public services in future.

It is encouraging that the Chancellor's review has the ambition to make productivity part of the solution. The traditional alternatives of either spending one's way out of short-term problems or squeezing budgets will not achieve a sustained increase in public sector productivity.

Instead, we advocate broadening the scope of thinking about public sector productivity to include organisational productivity and effectiveness. A clear understanding of the delivery chain for different types of public services is required.

Public sector organisations need to create the administrative and legal capacity to nurture the drivers of productivity (organisational design, technology and innovation, and an agile workforce and management), and engage in evidence-based, collaborative, and inclusive policymaking. Whenever possible, the social value added by public services should also be recognised and adequately measured. Productive and effective public services are vital for private sector productivity as well as for a healthy polity and cohesive society.

Key takeaways

Further public sector efficiency gains will be hard to achieve through cost-cutting measures.

Broaden the scope of public sector productivity to include organisational productivity and effectiveness.

The three main areas on which pro-productivity policies in the public sector should focus are an adaptive organisation design, continuous innovation, and an agile workforce.

Increased trust between citizens and public sector officials is an important step in boosting public sector productivity, especially at the local level.

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