

The Great Rebalancing

A sovereign wealth fund to make the UK's economy the strongest in the G20

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EXECUTIVE SUMMARY

Leaving the European Union creates an opportunity to ask fundamental questions about our future for the first time in 40 years. In particular, we are historically worse at long-term planning than many other developed nations: we save less, invest less, and build less economically-vital growth-promoting infrastructure (roads, rail, ports etc) than they do. Other oil-rich countries like Norway have built up large sovereign wealth funds, but we have not. Can we resolve these weaknesses, using the spur of our newly-won freedoms to change the way we work once separation from the EU is complete?

These weaknesses are long-term and structurally-ingrained into our economy and our politics, so they will take many years to solve. Governments that always invest heavily in economic infrastructure, balance the budget over the economic cycle, and promote stronger savings and investment across the wider economy, no matter which political party is in power, are not what Britain is used to. We will need new fiscal rules, backed by strong new institutions, to change the way British politicians, governments, savers and businesspeople behave over the very long term, so financial virtue becomes a reliable, permanent and boringly predictable part of our national finances.

The results should be profound, rebalancing our economy from being heavily dependent on consumer spending to one that reliably generates more investment in growth, underpinning stronger and better public services, insulating us against the next unexpected economic shock whenever it comes along, and enhancing our international heft around the world as well.

The underlying principle which underpins the changes that will be needed to fix our long-term weaknesses is generational justice:

the idea that it is unfair to saddle our children and grandchildren with the costs of our current spending. But that is exactly what we are doing if we pay for those costs with long term debt, so there must be fundamental changes to the shape of government finances:

- We need to build and invest more in crucial economic infrastructure, and keep doing it consistently and predictably no matter what the short-term economic weather may be, so we match (or beat) other developed economies. We can and should start doing this immediately, because it is the only kind of government spending which can justifiably be paid for with long term debt. It will inevitably mean a slightly longer wait to eliminate the government deficit and achieve a balanced budget, but should earn a good financial return through higher economic growth nonetheless.
- Once the government's budget is back in balance, there should be no other long-term borrowings beyond those for building economic infrastructure. Short-term debt should only be used for temporarily smoothing out the effects of periodic recessions (i.e. we would only borrow in a recession, and repay it all in the next expansion, so there's none left when the next recession strikes).
- We have inherited very high levels of accumulated national debt, partly as a hangover from the 2008 financial crisis, and partly because the promises we've made in our pay-as-you-go pensions and benefits system fail our generational-justice test (they aren't investment in economic infrastructure, and they create long-term liabilities which are the same as debt). We will have to reduce them through a very long term project (lasting

several generations at least) to repay Gilts and create a UK sovereign wealth fund to replace the taxpayer liability underpinning state pensions and benefits.

These changes – particularly the new sovereign wealth fund – would have profound social effects, as well as economic ones. They would affirm British social justice by ensuring we are not saddling our children and grandchildren with the bills for our lifestyle today, through future debt repayments. And the sovereign wealth fund would give low and high-paid taxpayers alike a personal stake in the system which underpins their individual state pension and benefits payments, creating a broad-based, socially-just, asset-owning democracy on a scale even bigger than the one created by Margaret Thatcher's sales of council housing 30 years ago.

These things won't happen without very significant changes to the way successive generations of governments, politicians, savers and businesspeople think and behave. We will need new institutions to lock in the new approach for the very long term, so future governments can't abandon the project whenever short-term political pressures are high:

- A government target as a % of GDP for government long-term infrastructure investment, similar to the ones already in place for Overseas Development (0.7% GDP) and NATO (2% GDP).
- An annual public declaration by the independent Office of Budgetary Responsibility (OBR) of whether the government is being financially virtuous, to confirm whether the new infrastructure investment target is being followed, and whether the budget is being balanced

across the economic cycle so day-to-day public spending is not being financed by long term borrowing.

- A new National Debt Charge ('NDC') carved out of Income Tax to pay the interest on the national debt in the same way as National Insurance Contributions (NICs) pay for the pensions and benefits system at present. It would be set as a % GDP and, as the economy grew, any surplus would be used to begin repaying the National Debt, and to build up a new UK Sovereign Wealth Fund.
- The Sovereign Wealth Fund will build up over the very long term (several generations at least) to fund the liabilities in our pensions and benefits system. It will have a target date by when the build-up must be complete, and the Bank of England will publish an annual letter confirming whether the NDC is set at the right level to achieve the target. The Fund will be managed through a fully-independent, standalone National Insurance Trust with a heavyweight Board of Trustees equivalent to the Bank of England, to prevent political meddling. It will be subject to the same rules for prudent investments and transparent reporting as every private-sector pension or insurance firm so taxpayers get value for money.

These are very big, long-term solutions for equally big, long-term and ingrained problems. They will need a sustained political, social and financial commitment, over several generations, if they're to be completed successfully. It is the kind of commitment which parents often make for their own children or grandchildren, to ensure they have a better life than they did. These proposals will do the same for the entire country. We should think big.

CHAPTER 1: INTRODUCTION

After voting to leave the European Union everyone is, rightly and understandably, focused on the terms and type of Brexit deal which will be agreed between the UK and the EU. But leaving also creates a bigger, broader opportunity; a moment when we can and should think more deeply about other, fundamental issues for the UK's future, which we haven't needed (or bothered) to confront during the 40 years we've spent under the EU's umbrella.

If we want to make the most of the extra freedoms and independence which leaving the EU should bring, we need to address these underlying questions. In particular, we are historically worse at really long-term planning for our future than many other developed nations: we save less, invest less, and build less economically-vital growth-promoting infrastructure (roads, rail, ports etc) than they do. Other countries which had the same oil-revenue windfall as we enjoyed from the 1970s to the noughties (like Norway, or some Gulf states) have built up large sovereign wealth funds, but we have not.

This paper will address those long-term planning weaknesses, and propose new institutions to fix them so we are financially stronger than ever before, and able to make the most of our extra freedoms and independence once separation from the European Union is complete.

CHAPTER 2: DOES GOVERNMENT'S FINANCIAL MUSCLE REALLY MATTER?

The short answer to this question is 'yes – a lot'. The rest of this section explains why.

Weak Public Finances Cripple Good Governments...

Any Government which is financially crippled by, for example, too much debt interest, or unaffordable and unproductive but politically sacred spending programmes, will find it much harder to deliver public goods or services like health, education, defence or roads. In contrast, Governments with strong finances (in other words, lower borrowings) have to spend less on debt interest payments, which means they have more cash available to spend on public goods and services.

...And Hamstring Economic Growth

Excessive Government borrowing can undermine a country's economy in a variety of ways:

- It can soak up an over-large share of the money which lenders are willing to provide to their country's economy, crowding out private sector investment so wealth-creating projects can't happen, and driving up interest rates so the remainder cost more than they should as well.
- It requires Governments to spend less on public goods and services, or to raise extra taxes to pay for them which will stifle growth and dampen wealth creation.

- In extreme cases, like Greece, it can weaken currencies, stop creditworthy companies from investing in profitable projects, undermine a country's financial and banking system and create a full-scale economic disaster.

Strong Public Finances Enhance International Heft...

The effects of strong public finances don't only flow one way, from Governments into a country's economy. They work the other way too, in a virtuous circle because a strong economy underpins and finances any Government's political power at home and abroad. Internationally, the UK's economy means we can afford large and effective armed forces so, as a last resort, we can back our words with military deeds and 'hard power' if we have to. And it gives us a strong and influential 'soft power' voice in most international gatherings we care to join, whether they are international aid conferences, climate change negotiations, or global financial institutions like the IMF, World Bank and, most recently, the Asian Infrastructure Investment Bank too.

...Insulate Against Crises & Shocks...

Strong public finances don't only help Governments provide day-to-day public goods and services, as described above. They also provide important shock-absorbers when, inevitably, crises or external shocks occur. The 2008 financial crisis is a recent example, as were World War 1 and World War 2. Since these events are often hard to predict in advance, and often require large, expensive or long-term structural changes or reconstruction of our economy, infrastructure or society before they can be dealt with or absorbed properly, strong public finances provide maximum freedom of movement and financial resilience when we need it most.

...And Mean Strategic Opportunities Can Be Grasped

Strong public finances don't just insulate Government from the negative effects of crises and shocks. They also provide financial muscle to grasp strategic opportunities which would be more difficult for Governments with smaller, weaker finances. West Germany would have found it far harder to reunite with the East if it's Government couldn't have afforded the extra post-integration spending which was needed to upgrade and modernise large parts of the country, for example.

CHAPTER 3: A NEW FRAMEWORK FOR GOVERNMENT BORROWING

The previous section explained why it's important to limit the amount any Government can borrow. But that begs the question of what the limit should be, so this section provides an answer.

'Could' Is Not The Same As 'Should'

Finding the right or best level of borrowing is a different question from gauging how much debt a country can get away with, before they end up like Greece.

Economists, bankers and politicians have paid plenty of recent attention to the second question, of how much a country 'could' borrow before getting into trouble, because the consequences of the 2008 financial crisis were so immediate and serious. Even so, their answers are fairly imprecise because so much depends on hard-to-measure and ever-changing factors such as whether international investors trust a Government's commitment to financial prudence, whether international markets and banks are open for business when a particular country needs to borrow, and whether a country's citizens save enough for their Government not to need to borrow internationally at all.

But the question of how much a country 'should' borrow is different. When there is no immediate crisis or 'Minsky Moment' (which, for well-governed countries, is most of the time) should they still borrow up to the maximum they can get away with? Most people would argue they shouldn't, and that a country should borrow less than its theoretical maximum, so it has headroom in reserve to borrow more if there's a crisis. But since the theoretical maximum is so hard to gauge accurately, and is likely to move without warning if international market sentiment or

liquidity changes, is that a terribly useful conclusion? And is there another, different level which might be better still?

Generational Justice: Investment or Spending?

Much of Britain's economic success is built on investments made by previous generations. The Victorians inherited canals and bequeathed railways; the post-war generation added motorways; we are extending all of these, and adding digital infrastructure (like fibre broadband networks) too. If we don't maintain them, our economy will get smaller as things like ports stop working so well, and trade slows down as a result. And if we don't expand them, our economy won't grow as strongly or as fast in future. But how should these essential pieces of economic muscle and bone be paid for, if they are being provided by Governments rather than private or not-for-profit organisations, and should the money that's needed be borrowed or not?

The first, vital distinction is between long-term Government investments which will maintain or create economic growth (like transport networks) and day-to-day public spending on consumption of current essentials like policing, or benefits for people who are too sick to work. In principle, it would be generationally unjust – morally wrong – to saddle our children and grandchildren with the costs of our day-to-day spending by paying for it with borrowed money. They will have their own police and sickness benefits to pay for, and we shouldn't expect them to pay for ours as well.

There are two important limits to this fundamental principle. The first is that most people would accept that short-term borrowing (within the same economic cycle) is both sensible and desirable to minimise the impact of economic recessions. But if the extra borrowing is being used to finance day-to-day spending then,

morally, it ought to be repaid in full over the course of the economic cycle (probably within about five years of the economy starting to grow again) so when the next recession comes we aren't left with an ever-higher accumulating pile of debt to pass on to future generations.

The second limit on generational justice would be when a serious external shock, like the 2008 financial crash or World Wars 1 and 2, means that the financial shock-absorbers created by strong Government finances have to be used immediately. Clearly it wouldn't be generationally fair or just to expect the same people who had just fought a war, or weathered the financial storm of a global financial crisis, to rebuild the financial cushion (by paying off war debts, for example) within the next few years of a single economic cycle. The survivors' children and grandchildren will benefit from the cushioning effects of using the shock-absorbers when they were most needed, just as the generation who lived through the crisis did as well. They can fairly be asked to contribute towards rebuilding them over time.

Generational Justice: Things Or People?

For this fundamental distinction between investment and day-to-day consumption to be useful, it's vital to be clear about the difference between the two. Most people would agree that building new pieces of physical economic infrastructure (like transport networks) counts as investment. But what about Government spending on things like health or education to create a healthier and more skilled workforce which improves economic growth for many years ahead? Should it count as an investment in 'human capital' rather than day-to-day consumption as well?

There's a broader academic argument about this issue but, for the narrower question of whether it would be generationally fair

and just to finance health or education spending through long term borrowing, the answer is much simpler and more straightforward. Most of the benefits of Government spending on health and education go to the person receiving the education or medical treatment, rather than to future generations. So Government spending on health and education should count as essential and important consumption rather than investment, for the purposes of this paper at least.

This conclusion doesn't deny that Government spending on health and education has some broader benefits; a medical patient's family and their boss will doubtless be pleased they will live a longer and healthier life, and a graduate's family and their employer will usually be better-off because of their improved skills. But these broader benefits are a far smaller proportion of the overall total than an equivalent investment in roads or railways, where all the benefits go to the people and businesses using the network, rather than to individual beneficiaries.

Some people would argue there's another, even broader benefit from health and education spending because societies with healthy and skilled workforces are generally more rational, stable, productive and wealthier than those which are not. But however strong or weak this effect might be, it wouldn't justify paying for health or education spending using long term borrowing. Firstly, the same argument would be equally valid for other types of Government spending like policing, the courts or defence which help maintain an orderly and rational society. And while these are certainly essential and important areas of spending, few people would argue they are investments in 'human capital'. Secondly, their benefits aren't enjoyed by future generations in the same way as bridges or roads; Government spending on policing or defence will only keep society safe today, but crime will rise or enemies could attack if it stops tomorrow.

Generational Justice: Maintenance Or New Build?

The basic distinction between investment and day-to-day consumption provides an answer to part of our question of how much Governments should borrow, because it means long-term debts should in general only be used to pay for equally long-term public investments in economic infrastructure rather than day-to-day spending. And there's a further principle which narrows the circumstances when borrowing is right still further; the difference between investing to maintain the infrastructure we inherited from previous generations (to stop Victorian railways or post-war motorways from crumbling away or grinding to a halt) and building new.

Maintaining what we've inherited from our ancestors is the investment equivalent of day-to-day spending. Everything wears out and needs periodic replacement or repair, and it would be just as generationally unjust to saddle our children and grandchildren with these costs by paying for them with borrowed money as it would be to expect them to pay for our policing or sickness benefit costs. They will have their own repair bills to maintain whatever infrastructure they inherit and, accordingly, we shouldn't expect them to pay for ours too.

So the only remaining area of spending which might legitimately be funded by borrowing is new long-term Government investments which will drive future economic growth. Because the benefits will be felt by future generations as well as ourselves, it is the only area of Government spending which satisfies the test of intergenerational justice. But even though we could morally fund these investments through borrowing, should we?

Borrowing or Budget Surplus? A Question Of Timing

Whether investment projects are funded by borrowing or from a budget surplus, they will – rightly – be approved by ranking the projected economic growth which the business cases say they will create, and the ones with the best results (ideally including hard-to-measure but real benefits like environmental improvements) should be approved first. There are plenty of potential flaws with the way this approach works in practice, which are addressed in the ‘Political Risk’ section below, but it is right in principle because taxpayers get the best return for money which Governments are taking from them to spend on their behalf.

In theory, the only difference between funding investment projects through borrowing or a budget surplus should be in the minimum rate of return which has to be achieved for a scheme to be approved. If they are being funded by borrowing then they must earn an extra return to repay interest and capital on the debt, before they make a net contribution to economic growth. But if they are being funded through a surplus then the hurdle is lower before net economic growth is created.¹

There is a further, important potential benefit from funding long term investments through borrowing (providing they produce a big enough return to clear the minimum hurdle); that we can afford to make more growth-producing investments now rather than later. At a time when the Government isn’t running a budget surplus, and isn’t expecting to for several more years, borrowing is the only way to finance growth-producing projects at all. If we wait until the Government’s budget is in surplus, we won’t invest anything for years and economic growth will stall. This argument is even stronger when interest rates are low, as they are at

present, because the extra return which a project must earn to finance the interest and principle on its debt is very small.

But this argument has limits. Once the Government's budget moves from deficit into balance or surplus, the choice isn't nearly so starkly between making any long term investments or none. At that stage some projects will happen anyway, using budget surplus financing, so the question becomes whether to begin any extra schemes using debt financing this year as well, or wait until next year when we can use a fresh budget surplus to pay for them without debt instead. The decision stops being about whether a scheme happens at all or not, and becomes a question of timing; is the entire cost of the debt worth the extra year or two's economic benefit of starting (and finishing) earlier? This makes the economic case for borrowing a great deal weaker, and refinancing (rolling over the original borrowing which was incurred to build a piece of infrastructure, rather than repaying it when it is due) almost impossible to justify, because the extended borrowing and extra years of interest could not possibly increase economic growth as the project would have been completed many years before.

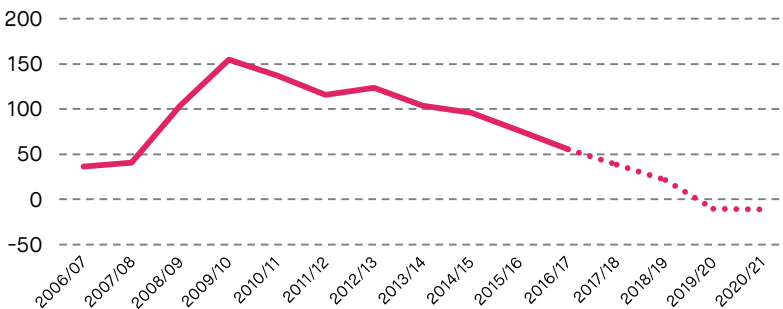
CHAPTER 4: A NEW SHAPE TO GOVERNMENT FINANCES

The implication of this new framework for Government borrowing is that, once the Government's budget has reached balance and the deficit has been eliminated, the case for any borrowing at all becomes much weaker. This is dramatically different from what the UK has done before, so this section lays out how the Government's budget will have to change.

Much Lower Government Borrowings

The implication of this new framework for Government borrowing is that there should be much less of it in future than before. To be fair to future generations, the maximum we should borrow in the short term would be the cost of making new long-term economic infrastructure investments each year. And once the budget is in balance and then surplus we should aim to reduce the figure still further to achieve more resilient Government finances, and because the business case for incurring lots of extra debt just to bring forward a project by a year or two is much weaker.

Figure 1: UK public sector net borrowing, 2006/07-2020/21 (£ Billion)²



Balance The Budget Across The Economic Cycle

The new framework means that, apart from new long-term economic infrastructure investments, there should be no other long term borrowing at all. The only other Government borrowing should be during recessions, when we should allow short-term financing of the ‘fiscal stabilisers’ – the deficit spending inherent in the benefits system during economic slowdowns, when tax revenues fall and out-of-work benefits rise – to minimise the impact of the downturn. To make sure this is strictly temporary, the borrowings should be repaid in full within the same economic cycle, within at most four or five years of the end of the recession which caused them, so they are cleared before the next one begins. Otherwise, if they last into the next economic cycle, we will have allowed day-to-day spending to be financed through long term borrowing, which would be generationally unjust.

Consistently Higher Long-Term Investment

The new framework treats long term investments in economic infrastructure differently from all other spending. This is important because it is always tempting for Governments to delay long-term capital investment projects during moments of political pressure (such as before General Elections or during recessions) rather than fixing the roof when the sun is shining by making potentially painful but necessary structural changes to current spending when times are good instead. For decades, the UK has invested less as a percentage of GDP in these types of project than most other economically developed nations. The result is chronic under-investment relative to other developed nations, and creaking infrastructure which chokes and slows economic growth.

Table 1: Public sector investment by country, 2014-15 (% GDP)³

Public sector investment (% GDP)	2014	2015
Slovenia	5.2	
Sweden	4.5	4.3
France	3.7	3.5
Japan	3.5	
Netherlands	3.5	3.5
USA	3.2	
EU Average	2.9	2.9
UK	2.7	2.6
Italy	2.3	2.3

Increasing this level, and maintaining it throughout the economic cycle, whatever the political pressures to prioritise current spending during recessions or before elections, represents a major opportunity for our economy to grow faster in future. We should set a target level of spending on these projects, as we already do for foreign aid (0.7% of GDP) and defence (2% of GDP, as demanded by NATO) and commit to maintaining it in future in the same way.

Be Honest About The National Debt

We typically exclude the huge liabilities embedded in the state pension and benefits system from our measurements of national debt even though, as liabilities which must eventually be paid by future generations of taxpayers, they are effectively long-term debts. The decision to exclude them stems from the original decision to make the system ‘pay-as-you-go’ (where current and future pensioners and benefits claims are backed by a Government guarantee that they will be paid by taxpayers) rather than ‘fully-funded’ (where future liabilities are backed by a big investment fund instead). But just because the liabilities are backed by a taxpayer guarantee rather than an investment fund

doesn't mean they are value-less. The liabilities are no less real, and the costs for taxpayers are the same, regardless of how the country decides to pay for them. If they were owed by a private pension or insurance company, we would expect them to be actuarially calculated and included in the firm's balance sheet, and we shouldn't operate a convenient double-standard for equivalent liabilities here just because they are owed by the Government instead.

So, to be honest and transparent, we should recognise the – very high – value of the Government's guarantee that current and future generations of taxpayers will fund the costs of the pensions and benefits which are legally due under the scheme, and count it as part of the nation's long term debt. Estimates of this truer value vary from £4.8 trillion (333% GDP)⁴ to £6 trillion⁵ but, wherever the precise answer lies in this range, this isn't merely an accounting change. It recognises important realities as well:

- It reveals that Britain's public finances are a great deal more brittle, and less resilient whenever future crises occur, than we like to pretend. Our financial freedom of movement is constrained by these future liabilities and promises we have made, which means there would be much less free cash available to solve whatever problem causes the next economic shock, whenever it inevitably crops up.
- Pensions and benefits are a vital, central part of Government day-to-day spending in modern Britain. And because they are day-to-day spending, they fail our test of generational justice: we shouldn't be paying for them with long term debt. But the Government's taxpayer guarantee which underpins the scheme is, effectively

long-term debt so that is precisely what we have been doing for years.

A Funded National Insurance Scheme

Once we have been honest about our national debt, and admitted that a pay-as-you go system is generationally unjust, we can begin to wean ourselves off the habit of paying for day-to-day spending on our pensions and benefits system with long term debt. This is different from the other changes which have already been proposed to rebalance Government spending in earlier parts of this section, because it affects the accumulated historical stock of national debt, rather than just the yearly spending.

The inconvenient conclusion is that the only way to achieve this goal is to create an investment fund to underpin the pensions and benefits system, rather than using a Government guarantee. If the estimates of the value of the Government guarantee on the national debt are any guide, it would be worth between £3.5 trillion and £4.5 trillion. It would become, in effect, a ring-fenced sovereign wealth fund for the UK and would make Britain one of the richest and most financially resilient countries in the world.

The broader effects of this change on the UK's economy would be profound, and positive. It would significantly increase⁶ the UK's rate of saving, where we currently rank bottom amongst major economies as Table 2 shows below.

Table 2: Public sector investment by country, 2014-15 (% GDP)⁷

Gross Domestic Savings (%GDP)	2014	2015
China	48.7	
India	33.1	
Germany	26.8	27.4
Russia	24.0	25.9
Japan	22.3	24.8
Canada	22.0	20.4
France	20.4	
Italy	18.1	18.9
USA	17.6	17.6
UK	12.4	12.4

The extra saving should rebalance our economy from being heavily dependent on consumer spending and foreign direct investment to one that generates more investment in growth, and create the sustained, stable, positive economic relationship between Government and the wider economy described in ‘Does Government Financial Muscle Really Matter?’ above.

Switching to a funded national insurance scheme would future-proof our pensions and benefits system too, making it more sustainable in the face of some important long-term risks:

- A funded scheme can invest in companies and industries anywhere in the world, spreading the investment risks more widely than using a Government guarantee, which is backed by the ability to levy taxes on – and therefore the financial performance of – the UK economy only.
- Investing internationally helps insulate the fund against demographic risks too. In common with many other developed countries we have an ageing society, where ever-fewer workers have to support more and more

retired folk. If the reducing number of workers can't become more productive quickly enough, then the UK's economy will start to shrink, putting any Government-guaranteed scheme under pressure because tax revenues will fall too. An internationally-invested fund avoids much of this problem because it can invest in sectors and companies which are still growing vigorously, even if the UK overall is not.

Timing: Slowly Does It

Given the huge size of this undertaking, it will inevitably take many years to achieve. There are several factors that should dictate when we should start, and how fast we should go:

- It would make little sense to begin the process of building up the fund before the Government budget has been balanced as described in 'Much Lower Government Borrowings' (above), and until we are delivering the levels of economic infrastructure investment described in 'Consistently Higher Long Term Investment' (above) through budget surpluses rather than borrowing each year either.
- Equally, there will be little point in building up an investment fund with our national debt at its current, historically high levels. So we should either repay our entire national debt in full before starting to build up the fund or, alternatively, partly repay it while also beginning the fund.

Complete repayment would mean the fund would start later, but build faster because none of the contributions would be needed to pay debt interest. Partial repayment

would only make sense in a low interest-rate environment, where the returns on the fund would be higher than the interest on the remaining debt. The fund would build more slowly at first because part of the contributions would be needed to pay debt interest, but the extra investment asset returns of an earlier start would accumulate at a compounding rate over time. Economists and central bankers would also argue in favour of retaining a small amount of national debt because it makes monetary policy and investment pricing easier. Norway has chosen this route of having both a sovereign wealth fund and a small national debt at the same time.

- Once we start paying off the debt and building up the fund, the size of the yearly contributions should not be too large so it doesn't grow too fast. Otherwise current taxpayers would not only be paying for today's pensions and benefits under the existing system, but also for tomorrow's payments under the new one too. This would breach the principle of generational justice, so we will need to take our time. Morally, the process should take no less than two generations (about 60 years) but, to spread the costs more evenly, it could justifiably be spread over even longer periods, for example three generations or two working lifetimes (about 90 years). There's an instructive parallel with Chile, which is part-way through a similar process and expects to take about 70 years.
- Because this process will cut total levels of UK debt, we need to be careful it doesn't push us into recession while it is underway. Building up the fund slowly will help, but we should also make sure the process doesn't begin too

abruptly to ensure the economy continues to grow steadily and the risks of deflation are low.

Timing: Don't Miss The Moment

Once the deficit has been eliminated and the Government budget moves from balance to surplus, there will be calls to use the extra money for tax cuts or more consumption spending (on important things like benefits, health, schools or police) either alongside or instead of building up the Sovereign Wealth Fund or repaying debt. Some of these will be simple opportunism from politicians who want to buy votes as soon as there's a budget surplus, and should be resisted strongly. But others – more principled – will come from people arguing that the economic returns of tax cuts (mainly on the political right) or extra consumption spending (mainly on the left) would be higher than building a sovereign wealth fund or repaying debt, so there would be an opportunity cost if the chance is missed.

There's a much broader debate about whether extra consumption spending provides higher economic returns than tax cuts but, regardless of which is better, these alternatives needn't – and shouldn't – be used to derail or delay the new fiscal framework from being introduced promptly once the Government's budget reaches balance and then surplus, for several reasons:

- The narrow economic argument ignores the central moral question of how to deliver generational justice. To be fair to our children and grandchildren, building up the sovereign wealth fund or repaying debt must come first. Only once it is safely underway can tax cuts or extra day-to-day spending be ethically justified.

- Even within the narrowly economic argument, the benefits of rebalancing the UK's economy away from dependence on consumer spending and towards more investment in growth should be very significant. So it is much less likely that the business case for tax cuts or extra consumption spending would be good enough to justify a higher priority than building up the sovereign wealth fund, particularly over the very long-term (multi-generational) timescales involved in these proposals.
- Politically, it will become steadily more difficult to introduce the new fiscal framework and rebalance the UK's economy if the opportunity isn't grasped at the moment when the public finances return to balance and then surplus. Missing this window will mean we have relapsed immediately into familiar bad habits of over-reliance on consumer spending and foreign direct investment, and reversing them will be much harder than avoiding the relapse in the first place.

In practice, it should be possible to deliver both the sovereign wealth fund and either tax cuts or extra spending (or both) fairly quickly after the Government's budget reaches balance. Once the institutions which will be needed to embed and maintain the new fiscal rules have been created⁸, tax cuts or extra spending could be justified as soon as the economy had grown enough to fund whatever rate of contributions to the sovereign wealth fund or debt repayments had been set by the Chancellor of the day. The sovereign wealth fund would have to come first, but it need only delay these other options temporarily once the Government budget has been balanced.

CHAPTER 5: NEW INSTITUTIONS FOR FINANCIALLY VIRTUOUS GOVERNMENT

This section lays out strong, independent new institutions so our public finances can become stronger without being derailed by future changes of Government.

Political Risk: Where Theory Loses To Reality

Without these new institutions, any new shape for Government spending would be wildly over-optimistic because of political risk, which comes in several different forms:

- There is no political consensus between left and right over Government finances. In Britain the right and the centre believe (broadly) in variants of the ‘golden rule’ (that the budget should be balanced over the course of the economic cycle) while the left (broadly) believes in higher public spending throughout the economic cycle. So any attempt to reshape Government finances using the kind of very long-term process that’s proposed here would have a high risk of being unpicked before the transformation was complete.
- In moments of political stress, such as during recessions or in the run-up to elections, the temptation for Governments to borrow more to pander to electorally-important groups of voters is always strong, and leaves future generations to pay the bill.
- A lesser version of this problem occurs when Governments delay long-term capital investment projects during these moments of political pressure, even if they don’t resort to full-scale attempts to buy votes with

borrowed money. The result, as described in ‘Consistently Higher Long Term Investment’ above, is chronic under-investment relative to other developed nations, and creaking infrastructure which chokes and slows economic growth.

- Even where Governments avoid the temptations to under-invest in long-term infrastructure projects, there is always the risk of ‘vanity projects’ which flatter political egos rather than using taxpayer’s cash to deliver the maximum possible increase in economic growth. These projects take unfair precedence over better, more productive schemes which would create far more growth if the same budget were spent on them instead.
- Because we typically exclude the huge liabilities embedded in the state pension and benefits system from our measurements of national debt, any changes can add billions of pounds to the liabilities by stealth. It is relatively easy – and tempting – for politicians to make changes which have an immediate short-term cash benefit for target groups of voters but where the long-term costs aren’t immediately felt because they fall on future generations. As a result, excluding these liabilities from the national debt creates a tempting hiding place where extra borrowing can be concealed from electors. And, equally, potentially painful but necessary changes in the other direction, which effectively reduce the national debt, yield much less political benefit for any Government prepared to make them if they are concealed from view.
- Politicians will always be tempted to mis-label day-to-day consumption as ‘investment’, in an attempt to pretend it has long-term benefits and justify handing the costs on to

future generations by paying for it through borrowing. We should take attempts to make everyday spending plans sound more economically prudent than they really are with a generous pinch of salt.

If the 'right' level of Government borrowing is to be achieved, with all the knock-on benefits to savings, economic investment and growth which would then follow all these sources of political risk must first be addressed, and neutralised. We will need new, independent institutions to achieve this, in the same way that an independent Bank of England has reduced political risk in the UK's interest rate decisions, to ensure we continue fixing the roof when the sun is shining no matter which party is in Government.

The Chancellor Announces A New Target...

The first step should be a publicly-announced target as a % of GDP for Government long-term infrastructure investment, similar to the ones already in place for Overseas Development (0.7% GDP) and NATO (2% GDP).

Given the lead time on public infrastructure projects, and the urgent political importance in the wake of Brexit of showing both foreign countries and investors as well as UK companies and consumers that Britain will be an open, dynamic and fast-growing economy, the new target should be announced and put into effect as quickly as possible. This will mean it will take longer to eliminate the Government's deficit and get the UK's public finances into long-term balance but, given the moral justification which underpins long-term borrowing for infrastructure investment, and current low interest rates which make the business case for these projects very strong, it would still be in line with the new fiscal framework outlined in this paper.

...And A New Responsibility

At the same time as announcing the investment target, the Government should give the Office of Budgetary Responsibility (OBR) a duty to declare whether the Government finances are following the framework which has been outlined here. Specifically, that:

- The infrastructure investment target above is being followed throughout the economic cycle, rather than being squeezed whenever it is politically helpful.
- That day-to-day public spending is not being financed by long term borrowing.
- That any short-term borrowing required to minimise the impact of recessions through the 'fiscal stabilisers' is only being financed through short-term borrowing, and is being fully repaid before the next recession starts.

The Government should also announce a date by which, once these first three conditions have been met, infrastructure investment will be financed by annual budget surpluses rather than long term borrowing, so the OBR can assess progress towards achieving it and, once it has been reached, whether it is being consistently delivered by future Governments as well.

The OBR should make a public declaration of whether the Government is achieving these aims at least once a year although, in practice, it would probably be included in the analysis they publish after each Budget or Autumn statement. Clearly any democratically elected Government could, in theory, decide to ignore this assessment and not adhere to the framework. But, in practice, it would be politically simpler and

safer to follow it instead of explaining why they weren't being prudent with taxpayers' money, or why they were expecting future generations to pay for today's public spending instead.

The Bank of England's 'National Debt Charge'

The next step would be to create a new National Debt Charge ('NDC') through an Act of Parliament, to pay the interest on the national debt in the same way as National Insurance Contributions (NICs) pay for the pensions and benefits system at present. Initially, the NDC would simply replace the part of Income Tax which currently funds the interest on the national debt, with income taxes being reduced by an equivalent amount so the overall fiscal and financial effect would be zero. It would be paid to the Bank of England, as managers of the national debt, for them to use to fund interest payments.

In practice, having set the NDC at a % of GDP which was sufficient to fund existing debt interest repayments at the beginning of this process (projected to be 2% in 2020⁹) the combined effects of a growing economy and a static or declining absolute value of Government debt would mean that the NDC would soon show a surplus, above what was needed by the Bank of England to fund debt interest costs each year. This surplus would be used to repay the national debt and to build up a large UK Sovereign Wealth Fund to replace the taxpayer guarantee which currently underpins our state pensions and benefits system.

At the same time as the NDC was created, the Chancellor would announce a target date (several generations ahead, as explained in 'Timing – Slowly Does It' above) by when the Sovereign Wealth Fund would have been completely built up. To deal with the political risk of future Governments eroding the Fund, the

Governor of the Bank of England would have a duty to write a public letter to the Chancellor at least once a year, advising if the current level was sufficient, in the view of the Bank, to fund the debt interest while also delivering the Fund by the target date. Again, a future Government would be within its powers to ignore this public advice but, in practice, most of the time it would be far simpler and politically safer to follow it instead.

The National Insurance Trust – a UK sovereign wealth fund

Once the Sovereign Wealth Fund starts to build up, there will be a permanent temptation for future Governments to meddle with it, either by requiring it to invest in pet projects whether the financial returns justify it or not, or by siphoning off parts of it to pay for other areas of Government spending. To prevent these or other problems the fund should be managed and administered through a fully-independent, standalone National Insurance Trust¹⁰, with a heavyweight Board of Trustees equivalent to the Bank of England, and they should be subject to all the same duties and rules for prudent investments and transparent reporting¹¹ as any private-sector pension or insurance firm, to ensure taxpayers get the best value possible for the money which is being invested and distributed on their behalf.

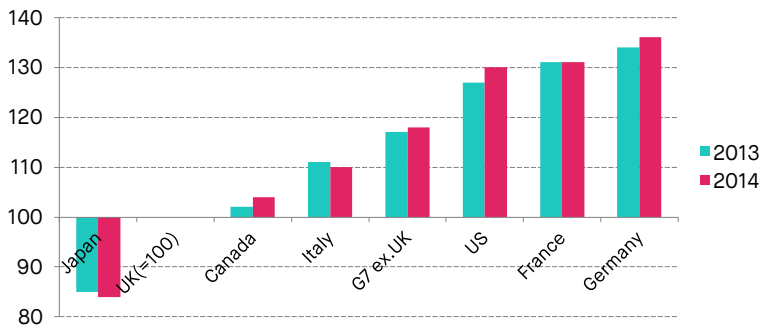
We're All In This Together

Requiring the Trust's independent Board to follow the same duties and rules as private-sector pension or insurance firms would mean they would have to send their policy-holders an annual statement of the pension benefits they would be entitled to once they retire, and the Trust's overall financial position. Since the Trust's policy-holders would include almost everyone of working age or above in Britain, it should have some profound political and social benefits:

- It would provide an annual affirmation of British society's social and financial justice, particularly for young people or families with young children and grandchildren, that we are not saddling them with the bills for today's Government spending through future debt repayments,
- It would show low and high-paid taxpayers alike that they owned a personal stake in an investment fund which would fund their individual state pension and benefits payments. Given the huge scale of the fund once it built up, and the enormous social breadth of its coverage, this would create a shift towards a broad-based, socially-just, asset-owning democracy on a scale even bigger than the one created by Margaret Thatcher's sales of council housing 30 years ago.
- It would make any attempt by future Governments to return to weaker public finances much harder, because all taxpayers would have a concrete ownership stake in maintaining solid financial foundations for the first time ever.

The UK has a higher incidence of low pay (as defined by two thirds of median pay) than most other countries. In response, the last Chancellor announced in July 2015 that a 'National Living Wage' will be introduced as part of an attempt to 'move from a low wage, high tax, high welfare society to a higher wage, lower tax, lower welfare society.'¹²

Figure 2: GDP per hour worked (G7 countries)¹³



However, the UK's productivity per worker hour lags far behind many competitor countries: 30% behind the USA, 31% behind France and 36% behind Germany.¹⁴ The ultimate goal of the NLW is, therefore, to drive not only higher earnings and higher household incomes but also better productivity and a more competitive economy.

ENDNOTES

¹ This is a different question from the much broader ‘opportunity cost’ debate about whether Governments earn better returns from spending on infrastructure investment vs tax cuts, more consumption spending (on things like benefits, health or police) or repaying debt, which is addressed in ‘Timing: Don’t Miss The Moment’ later in this paper. The proposed new fiscal framework would only allow tax cuts or extra consumption spending once we have achieved a budget surplus, so the narrower decision whether to fund investment through borrowing or surplus is a separate (and prior) question entirely.

² Office for National Statistics and Office for Budget Responsibility, 2016

³ OECDStat, House of Commons Library calculations. Gross fixed capital formation of general government sector divided by nominal GDP (EU average therefore GDP weighted too)

⁴ Institute of Economic Affairs (IEA) 2010

⁵ Taxpayers Alliance 2015

⁶ Some economists argue this might not happen if companies and consumers decided to save much less because of the sovereign wealth fund. But given the huge scale of the fund, and our already-low savings levels relative to other developed economies, the risk would be very low in this case.

⁷ World Bank ‘World Data Bank’

⁸ Explained in the next section

⁹ Office for National Statistics, 2016

¹⁰ Canada has something very similar to this already, which is held to be a success.

¹¹ This would include independent annual actuarial calculations of the value of long-term liabilities embedded in the pensions and benefits system, so any otherwise-hidden costs of Government changes would be immediately apparent, and the value of the investment fund could be easily compared to the liabilities at any stage.

¹² HM Treasury, Summer Budget (July 2015)

¹³ ONS, International Comparisons of Productivity - Final Estimates: 2014 (2016)

¹⁴ ONS, International Comparisons of Productivity - Final Estimates: 2014 (2016)