BANKRUPT BRITAIN

By Malcolm Offord

Bankrupt Britain

Just how indebted is Britain right now?

On 19th December, 2008, *The Daily Telegraph* wrote an article saying that Britain now has the largest national debt in the developed world after the Office for National Statistics (ONS) confirmed that it is officially making the recently nationalised Royal Bank of Scotland a part of the public sector. It went on to say that the UK's total indebtedness is forecast in 2009 to rise to £2,700 billion which equates to 184% of national income – i.e. of £1,463 billion gross domestic product ("GDP"). This pushes the UK ahead of Japan (173% of GDP) and Italy (113% of GDP).

In reality, it is very difficult to find a reliable single source for Britain's total indebtedness. The £2.7 trillion quoted above is actually closer to £3 trillion (twice the national income) based on an aggregate of the following five component parts:

- HM Treasury's published public sector net debt ("PSND") of £602 billion [1]
- Maastricht definition of additional gross government debt of £172 billion [2]
- One-off "credit crunch" financial stability measures of £77 billion (Bail-Out I) [3]
- Unfunded public sector pension liabilities of £650 billion [4] (the CBI claim this figure is nearer £900 billion)
- Private indebtedness of £1,400 billion [5]

For the purpose of this paper – and ease of analysis – the focus is entirely on the published figures for the Government's borrowing as set out in the Treasury's Pre-Budget Report 2008. The reader is encouraged to first read Section B of the Pre-Budget Report (pages 185 – 223). This Report is the source of the first three categories of national debt set out above (which amount to £850 billion in fiscal year 2008-09) and which are generally grouped together to form what we describe as government borrowing.

[1] Pre-Budget Report 2008
[2] Pre-Budget Report 2008
[3] Pre-Budget Report 2008. Bail-Out I is quantified by analysts to amount to £400 billion of which £77 billion has been taken "on balance sheet" by the Treasury. Bail-Out II announced by Alistair Darling on 19th January, 2009 is unquantified but includes a series of measures including guarantee scheme for asset backed securities, insurance of risky loans and credit guarantee schemes on bank lending.
[4] Government Actuary's Department (GAD), 31st March, 2006
[5] ONS

Can we objectively assess when government borrowing is too high?

When a Company borrows money, analysts will assess the level of that borrowing against three metrics:

- *Leverage:* the ratio of net debt to pre-tax earnings
- *Interest Cover:* the ratio by which interest payments are covered by pre-tax earnings
- *Gearing:* the ratio of net debt to net assets

As a rule of thumb, it was considered that a well run, publicly listed company in the UK would have a leverage ratio not exceeding 4x pre-tax earnings, interest cover not less than 4x pre-tax earnings and gearing not exceeding 40% of net assets. When any one or all of these ratios were exceeded, the company was considered too highly indebted by the stock market and, in the absence of a credible management plan to reduce its borrowings in the near term, its share price would fall in value.

So can the same sort of metrics be applied to government borrowing? The answer is yes, the following two metrics can be applied:

- *Leverage:* government debt as a percentage of GDP
- *Budget Surplus / Deficit:* the gap between annual public spending and annual tax receipts

As a rule of thumb, a well-run country would be characterised by government borrowing not exceeding 40% of GDP, a budget deficit of zero over the economic cycle (Gordon Brown's now abandoned "golden rule") but where public spending did not exceed tax receipts by more than 3% of GDP in any given year (the Maastricht Treaty rule). The currency and government bond markets were the final arbiter of a country's performance and where one or other of these metrics were exceeded, that country's currency would fall in value, and borrowing costs would rise, unless there was a credible government plan to get back on track in the short- to medium-term.

Where does Britain sit currently against these metrics?

In his Pre-Budget Report on 24th November 2008, the Chancellor Alastair Darling announced that he was planning a budget deficit of 8% of GDP in 2009-10. This translates into an extraordinary figure of £118 billion of additional government borrowing in just one year. He announced this against a forecast of negative real economic GDP growth of between 0.75% and 1.25% in fiscal year 2009-10 and effectively conceded that the Treasury does not plan on bringing the budget deficit down to the Maastricht target of 3% until 2014. With this additional borrowing planned, the Government will end the 2009-10 fiscal year with public sector net debt of £729 billion – 49% of GDP. Total debt measured under the Maastricht Treaty rises to £896 billion – 60% of GDP. If we add the initial £77 billion of financial stability measures taken by the Treasury to deal with the fall-out from the recent banking crisis (Bail-Out I) this figure rises further to £973 billion – 65% of GDP.

The table below sets out the key metrics as published in the 2008 Pre-Budget Report:

£ billion	Out-turn 2007-08	Estimate 2008-09	Projection 2009-10	Projection 2010-11	Projection 2011-12	Projection 2012-13	Projection 2013-14
GDP (Nominal) *% growth (Nom)*	1421	1463 *3.0%*	1480 *1.2%*	1549 *4.7%*	1638 *5.7%*	1735 *5.9%*	1836 *5.8%*
Tax Receipts *% GDP*	547 *38.5%*	545 *37.3%*	535 *36.1%*	576 *37.2%*	621 *37.9%*	664 *38.3%*	708 *38.6%*
Total Managed Expenditure *% GDP*	584 *41.1%*	623 *42.6%*	654 *44.2%*	682 *44.0%*	708 *43.2%*	734 *42.3%*	762 *41.5%*
Annual Surplus / (Deficit) *% GDP*	(37) *2.6%*	(78) *5.3%*	(118) *8.0%*	(105) *6.8%*	(87) *5.3%*	(70) *4.0%*	(54) *2.9%*
Public Sector Net Debt *% GDP*	527 *37.1%*	602 *41.1%*	729 *49.3%*	842 *54.4%*	938 *57.3%*	1020 *58.8%*	1084 *59.0%*
Maastricht Treaty Debt *% GDP*	614 *43.2%*	774 *52.9%*	896 *60.5%*	1008 *65.1%*	1106 *67.5%*	1191 *68.6%*	1258 *68.5%*

To put these figures into historical context, the reader should refer to Table B21 on page 222 of the Pre-Budget Report. This sets out the historical series of public sector balances, receipts and debt since 1970. Two relevant major economic shocks occurred in Britain in 1973-74 and in 1993-94. The biggest single annual budget deficit since 1970 was recorded in 1993-94 at 7.7% of GDP; compare and contrast this with the 2009-10 projection of 8% of GDP (which was calculated before the two Bank Bail-Outs and the rapid deterioration of the economy in the last three months). The highest public sector net debt since 1970 was recorded in 1975-76 at 54% of GDP two years after the 1973-74 recession; compare and contrast this with the current Treasury forecast of 57% two years after the 2009-10 recession. Note that it took the UK economy 11 years to get back to 40% net debt following the 1970s recession and 5 years to get back to annual budget surplus following the 1990s recession.

The table above indicates, therefore, that hidden within these Government projections is the unrealistic assumption that the economy will bounce back to real GDP growth in 2010-11 after a one year recession. Do the currency markets believe the Chancellor? Clearly not: in the last three months of 2008, Sterling declined in value by 18% against the Dollar and by 17% against the Euro. This may reflect the perception that the Chancellor himself, based on the Treasury figures set out above, seems to have abandoned the principle of returning public sector net debt to 40% of GDP in the medium-term.

Perhaps most worrying of all, in the first quarter of 2009 we are now beginning to get a sense of how this recession is actually going to impact the earnings of Britain, i.e. the means whereby we can repay this extensive borrowing. First, we had Bank Bail-Out II on 19th January 2009: a series of unquantified measures to further prop up the UK banking sector. As a result Sterling went into free-fall, hitting $1.35 on 23rd January 2009 – a drop of 25% since 30th September 2008 – its lowest point since 1985.[6]

Next, official Government figures on 23rd January 2009 confirmed that the UK economy is now officially in recession. In the last quarter of 2008[7]:

- GDP fell by 1.5% (having been -0.6% in the third quarter and flat in the second)
- Manufacturing output fell by 4.6% (the largest annualised fall in output for 28 years)
- Unemployment rose by 6% (unemployment has reached 1.92 million, the highest figure since 1997)

In addition, tax receipts are now in free fall. To put this in context, in their peak year of 2007-08, tax receipts from the financial and housing sectors alone combined to contribute £60 billion to the Treasury. The Chancellor's forecast that tax receipts in the worst forecast recession since the War will fall only by £10 billion is likely to be unrealistic. For reference, tax receipts fell by 6.4% of GDP (£94 billion in today's money) in the last boom-to-bust cycle from 1985 to 1994. Given the precipitous decline in economic performance in the fourth quarter, could it be that all these economic figures announced by the Chancellor in the Pre-Budget Report, however worrying they seemed at the time, may prove to be optimistic, perhaps excessively so?

Time for a simple model

To roll forward the public finances, we have prepared the very simplest of models. It has 37 lines and can be printed on one page of A4 paper. It is, of course, open to criticism, but we have opted for simplicity for two reasons:

- This is not aimed at experts in Microsoft Excel. By keeping the model simple the aim is to make it accessible to both politicians and members of the public, on whom any future burden of increased tax must fall. Mr Darling might even find it useful in order to "road test" the Treasury's models (which are, I have little doubt, enormous, byzantine and incomprehensible to all except their authors, and quite possibly even to them)

- The extraordinary severity of the economic downturn makes detailed modelling rather pointless. So great is the uncertainty around the inputs (for example, GDP trends, inflation, cost of further bailouts, cost of borrowing, growth of unemployment, reduction in tax receipts etc.) that big models are of less use than small ones. They spit out their answers too slowly and their answers are undermined by the complexity of the underlying assumptions, many of which break down when faced with extreme circumstances

6 See Lex Column, The Financial Times, 20th January, 2009 – Appendix I
7 ONS

"Business as Usual"

The results of our modelling are unnerving. If we assume that in 2009-10, UK GDP falls by 5% overall in real terms, we think that "business as usual" levels of public spending and taxation would lead to national debt (on the Maastricht definition) rising to around 105% of GDP by 2012 and continuing to rise thereafter to 156% of GDP by 2020. If the UK was a company, it would be insolvent. By 2013, it would be loss-making (to the tune of £240 billion p.a.) and would have a rising debt burden such that the country was unable to meet its debts as they became due. The country would be at serious risk of a collapse in investor confidence and would face the unenviable prospect of another trip cap-in-hand to the IMF.[8]

Our "business as usual" scenario has the following features:

- GDP falls by 5% from 2008-9 to 2009-10. In the 1929-31 depression, US GDP fell by 30%, French GDP by 15% and UK GDP by 5%. We don't believe a drop of 5% is at all unrealistic; the country is currently witnessing a consistent pattern throughout this downturn of politicians and economists alike underestimating its severity (the British Chamber of Commerce said at Gordon Brown's recent jobs summit [9] that they were currently revising downwards their forecasts for the economy prepared only two weeks before!).[10] The IMF has also recently revised its forecast for the UK economy in 2009 to minus 2.8% for 2009. Given the lag in the statistics, we believe that the contraction seen in the last quarter of 2008 is going to get worse before it gets better. Politicians and bankers are at last beginning to recognise this. Most recently, Ed Balls MP said that Britain is facing "the most serious global recession for over 100 years" and two days later the Bank of England released its latest Quarterly Inflation Report projecting GDP contracting by around 4% year-on-year in the middle of 2009.[11] Moreover, an extrapolation of the 4th quarter figures in the US and Japan gives an annual contraction in these two major economies of 6% and 12% respectively. Therefore, I am working on the basis of minus 5% for 2009 in the UK and hope that our assumption that it flattens out in 2010-11 and then resumes 2.5% real growth thereafter does not prove to be excessively optimistic

- This paper forecasts a fall in the tax take to reflect what has been seen in previous downturns. I note the recent Green Budget from the Institute of Fiscal Studies, in which they highlighted potential shortfalls of a few billions in tax receipts (£6.6 billion worse than the Treasury estimate of £10 billion). Their bottom-up approach misses the wood for the trees, just as Mr Darling's Pre-Budget Report did. City bonuses have been slashed, financial sector and company profits are collapsing, the property market has stalled, capital gains are non-existent, savings rates have slumped, VAT has been reduced, the price for North Sea oil has fallen – and the list goes on. HMRC must be haemorrhaging tax revenues and I firmly expect them to crash as a

[8] For reference, the IMF bail-out in 1976 amounted to £2.3 billion. In 2005, the Treasury released 34 documents on the IMF bail-out under the Freedom of Information Act. There is a useful article from The Financial Times attached in Appendix II.

[9] 12th January, 2009

[10] Eg Ernst & Young Item Club are forecasting that GDP will decline by 2.7% in 2009 and 0.5% in 2010 leading to unemployment of 3.4 million in 2011. Capital Economics predict -2.5% in 2009 and -1.0% in 2010.

[11] 11th February, 2009

percentage of GDP from their high point in 2007-8.[12] Judging the extent of this fall is much more important than our call on GDP growth. I have kept it simple and looked at what has happened in the past as a guide – so far, monthly government borrowing figures (which are eye-watering) suggest this may well be right;

- Inflation remains, on average, at 2.5% throughout the period. There is much discussion about deflation due to falling oil and commodity prices, but Sterling has also fallen sharply and we import a lot. The assumption is therefore that the Bank of England succeeds in its mission of taming both deflation and inflation

- Government spending grows in line with inflation[13], save for two areas of spend: welfare and debt interest. Government spending has been growing well ahead of inflation for some 15 years now, but I assume that whoever is in Number 10 in 2010 will recognise the need to face down the public sector over pay and pensions in the current crisis. This assumption of public spending growth in line with inflation may be too optimistic, but we hope it is not

- Welfare spending grows in line with inflation, save that pensions grow in line with historical trends (above inflation, as the population ages) and that we overlay a cost for the inevitable increase in unemployment brought about by the current downturn. To estimate this cost, we have looked at previous downturns and made some simple assumptions. In the past 60 years, UK GDP growth has averaged 2.5% p.a. In each period where it fell below this for some time, the GDP gap has caused job losses. On average, a 1% "gap" in GDP leads to 137,000 job losses. In severe downturns, this figure is higher and we have taken the experience from the 1980s as our guide, which leads to a job loss figure of 200,000 per 1% of "missing" GDP. We then assume that each additional unemployed person costs the state £11,800 per year in today's terms, which is based on the official poverty line of 60% of median income. It is difficult to estimate the true "fully loaded" cost of an unemployed person and his or her dependents. Estimates vary widely. Our assumption of £11,800 per head may be materially understating the true cost of another 2 million people dependent on the state for their own and their families' wellbeing

[12] Current government receipts as a percentage of GDP were 38.5% in 2007/08, the highest percentage for 20 years, and 20 years ago, we believe that north sea oil revenues made up a significantly greater proportion of government receipts.

[13] For the first two years, government current spending plans are taken; the supertanker will take time to turn!

- Debt interest grows along with the growth in public debt, which results in the cost of debt service rising to 21% of total public spending in 2020. We have assumed that the interest rate on this debt increases as national debt grows in relation to GDP, but we have capped the cost at 7% p.a. This is a big unknown. We rely on overseas funding of UK debt and, in our "business as usual" scenario, debt rises dramatically to 156% of GDP. It is far from clear that overseas investors will cherish the opportunity to buy that level of UK government debt even at 7% returns. If you want to scare yourself, then look at history. In 1995, just 2.1% of global government reserves were held in sterling. By 2007, that figure had risen to 4.7%. If the trend reversed back toward the 1995 level, the UK government would really have to push up the returns on government debt to entice back international investors who were worried about the solvency of the country.

The results of our "business as usual" case are summarised in the following table. The weak points are highlighted: national debt at 156% of GDP [14] and annual debt interest at 21% of public spending.

Base model (£bn)		
	2009-10	**2019-20**
GDP	1,427	2,270
Public spending	684	1,042
Public spending / GDP (%)	48%	46%
Tax receipts	485	794
Tax /GDP (%)	34%	35%
Annual "profit"/"(loss)"	(198)	(247)
National debt (Maastricht)	1,149	3,534
National debt / GDP (%)	81%	156%
Debt interest /public spending (%)	6%	21%
Top rate of tax (on all earnings over threshold)	41%	42%
Public spending cut (today's money) by 2020		0

The commentary above clearly shows that things could be worse than the "business as usual" scenario which has been painted. The point of the exercise is to highlight the big issues and to allow the powers-that-be to have a play on their home PCs. They will probably want to look at a more severe economic downturn, or look at the impact of a doubling of the interest rate on government debt, and so on. The resulting outputs would prove sobering.

[14] Starting point of 81% in 2009-10 is based on the PBR Maastricht debt figure of £896 billion and adds £77 billion for Bail-out I, £100 billion for Bail-Out II, £60 billion loss of tax revenue and £18 billion increased costs of unemployment benefit. This is then applied to GDP down 5% at £1,427 billion.

To those who accuse of us of being overly pessimistic, consider a more benign scenario:

- Instead of -5% then 0%, let's take GDP of -3% in 2009, then +1% in 2010, and then +2.5% thereafter
- Instead of receipts falling to 35% of GDP, let's take it down to 36% and keep it there (a fall in tax of only £20 billion in nominal terms)
- Bail-Out costs peak at £130 billion and fall to £25bn once the Treasury has been paid back, so only £25billion lost in the end (likely to be highly optimistic.)
- Each unemployed person costs £10k pa, not £11.8k

The output is that, in 2020, the UK would still have debt of 115% of GDP instead of 158% as set out above. In other words, even if we subscribe to the more widely accepted, more optimistic view of the world today, we would still have a critical problem and would still be forced to face up to some tough decisions.

If only we were able to rewind the last ten years. The profligate spending which has left us with £774 billion of public debt before the recession even started, horrendous unfunded public sector pension liabilities and built-in losses of potentially £200 billion per annum which could and should have been avoided. The reality is that, as the economic bubble which was based on 10 years of cheap debt and rising property prices deflates, the public spending splurge which was based upon it has locked us into huge debts and high spending which cannot be so easily deflated.

So what can the government do to improve the state of the public finances?

There are basically three levers a government can pull to try to return national debt as a percentage of GDP back to 40%:

- Increase taxes;
- Cut public spending; and/or
- Debase sterling (again) by allowing inflation to rise.

Or, should we accept that public debt can run at much higher levels than it has in the past?

Increase taxes

This paper assumes that taxation other than income tax rises with nominal GDP as growth resumes, after returning to previous levels as a percentage of GDP, and that real tax increases thereafter are focused on income tax, which accounts for c.50% of the tax take. Furthermore, the assumption is that governments of either colour won't want to hammer lower earners, because this would provide a disincentive to work and would be electorally unpopular. I assume, therefore, that any government will seek to "squeeze the rich". We define that as the 3.6 million higher rate taxpayers who comprise only 12% of the working population (6% of the total population) but actually account for 50% of income tax receipts.[15] We then see what the current 41% top tax rate would have to be to bring debt back down to the level of 40% of GDP (where it has hovered throughout the last 30 years) by 2020. The answer: it can't be done. In theory, one could put tax rates up to 90% for all higher rate earners, but this would take the total tax take up to 47% of GDP. That has never been attempted before in Britain. Tax take has never been above 38% of GDP (peak in 1982-3), and to attempt to squeeze 47% of GDP out in taxes would be counterproductive, leading to further erosion in GDP growth. We reflect this by taking real GDP growth down from 2.5% down to 1% p.a. and assuming that unemployment remains high as the economy won't grow to create new jobs. Moreover, all the empirical evidence from around the world proves that tax receipts decline as tax rates rise.[16] The conclusion is that this would be a tax bombshell which leaves a swathe of collateral damage behind.

Our "increase taxes" scenario produces the following key outputs. The weaknesses are again highlighted: national debt only gets down to 102% of GDP because the economy will not withstand a record tax burden of 47% of GDP, so GDP would fall well short of the £2270 billion in 2020 that we showed in our Business as Usual scenario, and unemployment would remain high:

[15] The population of the UK is 60.8 million. There are 12.3 million state pensioners and 11.6 million under 16. This leaves 36.9 million of working age of whom 29.4 million are in employment (5.8 million in the public sector and 23.6 million in the private sector). There are 5.2 million people of working age who formed the DWP's out of work "client group" in Aug-08 claiming one form of Benefit or another.

[16] There is a vast amount written about the detrimental impact on tax revenues caused by punitive tax rates in developed economies. Most recently, in relation to Alistair Darling's proposed increase of the top rate to 45%, the first such increase since 1974, the Institute of Fiscal Studies said that such an increase could reduce the overall tax take: "the government's expectation of raising £1.6 billion is subject to an extremely wide margin of error and the possibility must exist that the measure could lose the government income tax revenue."

Taxes up (£bn)		
	2009-10	2019-20
GDP	1,427	1,994
Public spending	684	961
Public spending / GDP (%)	48%	48%
Tax receipts	485	937
Tax /GDP (%)	34%	47%
Annual "profit"/"(loss)"	(198)	(24)
National debt (Maastricht)	1,149	2,029
National debt / GDP (%)	81%	102%
Debt interest /public spending (%)	6%	11%
Top rate of tax (on all earnings over threshold)	41%	90%
Public spending cut (today's money) by 2020		0

Cut public spending

It is easy to forget that ***no country with a fully mature welfare state has ever been tested by a full-blown economic depression***. The welfare state materialised ***after*** the last depression in the 1930s followed by the Second World War. Futhermore, in the last thirty years, the welfare state has been underpinned by two additional sources of government income which are now running out of steam: north sea oil revenues and state asset privatisations. In the last thirty years these two sources of extraneous government revenue amounted to £80 billion in the period 1978-88, £75 billion in the period 1988-98 and £60 billion in the period 1999-2008. Perhaps this is why no government of either political persuasion during the last thirty years has really felt the need to cut back seriously on public spending.

Our "business as usual" model shows that the current system may not be able to survive even a 5% decline in GDP. The classic Whitehall answer, to squeeze public spending, simply will not produce the long term answer. For example, even to get the debt down to 45% of GDP by 2020, one would need to save £185 billion by 2020 ***in today's money*** (a cut of 30% on today's spend). In other words, one would have to remove roughly the equivalent of ***all*** of today's spending on the NHS and Education (current total c.£193 billion). Whilst companies facing insolvency have to make unpleasant choices, such savage retrenchment would melt the firmest political will in the heat of the national counter blast. Nevertheless, our analysis makes clear that a root and branch review of public spending is required.

It is beyond the scope of this paper to address the best approach to this challenge and whilst difficult decisions will be required on short-term measures, they must go hand-in-hand with a longer term restructuring to bring spending back to a sustainable level.

Spending down (£bn)		
	2009-10	**2019-20**
GDP	1,427	2,270
Public spending	676	615
Public spending / GDP (%)	47%	27%
Tax receipts	485	794
Tax /GDP (%)	34%	35%
Annual "profit"/"(loss)"	(191)	179
National debt (Maastricht)	1,142	1,033
National debt / GDP (%)	80%	45%
Debt interest /public spending (%)	5%	7%
Top rate of tax (on all earnings over threshold)	41%	42%
Public spending cut (today's money) by 2020		185

Debase sterling

Inflation is the "hard drug" of the capitalist system: once you're hooked on it, it's hard to get off it. Inflation is bad for growth, discourages saving and investment and, once unleashed, it is very hard to tame. However, I recognise that a number of commentators and some politicians have hinted at the debasing of Sterling as the "painless" way of dealing with our debt problem, so thought it best to create such a scenario using the model in order to test this political thesis.

Let us say that inflation was allowed to run at high rates (e.g. 10% p.a.) to "deflate" the debt, making it cheaper to repay in tomorrow's money. We have assumed that public spending continues to grow with inflation; some of the most bitter public sector strikes in the seventies were caused by attempts to hoodwink public sector workers by allowing their wages to lag inflation. For example the winter of discontent in 1979: the grave diggers and street sweepers went on strike over their 5% pay deal, because the judges and civil servants received pay rises of 30% to out-pace inflation.[17] I also assume that inflation has its usual corrosive effect on economic growth, which is represented by deducting 1% p.a. from GDP growth in real terms and leaving unemployment at somewhat elevated levels. The figures show that inflation doesn't come close to fixing the problem. National debt as a percentage of GDP is only marginally lower in 2020 than in our "Business as Usual" case:

[17] Inflation (RPI) peaked at 24.2% in 1975

Debase sterling (£bn)		
	2009-10	2019-20
GDP	1,427	3,623
Public spending	680	1,941
Public spending / GDP (%)	48%	54%
Tax receipts	485	1,268
Tax /GDP (%)	34%	35%
Annual "profit"/"(loss)"	(194)	(673)
National debt (Maastricht)	1,146	5,403
National debt / GDP (%)	80%	149%
Debt interest /public spending (%)	5%	28%
Top rate of tax (on all earnings over threshold)	41%	42%
Public spending cut (today's money) by 2020		0

Why does inflation not work?

Inflation pushes up the cost of ongoing government borrowing and, because the annual deficit between public spending and tax revenues is so large, the amount the UK government is borrowing each year represents a relatively high proportion of its overall debt. Looking back from 2020, 85% of the UK's debt at that time will have been racked up *after* 2009. As such, while inflation does help to work away at the stock of pre-2009 debt, this doesn't help much because investors will demand a real return on their investment in post-2009 UK government debt. In other words, they will need to be paid interest at rates higher than the rate of inflation. They will also want to be compensated for the risk that they run on the exchange rate (Sterling would continue to fall as it is effectively devalued). We have assumed that the rate charged would be c.2% above the rate of inflation. It could be more. Recently, Spanish government debt has had to offer returns 2% higher than German government debt in order to entice investors and this trend towards increasing "pickiness" among international investors is likely to continue as more states go the way of Iceland.

It is clear then that inflation is no panacea. After many years, during which the Bank of England has sought to build and defend its inflation-fighting credentials, it would, in our view, be disastrous to allow inflation back out of the bag. It would severely weaken the UK economy in the long term and it would do little to solve the fundamental problem facing the UK's finances. As Keynes is used at present to justify much of what is proposed, it is worth pointing out what he felt about such a course of action:

> ***"There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."*** [18]

[18] 'The Economic Consequences of the Peace' Keynes 1919

Accept that public debt can run at much higher levels than it has in the past?

It is difficult to say what a sustainable level of debt as a percentage of GDP for the UK. Other countries appear to have higher public sector net debt, although the data sources often seem to compare apples with oranges. We have already demonstrated in our introduction that the UK is the most indebted country in the developed world.

In any event, it will not be long before we see the market's attitude as Government debt issuance looks set to balloon in the next couple of years. However, I assume that the market will want to see a clear path back to historical levels of debt (c. 40% - 50% of GDP) and think any government should plan on this basis. For comparison, net debt peaked at 54% of GDP in 1975-76 and how uncomfortable that period was for Britain should be remembered. It is also sobering to note the recent downgrading of Spain's national debt by Standard & Poors (Spain is forecasting an annual deficit of 10% of GDP against our possibly unrealistic 8%). In summary, we should assume that international investors will not continue to fund us indefinitely.

Is there a balanced solution?

The simple conclusion is that the size of problem is simply too large to be solved by pulling one single lever; therefore, a balanced approach is required to restore the UK economy:

- Increase the top rate of tax to 50%. This is obviously painful for top rate taxpayers, but is unlikely to persuade them to leave the country and shouldn't have a material effect on their motivation to earn, **so long as they believe that this is not the thin edge of the wedge and is part of a wider, balanced recovery plan.** The temptation to shift this tax burden only to the very rich should be resisted. Plus, we need them active in our economy. Lower rate taxpayers should not be discouraged from working by raising taxes heavily on them. But neither should they be taken out of the tax system altogether. This needs to be a burden shared by all. This isn't about redistribution or fair taxation – it is about raising what you can with the minimum of negative consequences. But any tax rises must be accompanied with a promise to reduce taxation again once the economy is stabilised

- Reform the bloated benefits system of this country to reduce the burden on the state and, just as importantly, boost the growth rate of the country by helping more people to be productive and contribute to the country's (**and their own**) wellbeing. We reflect this with real GDP growth running a little ahead of the trend rate of 2.5%, at 2.7% p.a.

- No government can solve this problem unless it commits to reduce the level of trend public spending once the worst of the crisis has passed – perhaps as much as £60 billion in 2014 rising to £100 billion in 2020, in real terms

- We would not change the inflation target. That is a fool's paradise, as Mr Mugabe has graphically demonstrated, that is why we ran our numbers at a 2.5% inflation rate

The “balanced solution” scenario produces the following key outputs:

Balanced approach (£bn)		
	2009-10	2019-20
GDP	1,427	2,309
Public spending	676	733
Public spending / GDP (%)	47%	32%
Tax receipts	485	907
Tax /GDP (%)	34%	39%
Annual "profit"/"(loss)"	(191)	174
National debt (Maastricht)	1,142	1,109
National debt / GDP (%)	80%	48%
Debt interest /public spending (%)	5%	6%
Top rate of tax (on all earnings over threshold)	41%	50%
Public spending cut (today's money) by 2020		100

The results of this balanced approach, i.e. pulling all the levers at once, are as follows:

- Government debt gets back to 48% of GDP by 2020 and is reducing rapidly at that point
- The budget deficit between spending and taxation returns to zero in 2015
- The annual cost of our borrowing returns to 6% of total public spending in 2020

Politically, however, the benefits of this transparent approach are to demonstrate to each constituency of the economy that the pain is being shared around; that the pain for private sector tax payers is balanced by public sector economy. Compare and contrast this with the imbalance of treatment meted out over the last ten years by Gordon Brown to private sector pensions versus those of the public sector.

Welfare Reform

Assuming that any government can settle our creditors with a credible, balanced and transparent plan along these lines, there will remain the daunting challenge of ensuring that the huge increase in welfare spending in 2009/10 caused by the recession unwinds as the economy resumes its growth. This will not happen automatically. Sadly, history shows that each previous recession has “locked in” a new level of welfare dependency.

The most difficult issue facing any government is, therefore, to re-design the welfare system so that it looks after the weak and vulnerable, whilst getting everyone-else back into training and then into work. In other words, let us reform the welfare state into an engine of economic growth. When this happens, it will follow that Britain can return in the medium-term to a low tax, dynamic economy where real jobs are created in the private sector rather than artificially created in the public sector.

Let's remind ourselves of the total public spending in Britain and where we spend it:

GOVERNMENT SPENDING BY FUNCTION 2008-09 (ESTIMATE)		
Social Security [19]	32%	199
Health	18%	112
Education	13%	81
Defence	6%	37
Public Order & Safety	5%	31
Housing & Environment	4%	25
Transport	3%	19
Industry & Agriculture	3%	19
Other Public Services	10%	62
Debt Service	6%	37
£ Billion	**100%**	**623**

The Treasury allocates total managed expenditure ("TME") between departmental spend (e.g. health, education etc) and annual spend (e.g. benefits, pensions, BBC etc) as follows:

TOTAL MANAGED EXPENDITURE 1994-2009						
	2008-09	**1993-94**	**Annual Growth**	**15 Year Inflation**	**1993-94 in today's money**	**2008-2009 "Overspend"**
Departmental Expenditure Limits (DEL)	374	156	6.0%	2.4%	223	151
Annually Managed Expenditure (AME)	249	127	4.6%	2.4%	181	68
Total Managed Expenditure (TME)	623	283	5.4%	2.4%	404	219
Of which:						
	2008-09	**1993-94**	**Annual Growth**	**15 Year Inflation**	**1993-94 in today's money**	**2008-09 "Overspend"**
Pensions	73	48	2.8%	2.4%	69	4
Working Age Benefits	126	35	8.9%	2.4%	50	76
Total Social Security	199	83	6.0%	2.4%	118	81

The first point to note is that current TME of £623 billion has grown over 15 years by 5.4% pa from the equivalent figure in 1993/94 of £283 billion. This is a long-term trend of real spending ahead of inflation: if TME had grown over 15 years in line with actual inflation of 2.4% pa during that period[20], current TME would amount to £404 billion. On that basis, we have increased real spending by £219 billion over the last 15 years. It is here that any Government will look for savings. Yet to do so without a proper reform of the benefits

[19] Combination of social protection (28% of GDP) and personal social services (4% of GDP)

[20] An average over 15 years of 1.9% CPI and 2.9% RPI

system risks repeating the failures of the past and the savings, such as they are, will be minimal. The present benefits system, with its complexity in too many areas, acts as a block or disincentive to people going back to work. This is one of the reasons why the Government's work programmes have been so costly and so ineffective. It was Frank Field MP who recently criticised the Government for spending £billions on the New Deal, with little to show for it. Some commentators have referred to a need to target savings of up to £100 billion (i.e. c. 45% of that £219bn real spending increase). Such significant savings will not be found unless the current byzantine system is radically altered.

The second point to note is that one third of TME is spent on social security: £199 billion, of which £73 billion is spent on pensions leaving a massive £126 billion in welfare payments being made to the working age population of this country. The equivalent figure to £199 billion for total social security spend in 1993-94 was £83 billion. Fifteen years of inflation at 2.4% pa should have increased that figure to £118 billion today. Of that increase (i.e. "overspend") of £81 billion, £76 billion is located in welfare benefits alone. 76% of the £100 billion previously referred to. This raises the obvious question: isn't this the right place to start looking for our savings?

Savings through balanced reform

After 60 years there is now a mounting body of evidence which supports the understanding that the benefits culture we have created – in good faith and with the best of intentions – for the weak and vulnerable does not actually improve their lives. In fact, quite the opposite. There is a growing body of evidence that the hand-outs actually embed the recipients in poverty, in hopelessness and in worklessness which not only degrades them as people but also robs the state of economically valuable citizens. The Shannon Matthews case where a mother has seven children by five fathers all paid for by the state does not provide strong endorsement for the benefits system. Frank Field MP was the first serious politician on to this ten years ago when he was asked by Tony Blair to "think the unthinkable", only to be blocked at every turn by Gordon Brown. Since then, Iain Duncan Smith MP, through the Centre for Social Justice, has produced reports such as 'Breakthrough Britain" which show conclusively that growing levels of social breakdown are linked to the benefits led dependency culture. The primary objective of any civilised society must be to help the weak and vulnerable, but that shouldn't leave them trapped in inter-generational poverty and hopelessness as the present expensive yet ineffective system seems to do.

Despite record increases in welfare spending, Britain is challenged by the fact that the social problems the investment was supposed to alleviate have remained entrenched.

Below we lay out some of the data relating to continuing and unaddressed social breakdown, before listing the cost of a few of the programmes intended to tackle it.[21]

[21] See Also, 'Tower Hamlets, The New East End.'

Levels of poverty in the UK remain higher than in many other European countries.[22] There are more people living in severe poverty than ten years ago.[23] This in itself should call into question the Government's whole approach to welfare. In 2006/7, there were 13 million people living in households below the official poverty line (60 per cent of the median earned and unearned income) – an increase of two million in two years. If we look at those whose income is below 40 per cent of the median – severe poverty – there has been no decrease since this Labour government came to power and an increase in the last two years.

Moreover, policy has not helped. Government policy intended work to be fully rewarding. However, 8.6 million in working age households (37 per cent of all working age households) fall below the poverty line *despite being in work.*[24]

Since 1997, there has been only a very small reduction in the proportion of working-age people on long-term out-of-work benefits.[25] One third of *Jobseeker's Allowance* (JSA) claimants have spent more time claiming out-of-work benefits than they have in work. Approximately 100,000 JSA claimants have spent six of the last seven years claiming out-of-work benefits.[26] We have also very high rates, internationally and historically, of incapacity benefit claimants – those who claim a medical reason for being unable to work. In November 2007, there were 2.64 million people receiving Incapacity Benefit.[27] This is almost four times the number of people (690,000) who claimed the equivalent benefits in 1979.[28] It forms 7.5 per cent of the working-age population, compared with 5.2 per cent in Australia, 4.5 per cent in New Zealand, 2.1 per cent in Germany and 0.3 per cent in France. Meanwhile, one-in-eight 16 to 19 year-olds in the UK is not in education, employment or training, a slight increase on ten years ago.

Government's spending on social protection now consumes nearly three quarters of all Income Tax and National Insurance receipts.[29]

The government spent £63bn on working age tax credits and benefits in 2006/7. It is quite obvious that despite the billions of pounds that have been invested, the investment fails to achieve the goal of protecting the poor from poverty. What is also quite obvious is that this growth in benefit dependency is not helping those who are being parked there and is unsustainable for the ever shrinking number of people who are paying for it. Put simply, Britain cannot afford this increasing welfare dependency whilst those who have become welfare dependent have more dignity than to want to stay that way.

Something has to give.

---

[22] Eurostat
[23] 'Severe poverty' is defined as 40% of the median income.
[24] Others may also be entitled to benefits; but this is a consequence, rather of taper rates than of their being in poverty
[25] "Monitoring Poverty and Social Exclusion," New Policy Institute/Joseph Rountree Foundation, 2005, p. 42.
[26] "It's All About You: Citizen-centred Welfare," Edited by Jim Bennett and Graeme Cooke, IPPR, September 2007.
[27] DWP, "Quarterly Statistical Summary," May 2008, Table 1.1, p. 4
[28] Moussa Haddad, "The Incapacity Trap," Social Market Foundation, 2005, p. 6.
[29] Total Managed Expenditure on "social protection" (including pensions) was £199 billion, out of a total managed expenditure of £623 billion. , HM Treasury, Pre-Budget 2008

Without proper reform it is the young who will have to pick up the lions share of the tax burden, with none of the benefits, and they will, "lose half their pay to taxes".[30]

If we were in any doubt, let's take a few moments to look even closer at just how ineffective much of this "investment" has been:

- £75bn has been spent on New Deal Programmes since 1997, including the New Deal for Young People and the New Deal 25 Plus, both of which promised extra training and support for finding employment. Neither has had any significant long term effect

- Frank Field MP has estimated that a third of Incapacity Benefit claimants could be in work – a £2.2bn saving for taxpayers – but the system does not support them back into work

- The National Audit Office estimated that fraud and mistakes in the benefits system costs £2.6bn per year driven by the over complexity of the system alone

Policy has not just failed to get people into work and supporting themselves, it has also failed to change social patterns that entrench poverty and preserve problems for the next generation. The proportion of families headed by an unmarried mother is among the highest in Europe, and teenage pregnancies account for 7.1 per cent of all births in England compared to an average of 3 per cent in Western Europe.[31] One-in-six of the working-age population lack basic literacy skills and around half lack basic numeracy skills.[32] The government has missed its targets on reducing absences from schools and has ditched altogether the target for truancy. The latest figures show that the truancy rate – the number of days missed with no parental excuse – has increased to 0.94[33] per cent from 0.7 per cent.[34] This means 60,000 pupils played truant every day – despite the government spending £1bn on schemes directly targeting truancy. There is, as many on both sides of the political divide maintain, too much money spent on programmes that simply do not work and thus is wasted. For example:

- More than £1 billion spent since 2003 trying to reform the Child Support Agency
- The Government pledge to halve teen pregnancies by the end of the decade by investing £150m in schemes, yet teenage pregnancy has risen

[30] *Class of 2006: a lifebelt for the IPOD generation* by Nick Bosanquet, Professor of Health Policy at Imperial College London for the think-tank Reform. The report gives warning of the cross-over generation of people who pay the cost of the welfare state without being able to expect many of the benefits and labels them the IPOD generation: Insecure, Pressured, Over-Taxed and Debt-Ridden. Rising taxes and the overhaul of the pensions system mean that students starting at university in 2006 will be spending 48 per cent of their income on tax and other repayments until they are 35. By contrast, older people will not bear the cost of higher pensions and those over 47 now can still retire at 65.

[31] Department of Health (2009) *Health Profile of England 2008*, p. 37

[32] Skills for Life Survey, 2002-3

[33] http://www.telegraph.co.uk/news/uknews/1932403/Truancy-rates-hit-12-month-high.html

[34] NAO 2005.

Time for a comprehensive plan

Britain faces a set of severe challenges as we try to negotiate our way out of this deep recession. Unless the Government of the day is able to demonstrate that they have a credible plan to return the economy to reasonable levels of debt in the medium term, it could jeopardise our ability to persuade foreign investors to continue investing in the UK. First we have to recognise the enormity of the problem and not pretend that there is some 'magic' lever which will painlessly get us back on track. Those who seem to drift from one instant solution to another are deluding the public that such a solution can be found. For example, latest fashionable talk is of quantative easing as though that is the key. Yet as this paper conclusively shows, it does not. Even after embarking on that road, we will still face an unsustainable mountain of debt. Tough choices are what lie ahead and this paper sets them out.

Consider, for example, as we watch each set of economic figures revised downward, how much this drip drip process in government begins to resemble a company insolvency process with no one prepared to accept the full "horror" of the problem.

First the CEO is in denial, and then the constant small downward revisions go on, from external analysts and agencies (although they tend to be well behind the curve) to monthly management accounts showing a deteriorating position. In a corporate situation, the crunch comes when the board suddenly realises that it cannot sanction further drawing on credit lines, as there is no reasonable prospect of repaying them, or when the lenders refuse further credit once lines have been exhausted. To be clear, this can happen within 24 hours, as we saw so dramatically with Lehman Brothers last year. On Monday, it's OK, and on Tuesday, it's not OK. People can be traumatised by insolvencies because they shatter egos and act as a sudden reminder that the whole corporate edifice (with the CEO at its peak) is a delicate construct, based on confidence, and it can easily collapse, no matter how long it's been around.

In a government context, all of the above is just as relevant, but the trigger for a crisis would be the failure of a government debt auction. There would probably, although not certainly, be some warning signs. For example, one might see certain investors' appetite for debt auctions dropping off sharply, or one might see the spread demanded by investors rising sharply. One might even get a ratings downgrade.

Whilst this is an extreme scenario, it demonstrates that a well thought out, concerted plan is required **NOW,** not just to stem the tide of this recession but to get Britain out of her massive debt overhang without the IMF having to be called in.

Anything else is just the politics of denial.

12th February, 2009

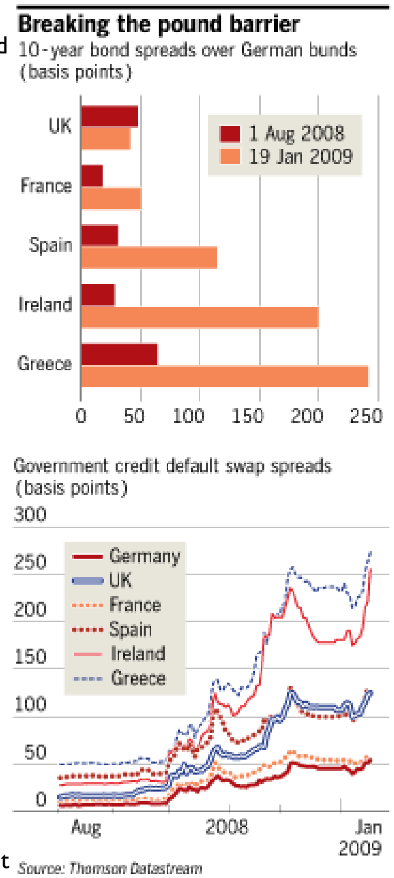
About the author

Malcolm Offord is a City fund manager with 21 years experience of advising and investing in both public and private companies. He is a member of the Advisory Board of the Centre for Social Justice and was a member of the voluntary sector working group which contributed to "Breakdown Britain" and "Breakthrough Britain". His paper "Bankrupt Britain" examines the public finances of the UK through the eyes of an investor looking at making an investment in a company. Malcolm Offord is also a trustee of Columba 1400, which works with young people from tough realities in Scotland, and has recently established his own family charity, The Badenoch Trust.

APPENDIX I

Pound foolish

Britain came off the gold standard in 1931, and sterling devalued by 28 per cent over the next year. The economic crisis that followed marked the end of the UK as a global power. It also led to an effective default on almost half the national debt, which was restructured into bonds still outstanding. Parallels with today are eerie. Since the middle of 2007, the trade-weighted pound has fallen by 27 per cent. Furthermore, as the government shoulders contingent liabilities for ever greater amounts of delinquent bank debt, worries are growing about the state's finances.



British banks have about £4,000bn of assets on their balance sheets, equivalent to 2.5 times gross domestic product. If losses on these assets accelerate, the banking bail-out could segue into a sovereign debt crisis. Investors might push up borrowing costs, then, if rattled, refuse to buy UK government debt altogether, triggering another run on the pound.

So far it has not panned out that way. Spreads of 10-year UK government bonds over German bunds tightened up to Christmas. This year, though, spreads have widened and the cost of insuring against sovereign default has risen. In the credit default swaps market, the UK is viewed as a riskier borrower than France and similar to Spain.

A back of the envelope calculation illustrates why. Assume the state takes ultimate responsibility for all of Britain's banks. Further, assume that 15 per cent of those banks' assets are worth nothing. The write-off would be equivalent to about £600bn or a third of GDP. Britain's debt to GDP ratio is about 54 per cent; add in these and other bail-out costs and the ratio could easily double. That would make the UK comparable to Belgium, Greece and Italy – none of which, as Merrill Lynch notes, has a triple A credit rating.

A downgrade could cost the UK dear. Investors obliged to hold only triple A paper would have to sell – as Spain may soon discover following its own rating downgrade yesterday. In another world, this might cause a run on the pound. In this world, however, sterling's saving grace is that no other currency, even the euro, is in a much better situation.

Source: The Financial Times, 20th January, 2009. Lex Column.

APPENDIX II

Painful medicine proved financial cure. Records just released show how crisis struck in 1976, write Chris Giles and Cathy Newman.

At the end of 1976, the economy was on its knees.

Inflation was still running at 14.7 per cent, even though it had fallen from its peak of 25.9 per cent a year earlier. Endemic trade and current account deficits threatened to send the pound into freefall as foreign capital was increasingly unwilling to finance Britain's international debts.

The public finances were in a terrible mess, with the public borrowing over 9 per cent of gross domestic product in 1975-76 and total government spending accounting for 49.9 per cent of gross domestic product.

Political leaders could not and did not attempt to hide the problems from the public and in the autumn of 1976 James Callaghan, the then prime minister, signalled a historic shift in economic policy.

Speaking at the Labour party conference, he said: "We used to think that you could spend your way out of a recession and increase employment by cutting taxes and boosting government spending. I tell you in all candour that that option no longer exists and, in so far as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step."

The next step was to steady the ship. Britain needed to finance its current account deficit in the short term in order to bring inflation better under control; bring public borrowing down; and reduce the importance of public expenditure in national income. Britain needed a lender of last resort so Denis Healey , the chancellor, turned to the International Monetary Fund for emergency funds.

He sought the ability to borrow foreign currency up to a total value of 3.3bn Special Drawing Rights - an IMF reserve currency, valued at £2.25bn in 1976 prices - and sent a letter of intent to Washington on December 15 1976, outlining the policy changes he agreed to implement if the money was forthcoming.

The letter details a strategy of emergency measures, including tax increases, brutal public expenditure control, tight money supply targets, a social contract with the unions to limit pay rises, elements of protectionism and investment incentives to improve the performance of industry, and the hope of North Sea oil arriving within a few years.

Much of the new economic strategy was public but the extent of the public expenditure reductions that Britain was proposing to the IMF were far more than was known by the public at the time. Mr Healey committed the government to reduce borrowing from 9 per cent of GDP in 1976-77 to "about 6 per cent in 1977-78".

The documents released under the Freedom of Information Act show that the following week was characterised by fevered diplomatic negotiation.

Britain received firm support from the US and West Germany, but faced tough questions by staff at the Organisation for Economic Co-operation and Development, who doubted, quite correctly with the benefit of hindsight, the ability of the UK's social contract and monetary targeting to bring inflation down. The Labour government and its social contract were killed by the strikes of the winter of discontent of 1978-79.

One of the most interesting documents is a secret government forecast for the economy of the effects of the IMF package. The government was agreeing to austerity measures and it knew that meant higher unemployment. It secretly forecast unemployment rising from 1.3m at the end of 1976 to an unheard of 1.9m by 1978.

That was the price of the fiscal and monetary probity that the IMF was bringing to Britain. The quid pro quo was that the government expected inflation to fall to 8.5 per cent by 1978 and the current account deficit of Pounds 2.3bn to turn into a Pounds 2.9bn surplus within two years.

History suggests the package was successful in bringing down borrowing, turning round Britain's chronic trade problems, but at the price of persistent high unemployment for almost a decade.

It was painful; it almost certainly contributed to the downfall of the Callaghan government; but in installing a first dose of discipline into economic policy-making for a generation; and in the recognition that international trends could not be bucked, recourse to the IMF laid the foundations for Britain's relative economic success in the 1980s, 1990s and in this decade.

By CHRIS GILES and CATHY NEWMAN

Source: The Financial Times , 10th December 2005