Policy Discussion Paper No.3

A Sovereign Wealth Fund (SWF)

Introduction

This paper addresses the problem of funding our ever increasing National Debt, now over £2 trillion, together with even greater unfunded state pension liabilities, probably over £4trillion now, as well as the long term possibility of using investment income rather than taxation to fund public services. The failure of government since interest rates first hit the floor ten years ago to start such a fund is a matter of the grossest negligence as the figures below indicate.

The National Debt

The National Debt is currently costing the taxpayer just over £50 billion a year in interest, which is about 2.5% of GDP – a very significant figure in excess of our entire defence budget for example. Yet is has been kept down to this level quite fortuitously by the very low level of interest rates which have been in force since the banking crisis in 2008. The government can currently borrow 30 year money for well under 3% simple interest, whereas historically there have been times when it has cost three or even four times this amount. At some point interest rates will rise again and if we still have this level of national debt the cost to the taxpayer will become astronomical.

The State Pension

The basic state pension now costs the taxpayer around £100 billion a year. That's well over 10% of the entire central government budget as it is a pay-as-you-go unfunded scheme. This burden is set to increase still further as the population becomes proportionately older. The government is currently depending on a combination of population growth through immigration and welfare payments (breeding for benefits) and inflation as part of a sort of Ponzi scheme, but we don't want either of those factors anyway, let alone as part of any Ponzi scheme.

The Burden of Taxation

Many argue that the burden of taxation is too high anyway, with some going as far as saying that all taxation is theft! Whilst I don't personally agree with that (try earning a living on a desert island!) I certainly sympathise with the general desire. One alternative source of funding for government expenditure in the long term (post 21st century) is investment income from an SWF.

Quantitative Easing

This is a mirage, a false hope that is persuading a number of people to brush this whole issue under the carpet and spend wildly on infrastructure and other things. Quantitative easing works if money (credit) has been destroyed or if its velocity of circulation reduces, but otherwise will just cause inflation. Zimbabwe and Venezuela are cases in point.

Since the banking crisis we have witnessed the destruction of credit first by the banking crisis itself as bank debts turned bad, and also through our ever increasing trade deficit with the EU. Now in addition we have the Covid pandemic which is creating havoc with supply chains as some business go bust. So QE will validly be around for some time to come, which means it could also be used to underwrite the issue of government bonds to fund an SWF. As interest on QE funded money costs nothing (the Bank of England just writes it off) the net cost to an SWF would be even lower.

<u>How would it work?</u>

Each month the Government Broker would issue new long-term bonds, typically 30 year, to raise money to pay into the fund. Starting at perhaps £1 billion per month and paying no more than 3% maximum, allowing the issue to fail if the market demands more, but with the issue underwritten by QE up to a maximum of 25% provided inflation remains below its 2% target, the amount would be increased by say £0.5 billion each month until the QE required to underwrite them becomes unsustainable, and vice-versa. This ensures the simple interest cost is never greater than 3%, but the rate of investment would unavoidably be uncertain and may cease altogether if interest rates rise too far.

These funds would then be farmed out to a large number of asset managers across the City and elsewhere. A nominal management cost limit of 0.25% of funds in management should be achievable, but in any case the performance of the managers would be measured by the net returns they deliver and the best performers rewarded with greater further funding. This gives them an incentive to cut management costs to a minimum.

Let's assume that around £3 billion of funding is raised each month – say £35 billion a year or £100 billion over three years. Over the past twenty years average returns by most fund managers have been over 5%, with some as high as 10%. 5% compounded quadruples your money over 30 years. Thus for each £100 billion raised at the end of 30 years you would be left with about £150 billion free after all capital and interest repayments. By year 60 that would be £600 bn, by year 90 £2.5tn, and by year 120 £10 trillion. Minimum!

<u>How would it be used?</u>

The enabling legislation would have to make sure that future irresponsible governments of other parties could not abuse the funds! It should therefore specify that:

1. No withdrawals can be made until the fund has reached at least £100 billion,

2. Thereafter 1% of the state pension and 1% of debt interest costs may be borne by the fund each year for each £100 billion in the fund. Assuming also receipt of National Pension Contributions of about £25 bn that would cost approximately £1.25 billion out of returns of over £5 billion initially, allowing the fund to continue increasing from both growth and further new funding whilst at the same time delivering an increasing benefit to the taxpayer at a sustainable rate.

3. The National Debt itself need not be paid off so long as the cost of it is less than the return on the SWF. The Bank of England, as SWF manager, can make these decisions as it goes along to optimise returns.