Ten Economic Priorities

An agenda for an incoming government

Nigel Hawkins

The Adam Smith Institute has an open access policy. Copyright remains with the copyright holder, but users may download, save and distribute this work in any format provided: (1) that the Adam Smith Institute is cited; (2) that the web address adamsmith.org is published together with a prominent copy of this notice; (3) the text is used in full without amendment [extracts may be used for criticism or review]; (4) the work is not re–sold; (5) the link for any online use is sent to info@adamsmith.org.

The views expressed in this report are those of the author and do not necessarily reflect any views held by the publisher or copyright owner. They are published as a contribution to public debate.

© Adam Smith Research Trust 2009
Published in the UK by ASI (Research) Ltd.
ISBN: 1–902737–62–8
Some rights reserved
Printed in England

Contents

Executive Summary 5

Introduction 6

1 Decreasing public sector borrowing 9

2 Implementing cuts in public expenditure 10

3 Cutting taxes 11

4 Restoring the principles of sound money 12

5 Pursuing privatization opportunities 13

6 Reducing public sector pension liabilities 14

7 Unscrambling PFI deals 15

8 Managing major procurement projects 16

9 Introducing stress testing for key banks 17

10 Unwinding the APS 18

Summary of policy recommendations 19

Appendix I - World banking data 20

Appendix II - Trends in UK total managed expenditure 21

About the author 22

Executive Summary

With a UK general election due by early June 2010, this report puts forward 10 key economic policies that the next government should adopt to address the truly appalling state of the UK's public finances, which was so graphically demonstrated in April's Budget.

Net public sector borrowing is now forecast to soar to £175 billion this year, whilst public sector net debt (PSND) is projected to reach £1,370 billion in 2013/14 – equivalent to 76% of forecast GDP – compared with £527 billion in 2007/08.

For 2009/10, the government plans to issue £220 billion of new gilt-edged stock, equivalent to an astonishing £8,800 per UK household.

To restore the UK's public finances, the 10 economic priorities for the next government should be:

1. Decreasing public sector borrowing;

2. Implementing cuts in public expenditure;

3. Cutting taxes;

4. Restoring the principles of sound money;

5. Pursuing privatization opportunities;

6. Reducing public sector pension liabilities;

7. Unscrambling Private Finance Initiatives (PFI) deals;

8. Managing major procurement projects;

9. Introducing stress testing for key banks;

10. Unwinding the Asset Protection Scheme (APS).

Introduction

UK macro-economic impact

The combination of a sudden and deep recession, which is expected to see a fall in GDP of well over 3% this year, and the recent banking crisis has had a profound impact on public finances, which have deteriorated alarmingly in recent months.

Net public sector borrowing is now projected to reach £175 billion this year – a figure which has risen by no less than £57 billion between the Pre-Budget Report last November and the Budget Statement itself in April.

In terms of the Public Sector Net Debt (PSND), the government confirmed a projection of £1,370 billion for 2013/14, a staggering figure which is imposing heavy financial liabilities on future generations. By comparison, the PSND in 2007/08 was £527 billion. Hence, on these figures, there will be an increase of 160% in just six years – a clear demonstration that control of public finances has been lost.

Furthermore, there is a view held – both by the IMF and many leading economists – that the government's economic growth forecasts for 2010/11 of 1.0-1.5% and for 2011/12 of 3.25-3.75% are decidedly optimistic. If these fears are realised, the net public borrowing figures would be considerably worse.

For 2009/10, the government has confirmed that it plans a gross gilt issuance figure of £220 billion, a quite unprecedented amount. In addition, it plans to raise Treasury Bill stock issuance from £21.6 billion in 2008/09 to £65.6 billion for this year.

The Table below shows how the government plans to split its £220 billion gilts issuance programme.

Given the colossal size of the gilts issuance programme, there will be real concerns about its ability to be financed.

On a best case scenario, the programme will be financed – but at the expense of far higher real interest rates, as investors demand a higher return. Consequently, interest rates would be driven up, all the more so if the UK's much treasured AAA sovereign credit rating is downgraded.

On a worst case scenario, the gilts issuance programme attracts insufficient investors and, in effect, cannot be met. On that basis, there would probably be very substantial cuts in public expenditure and a loan application to the IMF; this would repeat the 1976 experience but would require a far larger IMF loan and much deeper cuts in public expenditure.

Whilst this report focuses on some key macro-economic issues, it also puts forward various proposals to deal with the wide-ranging impact of the ongoing financial crisis – and to ensure that such a scenario can never be permitted to recur.

Inevitably, the role of the banking sector, both in the US and in

Maturity	Amount (£bn)	Percentage (%)
Short (under 5 years)	74	34
Medium (5–15 years)	70	32
Long (over 15 years)	46	21
Index-linked	30	12

Source: Budget Report 2009

the UK, has had an immense influence on the 'boom and bust' economic scenario that the UK has experienced in recent years. The sums of public money needed to support the UK banking sector, especially Royal Bank of Scotland (RBS) and Lloyds, have been astonishing.

Moreover, both the combined £37 billion capital injection into these two banks and the potential liabilities arising from their combined £585 billion of assets placed into the Asset Protection Scheme (APS) are excluded from the government's ongoing net public sector borrowing and PSND projections.

The UK financial crisis

Over the last 18 months, the UK has undergone a profound financial crisis, which has now escalated into a deep recession. Many other countries have suffered similarly.

The collapse of Northern Rock in autumn 2007, which had been offering its 'Together' mortgages on the basis of a maximum 125% of the property's value, has been followed by a series of major financial failures. Eventually, Northern Rock itself was nationalized.

Other former building societies that had demutualized suffered similar fates. As their share prices collapsed, both Alliance and Leicester, and Bradford and Bingley were incorporated into larger financial institutions.

The UK's most prominent building society, the Halifax, merged with Bank of Scotland in 2001 to become Halifax Bank of Scotland (HBOS). Recently, HBOS controversially became part of Lloyds, one of two UK clearing banks that are now effectively majority-owned by the government.

However, the full impact of the UK's financial crisis was only revealed when both RBS and Lloyds needed massive injections of public money to boost their seriously depleted Tier One capital ratios.

Prior to any APS liabilities (see below), the Government has injected almost £37 billion of new capital into RBS and Lloyds to ensure their continuing viability. Despite this massive equity investment, the shares of both banks have fallen by over 80% since January 2008, which underlines the gravity of the financial crisis that they have faced. Currently, the government effectively owns majority stakes in both these banks. In the case of RBS, if the impact of the APS is included, its shareholding may exceed 80%.

In seeking to clean up their balance sheets, both banks agreed to participate in the government's APS, under which the latter has agreed to insure 90% of the relevant toxic assets, net of any first losses. In total, RBS and Lloyds have placed £585 billion of so-called toxic assets into the APS.

The UK's two other leading clearing banks have experienced less serious problems. HSBC, the owner of Midland but also a very prominent financial institution in the Far East, has performed solidly, despite its disastrous acquisition of the US-based Household International in 2003. Recently, it undertook a £12.5 billion rights issue, which attracted a 97% take-up rate. HSBC has also gained from a large influx of deposits transferred from other less financially secure banks.

In spite of intense market speculation, Barclays has not been required to accept government finance to boost its capital ratios. Whilst it did secure £7 billion of funds from Middle Eastern investors to strengthen its balance sheet, the government holds no direct stake in Barclays. Indeed, following the recent stress test by the FSA, which Barclays passed, the latter has now confirmed that it does not intend to place any of its assets into the APS.

The international financial crisis

It should be emphasised that many banks in other countries have suffered similarly from the prevalence of toxic assets and the more general shake-out in credit markets.

In the US, most leading banks have received capital injections, some via the Troubled Assets Relief Programme (TARP). Many US financial institutions were exposed to high levels of sub-prime lending, which created large portfolios of toxic assets tied up within Collaterized Debt Obligations (CDOs).

In 2008, following the US government's decision not to provide financial support for Lehman Brothers – formerly a leading Wall Street investment bank – several leading American financial institutions received heavy capital injections to ensure their continued viability. Some sector consolidation also took place.

The world's top insurance company, AIG, has needed a vast amount of federal funds to ensure its survival. And the two top housing finance businesses in the US, Freddie Mac and Fannie Mae, have also received massive injections of public funding.

In May 2009, the US government announced the results of the financial stress tests that the 19 largest financial institutions had recently undergone. They showed that ten of these 19 institutions

required a collective c£47 billion of extra capital to weather the worst case economic scenarios devised by the US Treasury.

By far the largest shortfall was identified within Bank of America. In its case, the US Treasury concluded it needed a further c£21 billion of Tier One capital in addition to the c£28 billion that it had already received via the TARP scheme.

Appendix I shows the market capitalisations of the world's 20 most valuable banks in both January 1999 and March 2009. The changes over this period have been dramatic. In particular, the very dominant US banks of the late 1990s have either been merged or have seen their market values fall sharply, even after the receipt of large injections of new equity. There are now just four US banks in the top 20 compared with 11 in 1999. Appendix I also shows the relative importance now of Asian-based banks, including those in China.

In Europe, many banks have either collapsed or have required substantial injections of public money to survive. Ireland's banking sector, along with that of Iceland, have been notable casualties. Eastern Europe is also experiencing deep-seated financial problems, with Hungary, Latvia and Ukraine being particularly exposed. Several of the worst affected countries are currently in discussions with the IMF, whose financial assets are being increased following the recent G20 summit.

Bank Regulation

This report proposes more effective regulation of the four clearing banks, which are crucial to the well-being of the UK economy. After all, the over-riding regulatory priority is that none of these four banks – Barclays, Lloyds, Midland (part of HSBC) and NatWest (part of RBS) – goes bankrupt.

There is a case for introducing an updated version of the second Glass-Steagall Act that was passed in the US in 1933 and partly repealed in 1999. This Act provided a clear distinction between deposit-taking retail banks and investment banks as well as preventing financial institutions from participating in both banking businesses. Retail banks were effectively protected, investment banks were not.

Whilst there are undoubted attractions in returning to this model, there is no doubt that it would be immensely complicated to regulate, given how much international banking relationships have developed in recent years.

Instead, there is a compelling case for subjecting each of the four clearing banks – each of whom the government has implicitly agreed to protect – to periodic financial stress testing by the FSA.

The results should be placed in the public domain via a Regulatory News Service (RNS) announcement, with the key assumptions – used for the in-depth sensitivity analysis – being disclosed; these would include the ability of the bank to withstand a prolonged economic recession. The recent stress testing undergone by Barclays in the UK and by leading financial institutions in the US should serve as the template.

Imposing a general ceiling on the size of a mortgage as a percentage of a property's value – by setting a maximum Loan-To-Value (LTV) figure – also holds attractions; it could only be waived in exceptional circumstances.

It is also very clear that many banks have given insufficient attention to the views of their senior risk management executives, whose role in many financial institutions should be given greater prominence.

Some senior risk managers were clearly under pressure to approve risky deals, which would both boost short-term earnings per share for the financial institution concerned, and would give rise to substantial bonus payments for those directly involved. Undoubtedly, this short-termism has done real and lasting damage to the banking sector.

In terms of bonuses, this report recommends that particularly large bonus payments should be both signed off by the relevant Head of Human Resources and be subsequently published in the Annual Report alongside the directors' remuneration section, preferably with a brief explanation. To discourage short-term risk-taking, bonuses are best paid through deferred shares rather than in cash.

Finally, the next government should seek progressively to unwind the RBS and Lloyds assets within the APS over the next three years. By doing so, it should remove some of the tremendous uncertainty that has paralysed the UK banking sector over the last 18 months.

Once a substantial part of the APS portfolio has been wound down, the next government should start to reduce its shareholdings in both RBS and Lloyds. Only with the completion of both processes – APS liquidation (or something close to it) and predominantly private ownership of the two banks – can the banking crisis of the last 18 months be properly consigned to history.

Set out below are the 10 key economic policy initiatives that the next government should embrace, as matter of a priority, after the forthcoming general election.

1 Decreasing public sector borrowing

- For some years, the level of public borrowing has been uncomfortably high. Recently, the impact of the recession, especially in terms of plunging tax receipts, and large capital injections into the banks have seen borrowing levels soar.

- For 2009/10, the government is projecting net borrowing of £175 billion, which implies public sector net debt (PSND) of £792 billion (the cost of the financial interventions is excluded). As a percentage of GDP, this figure equates to 55%.

- The forward outlook is even more alarming. The government is forecasting a quite unprecedented PSND figure of £1,370 billion by 2013/14, which would equate to 76% of GDP. Furthermore, these projections are based on growth assumptions that are widely seen as being optimistic.

- Given this borrowing surge, reducing the overspend is a priority. Forecast net borrowing, as a percentage of GDP, for this year is 12.4%. When the UK last applied for an IMF loan in 1976, the relevant percentage was just 7%.

- To date, despite one small failed auction, the government has had little difficulty in funding its borrowing, which will rise sharply. Due to the financial crisis, demand for gilts remains strong, as the low yields imply.

- But the government's confidence in raising such massive sums could erode quickly, especially if foreign investors are dissuaded by a falling £ or if the UK's AAA sovereign credit rating is downgraded. Whilst Latvia's short-term financial plight is infinitely worse than that of the UK, its recent $101 million bond auction attracted no bidders.

- To reduce both public borrowing and to limit increases in the PSND, a return to economic growth and public expenditure cuts are needed. Policies to achieve these aims should be based on a medium-term financial strategy.

The next government should:

- Recognise publicly that current – notably the £220 billion gilt issuance programme for 2009/10 – and future planned borrowing levels are far too high.

- Draw up a medium-term financial strategy that seeks to return public borrowing to more sustainable levels.

- Accord a high priority to retaining the UK's much sought after AAA sovereign credit rating, without which funding the massive debt requirement would be even more challenging.

2 Implementing cuts in public expenditure

- The level of public expenditure has soared in recent years, reaching a projected £671 billion in 2009/10 – it is no surprise that borrowing levels have risen very sharply. For 2009/10, the government is assuming public borrowing of £175 billion.

- Based on 2007/08 prices, Total Managed Expenditure (TME) has risen from £360 billion in 1990/91 to £583 billion in 2007/08 – further details of this trend are set out in Appendix 2. To finance this very large increase during a recession is immensely challenging; to date, little effort has been made to curb the growth in public expenditure.

- Health and education represent the largest elements in Departmental Expenditure Limits (DEL), which account for a projected £387 billion of public expenditure in 2009/10. Including capex, the total figure for the NHS in England is £104 billion.

- In the Annually Managed Expenditure (AME) segment, which is expected to cost £284 billion in 2009/10 but is very sensitive to the state of the economy, social security is the dominant element, accounting for an estimated £165 billion: tax credits should cost a further £22 billion.

- Progressive across-the-board cuts in public expenditure – with a very few prescribed exceptions – over an extended time period would return public finances to equilibrium and reverse the surge in public borrowing. Such a policy could be implemented over a five-year period.

- With TME – including net investment – projected to exceed £670 billion this year, a 3% cut would equate to annual savings of c£20 billion. However, as PSND increases, debt interest payments, which are excluded from the TME figure, are likely to rise materially.

- In seeking these cuts, specific attention should focus on areas where public expenditure controls are lax. They include key elements of social security, local government expenditure, especially excessive staffing levels, and the MOD procurement division.

The next government should:

- Adopt a top-down approach to reducing public expenditure by implementing across-the-board departmental cuts – with very few exceptions.

- Aim to deliver progressive real cuts in TME (excluding debt interest) of c3% per annum over the medium-term period.

- Place special emphasis on tackling the soft element of public expenditure, including social security, local government and MOD procurement.

3 Cutting taxes

- Any resolve to cut taxes has been superseded by the surge in the levels of public expenditure. While the basic rate of Income Tax has – so far – been protected, yields from other tax-related measures, including non-indexation of personal allowances and higher National Insurance (NI) contributions, have risen sharply.

- The evidence that lower taxes give rise to greater prosperity is persuasive, as shown by the Laffer Curve. The most successful economies over the last two decades have generally been those with low tax burdens and greater incentives to work.

- In the current environment, with escalating borrowing levels, major tax cuts are simply not feasible. However, as the level of public borrowing declines and public expenditure is curbed, the tax-cutting agenda should be resurrected.

- Over a period of some years, aside from any upratings of Personal Allowances, there should be a policy of progressive percentage cuts in the basic rate of Income Tax, perhaps on a 1% per year basis.

- A radical overhaul of the NI system is also desirable given that it has strayed so far from its origins. Effectively, NI contributions are an additional income-related tax and should be incorporated within the charging structure of Income Tax.

- In terms of corporate taxation, there is strong evidence that low tax rates drive economic performance, all the more so since investment has now become increasingly mobile. Hence, further reductions in the standard rate of Corporation Tax and lower employer NI contributions can only be beneficial to the UK economy in the long-term.

- Other more specific tax reforms should include the abolition of some taxes that yield minimal revenues and the introduction of carefully targeted measures to promote enterprise. Reforming the current oil and gas taxation regime to encourage activity in marginal North Sea fields is an obvious example.

The next government should:

- Re-introduce a tax-cutting agenda, once control of public finances is regained – cutting the quite excessive levels of public borrowing has to remain the priority.

- Reduce progressively the rates of Income Tax and radically reform the NI system.

- Seek to lower the standard rate of Corporation Tax, which should help attract mobile international investment.

4 Restoring the principles of sound money

- The unprecedented financial crisis persuaded the government to undertake various short-term policies that are inconsistent with normal financial prudence. The priority in autumn 2008 was unequivocal – to prevent the collapse of RBS, Lloyds and HBOS by injecting massive amounts of public money into their balance sheets.

- As the recession loomed, interest rates were brought down steeply – a key factor in the recent near 20% decline in the £/$ exchange rate, which has boosted UK exports. More recently, some quantitative easing, effectively increasing the money supply, has been undertaken.

- The sharp decline in interest rates, which has benefited the business sector and limited the major downside in the housing market, has heavily penalised savers, especially the retired, many of whom rely on income from their savings.

- Whilst these policy decisions can be justified – at least in part – the priority now should be to return to the principles of sound money that underpin successful economies. Such a scenario is critical, especially since inflation may reappear.

- Given the pronounced increase in most measurements of money supply over the last 18 months, including M4, close control of the money supply should remain a priority, especially since the impact of the £125 billion of quantitative easing undertaken to date is unclear.

- With soaring public borrowing levels, the return to sound money will require cuts in public expenditure, which has risen steeply. To date, few problems have been encountered in financing sharply rising borrowing – but this may change.

- Promoting the concept of saving, whose importance has declined in recent decades, should be a social as well as an economic priority. The level of interest rates should provide real incentives to savers – thereby restoring the savings ratio, which has fallen markedly on the back of the decade-long retail boom.

The next government should:

- Reassert the principles of sound money as a matter of priority.

- Reduce substantially public borrowing levels as well as providing greater financial incentives to savers.

- Exert close control over the money supply and react promptly to any materially adverse changes brought about by the quantitative easing programme.

5 Pursuing privatization opportunities

- During the 1980s and early 1990s, widespread privatizations were undertaken. With a few exceptions, this policy, which has been widely copied overseas, has generally proved successful. Major infrastructure improvements, greater efficiency, substantial consumer benefits and, in most cases, good shareholder returns have all been achieved.

- In the UK, there are still some businesses that are suitable for privatization. The ASI publication *Privatization: Reviving the Momentum* in March 2008 calculated that £20 billion could be raised through further privatizations. With weaker markets and some subsequent sales, the estimate is now around £10 billion.

- There is unfinished utilities business; Scottish Water, Northern Ireland Water and Dwr Cymru, currently a debt-financed not-for-profit company, are clear candidates for privatization. Given the defensive nature of water company earnings, their shares are likely to attract considerable support from potential investors.

- Royal Mail, despite its burgeoning liabilities from its defined benefit pension schemes, would also benefit from majority – as opposed to the present planned minority – private sector ownership. In particular, it would allow a sharp rise in investment to modernise its operations.

- Some transport businesses, including the larger Trust Ports and the Government's stake in London and Continental Railways, are suitable candidates. In time, Network Rail and London Underground should move to the private sector. Their complex structures – not-for-profit status and PPP financing respectively – are both inefficient and unsustainable.

- Within the media sector, both BBC Worldwide and Channel 4 are suitable for privatization. Given the heavy mark-down of media sector valuations, due primarily to plunging advertising revenues, lower valuations will result, especially for the cash-strapped Channel 4.

- In the medium term, once the Asset Protection Scheme (APS) has enabled RBS and Lloyds to discharge most of their toxic debt liabilities, it should be possible to undertake a progressive selling down of the Government's stake in these two banks.

The next government should:

- Implement a renewed privatization programme, including the sale of publicly-owned water utilities as well as BBC Worldwide and Channel 4.

- Transfer the Royal Mail into the private sector, whilst retaining its large pension liabilities within the public sector.

- Privatize the larger Trust Ports and work towards the eventual transfer of both Network Rail and London Underground into the private sector.

6 Reducing public sector pension liabilities

- Due principally to the pay-as-you-go funding of public sector defined benefit pension schemes – many covering NHS staff – a vast unfunded public sector pension liability has been built up.

- In 2006, this unfunded pension liability, which is excluded from the PSND, was estimated by the government at £650 billion. More recently, the Institute of Economic Affairs (IEA) has calculated a figure in excess of £1 trillion.

- Unlike major private sector companies, which under new accounting rules are required to treat their defined benefit pension obligations as a balance sheet liability, the government has declined to confirm the current value of its public sector pension liabilities. Nor, more importantly, has it sought to reduce substantially the liabilities resulting from its defined benefit pension schemes.

- There is now a stark difference with pension arrangements for the private sector. Leading FTSE-100 companies, including British Telecom (BT) and British Airways (BA), have taken vigorous action to curb their large defined benefit pension liabilities – these have risen recently mainly due to poor investment returns.

- Few defined benefit pension schemes are now on offer to new entrants – BP has recently announced plans to remove this option. Barclays has gone further by closing its defined benefit scheme to existing employees. Mindful of the impact on their balance sheet liabilities, this trend is likely to be followed by others, including possibly by Royal Mail.

- To reduce its defined benefit liabilities, the government has several options, including imposing higher employee contributions, which could be considered alongside any salary adjustments. Public sector employees could be obliged to work longer to qualify for the full pension entitlement, and benefit eligibility could also be scaled back.

- More radically, the government could undertake a progressive phasing out of defined benefit pension schemes for much of the public sector. Such a policy would be very controversial but would yield massive long-term savings. Furthermore, defined benefit pension schemes should generally not be on offer to new public sector employees.

The next government should:

- Commission an audit of its existing public sector deferred benefit pension liabilities.

- Introduce a range of measures, covering contributions and benefits, to reduce these liabilities over a 20-year period.

- Close its defined benefit schemes to new joiners, with a few exceptions, and seek to phase out its existing defined benefit schemes for most participants.

7 Unscrambling PFI deals

- Over the last 15 years, Private Finance Initiative (PFI) deals – a mix of public and private financing – have been widely used. Some are on-balance sheet, but some are treated as off-balance sheet investments. In the latter case, substantial liabilities have accrued, which the squeeze on private sector financing is increasing.

- Identifying the total potential public sector PFI liability is a challenging task. The Institute of Fiscal Studies (IFS) has calculated a figure of £130 billion of off-balance sheet liabilities relating to existing PFI deals.

- A large proportion of PFI deals have been used to finance the construction of new NHS facilities, especially hospitals, and for the road-building programme. Currently, the off-balance sheet projects are not properly accounted for within the Government's net debt figures.

- PFI has also been used to finance improvements in the UK's railway infrastructure: Network Rail has been a party to many of these contracts. Some of the liabilities are neither included within Network Rail's £22.3 billion net debt figure nor within the Government's own net debt projections.

- The collapse of Metronet in July 2008, which took on a £17 billion work programme over 30 years on the London Underground, has been an indictment of the highly complex PFI structure. Instead, the Government should design a more conventional financing system, preferably separating out the work on the three lines concerned – Victoria, District and Circle.

- During the era of a prospering economy, this lack of PFI accountability was less of a problem. But, as the economy deteriorates, private sector participation is falling and some bad debts will accrue – at a time when the UK's AAA sovereign credit rating is under review.

- In any event, in common with widespread concerns about excessive debt-related project-financing, the number of new PFI deals looks likely to fall, especially as the building sector is facing particularly serious financing problems of its own.

The next government should:

- Commission a full audit of existing PFI deals in order to determine its total off-balance sheet liabilities.

- Decline participation in any new off-balance sheet PFI deals, unless there is a compelling case to the contrary.

- Focus on drawing up a viable financial structure for major London Underground investments, particularly for the successor to Metronet and for the Crossrail project – assuming the latter is not either deferred or cancelled on cost grounds.

8 Managing major procurement projects

- In the run-up to the Olympics in 2012, notwithstanding other procurement projects, efficient management will be crucial. According to the Taxpayers' Alliance, which analysed 305 public sector projects completed since 2005, there was an average over-run of a third, costing £23 billion.

- Gross mismanagement of public sector procurement projects is not new. The notorious Tanzanian groundnuts scheme, Concorde, the Channel Tunnel, the Millennium Dome and the West Coast Main Line (WCML) upgrade all experienced heavy cost and time over-runs. The NHS IT scheme is the latest in this infamous list.

- In many cases, there is insufficient information in the public domain. Hence, with a few obvious public interest-related exceptions such as the Trident submarine upgrade, an easy-to-read summary of the key procurement specifications should be published, along with the most important financial sensitivities.

- Bidders for a substantial element of these projects should also be required to publish on-line the key details – especially price and delivery - of their offers, which should be signed off by the relevant Chief Executive/Financial Director.

- Within the Civil Service, it should be made abundantly clear that considerable accountability, in terms of career progression, will lie with those responsible for poor procurement decisions and any consequent over-runs.

- In addition, there should be a specialised large projects team within Government, which should oversee major procurement projects: private sector expertise should be a central feature of this team. Analysing the many shortcomings of the NHS IT programme, whose costs have soared, would also be productive for future procurement management.

- More specifically, there should be an urgent financial review of MOD procurement. Initiatives to reduce – or at least defer – some of the expenditure on such high-cost items as the Trident replacement, the aircraft purchasing programme, including the Typhoon orders, and the two aircraft carriers, due to enter service in 2016 and 2018 respectively, should then be undertaken.

The next government should:

- Tackle large procurement schemes head-on; in particular, high class management and accountability are vital.

- Oversee each major procurement project and react promptly before serious over-runs are incurred. The recovery of the WCML project provides a template of how to rescue large schemes where financial control had been almost lost.

- Undertake a financial review of MOD procurement as a matter of urgency, which would focus on the costs of the most expensive equipment programmes.

9 Introducing stress testing for key banks

- The totally unprecedented collapse of large parts of the UK banking system, with both RBS and Lloyds needing cash injections from the government of almost £37 billion, has demonstrated the failure of existing banking regulation.

- Re-introducing a Glass-Steagall distinction between retail deposit-taking banks and investment banks has been widely proposed. In today's international markets, it would be immensely complex and very difficult to regulate.

- Whilst there is some role for co-ordination of bank regulation within the EU, the thrust for far better supervision should be UK-based. Otherwise, there would be a real likelihood that bank regulation becomes lost within prescriptive EU bureaucracy and therefore is ineffective.

- Some of the proposals in the Turner Report place great confidence on pan-EU regulation; this approach seems optimistic. Like engineering, regulation is only as strong as its weakest point, which would cover those EU countries with very relaxed attitudes to financial regulation.

- Instead, there is a strong case for requiring each of the owners of the four clearing banks – Barclays, Midland (HSBC), Lloyds and NatWest (RBS) – to undergo periodic stress testing by the FSA. This process could be implemented initially on a three-year cycle basis as part of each bank's licence obligations.

- The template for this stress testing would be that used recently for the leading US financial institutions as well as that applied to Barclays, which was extremely rigorous: unlike the Lloyds and RBS stress-testing, there was less urgency. In fact, Barclays' share price has rallied strongly since these tests were undertaken as investor confidence has returned.

- The results of this periodic stress testing – and detailed analysis of the sensitivities that were used – should be placed in the public domain via a Regulatory News Announcement (RNS). The ideal timing would be prior to UK markets opening on a Monday morning so that action to address any very negative results could be undertaken over the preceding week-end.

- Other reforms to address the inadequate regulation of the banks in the past include the imposition of a maximum Loan-To-Value (LTV) mortgage ratio, which could be waived exceptionally; greater prominence for risk managers in banks; and the obligatory publication of very large bonus payments.

The next government should:

- Overhaul existing bank regulation, by focussing on the retail deposit-taking banks.

- Adopt the principle that UK banking regulation should be UK-driven – and not be dominated by prescriptive EU regulations.

- Require periodic stress testing of Barclays, HSBC, Lloyds and RBS, the owners of the four clearing banks.

10 Unwinding the APS

- In order to address the toxic asset issue that has been overwhelming some banks, the government established the Asset Protection Scheme (APS), under which the public sector will insure most of the value of the toxic assets placed into it.

- To date, both RBS and Lloyds, which now owns HBOS, have decided to participate in the APS. Neither HSBC nor Barclays, following the latter's successful financial stress testing, are expected to put any assets into the APS.

- The carrying value of RBS' toxic assets in the APS is £325 billion, many of which arose from the disastrous ABN Amro purchase. Lloyds has placed assets worth £260 billion in the APS, much of which relate to its acquisition of HBOS.

- Under the APS, the participating banks will pay the government an annual insurance fee. RBS and Lloyds will also be responsible for any first losses – up to £42.2 billion and up to £35.2 billion respectively. Crucially, 90% of any further losses will be paid by the government.

- As the economy recovers, the government will hope to sell off parts of the APS portfolio. The protection provided by the government against future credit losses from these toxic assets, allied to the unprecedented capital injections that the two banks have received, should provide both greater clarity and stability.

- Over the next three years, it is expected that the government will seek to unwind – and ultimately to liquidate - these APS portfolios. To a limited extent, the much smaller Swedish banking crisis in the 1990s provides a precedent.

- Once the APS risk has been markedly reduced – or even eliminated – the government's shareholdings in RBS and Lloyds should be progressively sold down. If market conditions are favourable, there may be a positive return on the vast sums of public money that has been invested to date.

The next government should:

- Manage pro-actively a down-sizing of the APS, which should produce disproportionate financial benefits.

- Aim for an eventual full liquidation of the APS, preferably with positive returns for the taxpayer.

- Sell down progressively its stakes in RBS and Lloyds, once market sentiment improves and the adverse impact of the APS has been heavily diluted.

Summary of policy recommendations

Issue	Policy Recommendation
Public Borrowing	Recognise publicly that borrowing projections are far too high
Public Borrowing	Draw up a medium-term financial strategy
Public Borrowing	Accord priority to retaining the UK's AAA sovereign credit rating
Public Expenditure	Adopt a top-down approach in reducing public expenditure
Public Expenditure	Aim to deliver cuts of c3% per year (real)
Public Expenditure	Tackle the soft element of public expenditure
Taxes	Re-introduce a tax cutting agenda
Taxes	Reduce progressively Income Tax and reform National Insurance
Taxes	Lower the standard rate of Corporation Tax
Sound Money	Reassert the principles of sound money
Sound Money	Reduce public borrowing levels
Sound Money	Exert close control over the money supply
Privatization	Implement a renewed privatization programme
Privatization	Transfer Royal Mail into the private sector
Privatization	Privatize some trust ports and, in time, major rail businesses
Public Sector Pensions	Commission an audit of existing public sector pension liabilities
Public Sector Pensions	Introduce measures to reduce public sector pension liabilities
Public Sector Pensions	Close schemes to new joiners and phase them out for current members
PFI	Commission an audit of PFI deals
PFI	Decline general participation in off-balance sheet PFIs
PFI	Design a financial structure for London Underground investment
Procurement	Manage major procurement programmes directly
Procurement	React promptly before large over-runs occur
Procurement	Undertake a financial review of MOD procurement
Bank Stress Testing	Overhaul bank regulation for retail banks
Bank Stress Testing	Adopt the principle of UK-driven bank regulation
Bank Stress Testing	Require periodic stress testing of the four clearing banks
APS	Manage pro-actively the downsizing of the APS
APS	Aim for full liquidation of the APS
APS	Sell down progressively the public stakes in RBS and Lloyds

Appendix I - World banking data

3 May 1999 Bank	3 May 1999 Market capitalization ($bn)	31 March 2009 Bank	31 March 2009 Market capitalization ($bn)
Citigroup *	150.9	Industrial and Commercial Bank of China	175.3
Bank of America *	112.9	China Construction Bank	128.7
HSBC ^	93.7	Bank of China	112.8
Lloyds TSB ^	72.0	JP Morgan Chase *	94.5
Fannie Mae *	69.6	HSBC ^	78.3
BancOne *	66.8	Wells Fargo *	62.1
Wells Fargo *	66.1	Mitsubishi UFJ Financial	56.2
UBS	63.4	Banco Santander	54.1
Bank of Tokyo / Mitsubishi	61.8	Goldman Sachs *	45.7
Chase Manhattan *	61.1	Royal Bank of Canada	40.3
Morgan Stanley Dean Witter*	55.1	Bank of America *	40.1
Credit Suisse	48.1	Bank of Communication	38.0
Barclays ^	45.8	BNP Paribas	37.5
First Union*	44.7	Westpac Banking	34.0
Charles Schwab *	42.9	Commonwealth Bank of Australia	31.5
Freddie Mac *	40.5	Credit Suisse	31.2
NatWest Bank ^	38.8	China Merchants Bank	31.0
Banco Santander Central Hispano	38.2	Banco Itau	30.3
Sumitomo Bank	36.6	Toronto-Dominion Bank	29.1
Goldman Sachs *	32.3	UBS	29.0

*US Banks * UK Banks ^*
Source: Financial Times (as adjusted)

Appendix II - Trends in UK total managed expenditure

Year	Expenditure (£bn - 2007/08 prices)
1990/91	359.7
1991/92	379.5
1992/93	397.1
1993/94	403.5
1994/95	415.2
1995/96	420.0
1996/97	410.8
1997/98	408.1
1998/99	410.6
1999/00	417.5
2000/01	437.3
2001/02	457.4
2002/03	479.5
2003/04	504.3
2004/05	530.7
2005/06	553.5
2006/07	565.4
2007/08	582.7

Source: Budget Report 2009

About the Author

Nigel Hawkins is an investment analyst, who specialises primarily in the electricity, gas, water and telecoms sectors; he also covers several other sectors. He has worked in the City since 1988, notably for Hoare Govett (now owned by RBS), Yamaichi and Williams de Broe (now Evolution).

He is a regular feature writer for *Utility Week* and *Cleantech* magazines and frequently contributes to the financial media. In addition, he undertakes various research projects on energy, water, health and economic policies for Westminster-based think tanks and other organisations. He has written two previous publications for the Adam Smith Institute – *Privatization: Reviving the Momentum* and *Re-energizing Britain* – where he is a Senior Fellow.

Prior to joining the City, he worked for six years in politics, including three years as Political Correspondence Secretary to Lady Thatcher at 10 Downing Street. In 1987, he stood in the general election as Conservative Party candidate in Sedgefield against Tony Blair.

He was awarded a 2.1 degree in Law, Economics and Politics from Buckingham University and subsequently qualified as an Associate of the Institute of Chartered Secretaries and Administrators (AICS), whilst working as Export Sales Manager at Marlow Ropes, Hailsham, East Sussex.