1. **Introduction**

The Scottish Futures Trust was established in 2008, operating at arms’ length from the Scottish Government to improve the efficiency and effectiveness of infrastructure investment in Scotland by working collaboratively with public bodies and industry, leading to better value-for-money and ultimately improved public services.

The Finance Committee has invited views on the proposals in Chapter 2; Fiscal Framework of the UK Government command paper, *Scotland in the United Kingdom: An enduring settlement*. We have restricted our views to areas in which SFT’s particular perspective may be of most value namely:

- What additional borrowing powers for current spending and for capital spending should the Scottish Government have?
- What fiscal rules should be applied to these additional borrowing powers?

2. **Background**

The views below closely reflect SFT’s submission to the Smith Commission on devolved powers and infrastructure investment (Annex 1). The underlying principle is that Scotland should be able to determine the right level of infrastructure investment to affordably meet its economic and social objectives, and how this investment is both funded and financed.

The current limited powers for borrowing by the Scottish Ministers established by the Scotland Act 2012 (Section 32) are limited. SFT is interested in infrastructure investment and we therefore restrict our views to the proposals on borrowing for capital investment. The Act reserves control of the amount and nature of borrowing by Scottish Ministers, summarised in the Command paper as, “the Scottish Government [can] borrow (from the National Loans Fund, commercial lenders or through issuing bonds) to fund capital expenditure. Within an overall £2.2bn cap, the Scottish Government can borrow up to an additional 10% of its capital budget each year – in 2015-16 the Scottish Government can borrow around £300m”.

The Smith Commission Agreement included that, “The Scottish Government should also have sufficient borrowing powers to support capital investment, consistent with a sustainable overall UK fiscal framework. The Scottish and UK Governments should consider the merits of undertaking such capital borrowing via a prudential borrowing regime consistent with a sustainable overall UK framework”. A fuller extract of relevant sections is at Annex 2.

Chapter 2 of the Command Paper contains a number of references to borrowing powers but no proposed legislative amendments. Relevant extracts are at Annex 3.

3. **Views**

It appears that the proposal is to retain the cash cap on Scottish Ministers Borrowing at least until such a time as a “set of fiscal rules and robust institutional arrangements” are in place and to give “consideration” to something similar to the prudential regime for Local Authority Borrowing.

The Command Paper sets additional borrowing by Scotland as contrary to the no detriment principle. It states that, “A relatively higher level of borrowing in Scotland would mean that borrowing in the rest of the UK would need to be lower in order to meet a particular borrowing target and maintain market confidence”:
i. This statement pertains in circumstances when (as has recently been the case) the UK is at, or indeed beyond, the particular borrowing target it has set itself within its own fiscal framework. It could be questioned whether a set of powers intended for the long-term should be set so clearly by reference to statements based on this (hopefully) short-term situation.

ii. The statement aligns meeting overall borrowing targets with market confidence. This perhaps misses the distinction that many market participants make in taking differing views on borrowing to invest versus borrowing to spend, and many incorporating long-term obligations not counted as borrowing (and not constrained for Scotland – see SFT submission at Annex 1) into their assessment of confidence.

iii. With overall public sector net debt at £1,400 billion\(^1\), national PFI liabilities of around £33 billion\(^1\) and national pension liabilities estimated at £1,300 billion\(^1\), Infrastructure UK Guarantees of up to £40 billion\(^2\), any Scottish borrowing for infrastructure is unlikely to be of a scale to alter market confidence.

To provide flexible and meaningful support to infrastructure investment we suggest that it would be possible in the short-term, prior to the finalisation of fiscal rules and a consideration of a prudential regime, to:

1. Increase the cash borrowing limit under the 2012 Scotland Act to allow flexibility of financing approach. An increase to £7.5bn, around three times annual capital DEL, would credibly advance this aim and only potentially impact UK public sector net debt by 0.5% over a number of years.

2. Remove the annual limits set under the 2012 Act to further increase flexibility.

The effect of increased borrowing powers would be very significant. It would provide a real choice to current investment options such as NPD, it would allow wider innovation in areas such as providing guarantees to increase housing supply and would allow longer term planning and programming of infrastructure investment beyond the current restrictions of spending review periods.

We would further recommend when considering the longer term fiscal framework that:

3. A prudential regime based on affordability and transparency be developed. The current 5% cap used by the Scottish Government is one example of such an approach.

4. Consideration be given to how debt repayment is profiled over the life of an asset.

5. Investment plans be matched at the outset with suitable asset maintenance arrangements to ensure that the investment is sustainable.

6. Global best practice on prioritisation of investment be considered alongside the deployment of the new powers.

**Scottish Futures Trust**  
April 2015

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\(^1\) 2013-14 Whole of Government Accounts  
\(^2\) Cap set to December 2016
[The 2012 Scotland Act] situation restricts Scottish Ministers’ ability to utilise borrowing to finance investment which is ultimately funded from future DEL budgets. It restricts one of the financing tools which may be employed to facilitate investment at a chosen level.

Local authorities have substantially different controls over their powers to borrow. These powers are based in general on their own assessment of affordability, or ability to repay, codified through the Prudential Code for Capital Finance in Local Authorities. It appears inequitable that Scottish Government should have a cash value borrowing limit imposed as a reserved matter, whereas local authorities are essentially self-controlling under a codification of ability to repay.

Any limit on Scottish Ministers’ borrowing powers does not however remove all options to invest now and take on future repayment obligations. Since devolution in 1999 (and indeed before that time) Scotland has invested using various “revenue funded investment” structures including the Regulated Asset Base arrangements in the rail industry, historically the Private Finance Initiative (PFI) and more recently the £3.5bn Non-Profit Distributing (NPD) programme managed by SFT. Scottish Government figures show that over £6bn of assets have been financed through PFI and NPD contracts and that contracted payments (including capital repayment and service provision) exceed £1bn per annum. These programmes, both historic and ongoing, utilise different financing arrangements but must be afforded from the same ultimate funding streams as Scottish Ministers’ borrowing. They are clearly of a substantially greater scale than the capped borrowing powers about to be introduced. It appears inconsistent that borrowing powers, which could provide both flexibility and a lower cost of finance for investment, should have a cash value borrowing limit imposed as a reserved matter.

In that context, Scotland has already demonstrated prudence to determine a level of investment which it can afford to fund. It has committed to a limit on future revenue commitments in respect of capital investment at 5 per cent of its expected future annual DEL budget (Draft Budget 2015-16 Annex A). Within a broader framework for fiscal responsibility, and especially given the position of local authorities, there do not appear to be significant advantages to maintaining an arbitrarily set cash limit on Scottish Ministers’ borrowing. The advantages in changing the arrangement would be to give Scotland a wider range of financing choices for its infrastructure investment and potentially improve overall value-for-money.

We would therefore suggest that:

In the context of a broader fiscal responsibility framework, the reserved cash limit on Scottish Ministers’ annual and total borrowing is removed.
Borrowing Powers: to reflect the additional economic risks, including volatility of tax revenues, that the Scottish Government will have to manage when further financial responsibilities are devolved, Scotland’s fiscal framework should provide sufficient, additional borrowing powers to ensure budgetary stability and provide safeguards to smooth Scottish public spending in the event of economic shocks, consistent with a sustainable overall UK fiscal framework. The Scottish Government should also have sufficient borrowing powers to support capital investment, consistent with a sustainable overall UK fiscal framework. The Scottish and UK Governments should consider the merits of undertaking such capital borrowing via a prudential borrowing regime consistent with a sustainable overall UK framework.

(a) The Scottish Government’s borrowing powers should be agreed by the Scottish and UK Governments, and their operation should be kept under review in conjunction with agreement on the mechanism to adjust the block grant.

(b) Borrowing powers should be set within an overall Scottish fiscal framework and subject to fiscal rules agreed by the Scottish and UK Governments based on clear economic principles, supporting evidence and thorough assessment of the relevant economic situation.

SFT highlighting
2.2.6 Scotland’s fiscal position contributes to the overall UK fiscal position and has important consequences for UK fiscal policy. Where the UK Government has put in place a number of fiscal targets and limits (to ensure the public finances reach and remain at a sustainable position) fiscal decisions in Scotland would lead to trade-offs in the public finances for the rest of the UK. A relatively higher level of borrowing in Scotland would mean that borrowing in the rest of the UK would need to be lower in order to meet a particular borrowing target and maintain market confidence (and sustain a given level of interest rates). This would force a fiscal choice on the rest of the UK, either to lower spending or increase taxes.

2.2.7 An outcome which requires the citizens of one part of the UK to make a greater contribution to fiscal consolidation as a result of the actions of devolved government would be contrary to the ‘no detriment’ principles set out in the Smith Commission Agreement. Therefore the fiscal framework must require Scotland to contribute proportionally to fiscal consolidation at the pace set out by the UK Government across devolved and reserved areas.

2.2.8 A fiscal framework needs to be established so that actions across the authorities in the union will deliver the fiscal mandate set by the UK Government, while enabling the Scottish Government to exercise its devolved powers effectively.

2.4.25 The 2012 Act already provides the Scottish Parliament with specific powers for capital borrowing, as set out above. Increasing the Scottish Government’s ability to borrow to fund capital expenditure would lead to offsetting reductions in spending in the rest of the UK to remain within the UK’s overall fiscal rules (which are in place to keep the public finances sustainable).

2.4.28 Meeting the Smith Commission Agreement on sufficient additional borrowing powers will therefore depend on a number of factors and will be subject to discussion between governments. However, it is clear from international best practice that a set of fiscal rules and robust institutional arrangements will need to be in place to ensure that the overall UK public finances remain sustainable.

*SFT highlighting*