Summary

The financial reforms proposed in the Scotland Bill must be based on clear and objective principles to ensure that the new framework can remain fit-for-purpose over the long-term. The Scottish Government proposes that any borrowing framework for Scotland – whether through the Scotland Bill or through full fiscal responsibility – should be founded on a central principle: ensuring the long-term sustainability of debt obligations. This principle must inform the approach to capital and revenue borrowing respectively, and to the total stock of Scottish Government borrowing. The Scottish Government proposes that the rules governing the borrowing framework are written into the Scotland Bill.

Capital borrowing

The current proposals for capital borrowing set out in the Scotland Bill have been developed without detailed consideration or discussion of sustainability and affordability. There is an established consensus – among the Scottish Government, the Scottish Parliament, the House of Commons Scottish Affairs Committee and a number of independent experts – that the proposals in the Bill require enhancement and improvement in four key aspects:

- specification of annual limits on capital borrowing;
- a methodology for determining borrowing capacity that is sustainable over the long term;
- the term of repayments for capital borrowing; and
- the impact of the early implementation measures that are proposed.

The Scottish Government proposes that the framework for capital borrowing should be based on the assessment of overall debt sustainability, measured against the total resource base of the Scottish Government to service that debt. It is proposed that:

- borrowing equivalent to 2% of Scottish Government resources be permitted annually; and
- the stock of debt is capped at the equivalent of 20% of Scottish Government resources.

Illustrative modelling work by the Scottish Government shows that the annual and total limits proposed for capital borrowing are sustainable, robust to movements in general interest rates, and would provide a much more substantial economic lever to the Scottish Parliament.

The Scottish Government and the Scottish Parliament, by unanimity, are calling for early implementation of capital borrowing powers.

Revenue borrowing

Revenue borrowing powers are fundamentally linked to the wider proposals in the Scotland Bill for devolving and assigning taxation. The proposals in the Scotland Bill would effectively expose the Scottish Budget to cyclical fluctuations in revenue and embed a high degree of volatility in Scotland’s public finances.

The Scottish Government believes that significant amendments are required to the Scotland Bill provisions, and proposes this framework for sustainable revenue borrowing:

- revenue borrowing should be permitted to cover cyclical variations in income tax receipts, as well as differences between the forecast and outturn level of tax receipts;
- borrowing should be subject to a total limit of 5% of the Scottish Government resource base, in order to help provide a meaningful cushion against volatility in tax revenues; and
- repayments of revenue borrowing should be made over 5 years.

The Scottish Government does not seek borrowing powers to fund any structural deficit in the Scottish Budget and will seek to at least balance its revenue budget over the cycle.
Capital borrowing

1. Rationale for capital borrowing

International studies\(^1\) show that infrastructure investment is an essential contributor to productivity and economic growth. The accumulation of capital increases the potential output of an economy. In the short term, this can provide a boost to economic growth, total output and employment. Over the long term, capital investment, public and private, is a key driver of productivity, competitiveness, and long-term economic growth. Public sector investment that enhances a country’s physical, technological and digital infrastructure can increase the productive capacity of the economy and drive private sector growth and investment.

The Scottish Government is responsible for the vast majority of Scotland’s public investment, covering transport, water, health, education, local government, prisons, housing, regeneration, enterprise and environment. There is widespread agreement across the political spectrum that the Scottish Parliament should have full responsibility to determine the pace and scale of Scotland’s infrastructure investment programme, within a prudent and sustainable long-term financial framework. The Scottish Parliament should have substantial capital borrowing powers to fund productive expenditure for the following purposes:

i. **large, discrete projects or programmes** which because of their scale require a temporary increase in the level of investment. Projects such as the Forth Crossing will benefit several generations but in the absence of borrowing powers would impose widespread displacement of other investments in the short term;

ii. **delivering short term economic stimulus**, similar to the accelerated capital programme undertaken in Scotland in 2008-09 and 2009-10, and without the need to cut capital budgets while economic recovery is still fragile;

iii. **smoothing the medium term profile of investment in key public services**. Public capital investment in the UK has been subject to large swings and sustained under-investment. Borrowing could smooth investment and maintain capacity in key sectors; and

iv. **helping to lever in additional investment** from external funders. Government has a key role as lender and funder in areas such as renewable energy, enterprise, housing and regeneration where a small amount of public investment can leverage in significant additional investment from the private sector. As a result, borrowing powers will help leverage additional investment across the economy – a key issue when capital is scarce.

As a result of the decisions taken by the UK Government in the 2010 Comprehensive Spending Review (CSR), the capital budgets available to the Scottish Government will fall by 36 per cent in real terms between 2010-11 and 2014-15. This represents a cumulative reduction in real terms spending power of £4.1 billion over four years of the CSR; highlighting the sharp swings that infrastructure investment can be subject to. The speed and scale of spending cuts made by the UK Government significantly constrains the Scottish Government’s flexibility in managing its infrastructure programme.

It is vital that, while ensuring the overall sustainability of borrowing – at UK and Scottish level – Scotland’s capital borrowing facility has sufficient scale and is sufficiently flexible to enable the funding of productive investments over the long term. With greater authority over borrowing the Scottish Government would have greater flexibility to manage capital investment and to determine priorities according to needs of the Scottish economy and public services.

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2. **Scotland Bill proposals on capital borrowing**

**Overview of the current proposals**

The key provisions in the Scotland Bill in relation to capital borrowing state that:

“From 2015 the controls and limits applied to capital borrowing are the following:

- **Scottish Ministers** will be allowed to borrow up to 10% of the Scottish capital budget any year to fund capital expenditure; approximately £230m in 2014/15. The overall stock of capital borrowing cannot be above £2.2bn;

- **Borrowing to finance capital expenditure funded by a loan from the NLF** will be for a maximum of 10 years. However a longer timeframe may be negotiated, for example 25 years, if this better reflects the lifespan of the associated assets for example, in the case of the Forth Replacement Crossing.”

In a written statement of 13 June 2011, the Chancellor of the Exchequer and the Secretary of State for Scotland proposed the following changes to the Scotland Bill and accompanying package of capital borrowing powers:

- “Bringing forward to 2011 pre-payments, a form of ‘cash advance’, to allow work on the Forth Replacement Crossing to begin;

- **Introducing a power in the Scotland Bill which will enable the Government to amend, in future, the way in which Scottish Ministers can borrow to include bond issuance, without the need for further primary legislation.”**

Notwithstanding these new proposals, the annual limit on borrowing and the £2.2 billion limit for capital borrowing are both unchanged.

**Response to the Scotland Bill proposals on capital borrowing**

There is an established consensus among the Scottish Government, the Scottish Parliament, the House of Commons Scottish Affairs Committee and a number of independent experts that the Scotland Bill proposals for capital borrowing require substantial enhancement and improvement. On 9 June 2011 the Scottish Parliament held a debate on borrowing powers and growing the economy. The Parliament passed the following motion unanimously:

> “That the Parliament notes the Scotland Bill proposals on capital borrowing and the recommendations of the Scotland Bill Committee in that regard; calls on the UK Government and Scottish Government to undertake joint work to agree a clear, long-term and principles-based approach to capital borrowing and the sources of borrowing including the potential for bonds; recommends that the total limit should be set by reference to the capacity of the Scottish Government to finance debt prudently from devolved tax revenue, and calls for the implementation of capital borrowing powers at an accelerated timescale to that proposed in the Scotland Bill to support economic recovery and enhance Scotland’s infrastructure.”

The proposals tabled by the UK Government on 13 June 2011 offer marginal progress but do not challenge the basis of the consensus on the key provisions in the Scotland Bill. Analysis of the current proposals suggests that:

i. The framework has been developed without any explicit discussion of sustainability and affordability, and without offering any objective means to test these essential criteria.

ii. An annual borrowing limit of 10% of Capital DEL per year is arbitrary and does not offer sufficient additional spending power. There is no obvious justification for using the size of Scotland’s Capital DEL allocation as the basis of the Scottish Government’s annual borrowing capacity. Such a proposal would limit borrowing capacity when capital budgets are low and expand capacity when budgets grow; the opposite of what would be expected to be economically efficient.
iii. The proposed limit on total borrowing – set at £2.2 billion – is set too low to make a meaningful difference to the level of infrastructure investment the Scottish Government can undertake over the medium and long term.

iv. The UK Government has not proposed any objective criteria to determine the path of total capital borrowing capacity over time. This builds considerable uncertainty and discretion into the framework, which is not conducive to effective long-term capital planning and budgeting by the Scottish Government and Parliament.

v. The arbitrary mechanism that the UK Government has proposed for revising total capital borrowing capacity is inconsistent with basic principles of devolution and financial accountability. The Scotland Bill proposes that the borrowing limit can only be amended periodically by the Secretary of State for Scotland, with approval from HM Treasury and the House of Commons. A robust, objective long-term framework is clearly preferable.

vi. The central assumption of a 10 year repayment period for capital borrowing is inappropriate. Public capital assets may typically have a useful life of around 30 years; and far longer in the case of assets such as the new Forth Crossing. The term of repayments should match the economic life of the assets being financed.

vii. The early implementation measures proposed in the Scotland Bill and the recent Ministerial statement do very little to offset the huge loss in Scotland’s capital spending power; a reduction of £4.1 billion in real terms over the 2010 Spending Review period.

In summary, the UK Government’s proposals for capital borrowing require enhancement and improvement in four key aspects:

• specification of annual limits on capital borrowing;
• the methodology for determining the borrowing capacity that is sustainable, long term;
• the term of repayments for capital borrowing; and
• the impact of the early implementation measures that are proposed.

Reform of the financial framework for Scotland’s public finances must be based on clear and objective principles of sustainability to ensure that the framework can remain fit-for-purpose over the long-term. The next section considers how this can be achieved.

3. Developing a framework for sustainable capital borrowing in Scotland

Options for sustainable measures for public borrowing and debt

The Scottish Government proposes that the framework for capital borrowing should be founded on a central principle: ensuring the long-term sustainability of debt obligations. This concept of sustainability is at the heart of various regimes for controlling public debt; most notably in the UK Government and in the European Monetary Union (EMU).

In terms of annual borrowing, the UK Government has a forward-looking fiscal mandate to achieve cyclically-adjusted current balance by 2015-16. In relation to the total stock of UK public debt, the UK Government requires public sector net debt as a percentage of GDP to begin falling by 2015-16 at the latest. Budget 2011 also announced that “once the exceptional rise in debt has been addressed, a new target for debt as a percentage of GDP will be set, taking account of the OBR’s assessment of the long-term sustainability of the public finances”.

Separately, within EMU and under the provisions of the Stability and Growth Pact, Member States within the Eurozone have agreed to respect two criteria: a deficit-to-GDP ratio of 3% and a debt-to-GDP ratio of 60%. Notwithstanding the large increase in public debt across economies in the euro area since 2008, these two criteria remain the core provisions to ensure sound management of the public finances.
In summary, the UK and EMU frameworks for public debt seek to limit annual and total borrowing as a percentage of GDP. In each system, policymakers have substantial control over the scope and scale of taxation, and thus the revenue base available to service debt.

**A sustainable measure for capital borrowing in Scotland**

Even with the further devolution of taxation that the UK Government has proposed in the Scotland Bill, the Scottish Parliament will still not have substantial control over the scope and scale of taxation in Scotland. This would suggest that a GDP-based measure of public debt may not be the most appropriate measure of debt sustainability at this point.

The Scottish Government therefore proposes to measure the sustainability of its capital borrowing by reference to its ability to service that borrowing. Such an approach is consistent with the Scotland Bill Command Paper, which noted that: “capital borrowing will need to be self financed through increased revenue from taxation in Scotland or a reduction in public spending and the Scottish Government will need to describe in its budget how it will intend to meet the repayments.”

Under the Scotland Bill provisions, future capital borrowing by the Scottish Government could be serviced from:

- the block grant;
- the Scottish Rate of income tax;
- stamp duty, landfill tax, aggregates levy and air passenger duty – and potentially also corporation tax and excise duty; and
- other sources of income or receipts.

The Scottish Government proposes that, taken together, these funding streams represent the appropriate resource base against which to measure its ability to service capital borrowing. Within this framework, judgments on debt sustainability could be made by reference to:

(i) a prudent level of debt repayments to be funded annually from that resource base; and

(ii) a prudent total stock of capital borrowing (expressed as a share of the total SG resource base) which is consistent with a sustainable level of annual debt repayments.

Within this framework, long-term financial projections can be made – using clear and cautious assumptions – about the scale of future Scottish Government resources and the sustainable level of capital borrowing that could be serviced from those resources.

**Determining sustainable limits for capital borrowing in Scotland**

The question of sustainability of given levels of annual and total borrowing is closely linked to the budgeting treatment for that borrowing. Because the budgeting regime is yet to be confirmed by HM Treasury, this adds to the uncertainty associated with modelling long-term financial commitments and debt repayments. It is therefore suggested that the Treasury should clarify as soon as possible the budgeting treatment for capital borrowing.

Notwithstanding the uncertainty around budgeting, the Scottish Government has undertaken illustrative modelling on the scale of its future resources and the sustainable levels of annual and total capital borrowing that could be supported by those resources. For simplicity of the model, the basket of revenue streams outlined above is proxied by an estimate of Scottish Government Total DEL; i.e. total annual spending power. Making this assumption allows a consistent methodology to calculate the resource base: in this financial year; through the CSR; through the devolution of new taxes; and through several decades, to show the debt and revenue dynamics around long-term capital borrowing.
The central assumptions guiding the long-term modelling of capital borrowing are:

- the scale of the Scottish Government resource base, where Total DEL is used as a proxy;
- the length of term for repaying borrowing; and
- the interest rate(s) applied to borrowing.

In practice the length of repayment term and effective interest rate will vary for each tranche of borrowing. Nonetheless, prudent long-term assumptions can be made to inform the model.

The results of this modelling work undertaken by the Scottish Government suggest that:

- an annual limit on capital borrowing equivalent to 2% of SG Total DEL\(^2\) is comfortably sustainable over the long term. This conclusion holds where borrowing begins in 2011-12 and the Scottish Parliament chooses, over each of the next 15-20 years, to draw down the maximum amount of capital borrowing;
- assuming 30 year repayment terms and interest rates well in excess of current long-term levels, an annual borrowing limit of 2% of Total DEL would be consistent with a stock of total debt around 20% of Total DEL\(^3\). Thus this level of total debt is also sustainable; and
- increases in general interest rates of 300 basis points above the levels currently available through the National Loans Fund have a negligible impact on the assessment of annual affordability and overall sustainability of capital borrowing.

The Scottish Government is committed to operating within a robust and sustainable framework for borrowing and wishes to work with HM Treasury to implement this framework through the Scotland Bill. In summary, it is proposed that the Scotland Bill should set the following parameters for capital borrowing:

- the framework should be based on the assessment of overall debt sustainability, measured against the capacity of the Scottish Government to service that debt;
- borrowing equivalent to 2% of Scottish Government resources will be permitted annually;
- the total stock of capital borrowing will be capped at the equivalent of 20% of Scottish Government resources; and
- the framework should be implemented immediately following Royal Assent.

This framework offers a far more robust approach than the current proposals in the Scotland Bill. The proposed tests for annual and overall sustainability provide long-term flexibility and also certainty to the Scottish Parliament and Scottish Government about the capital resources that will be available. The judgment about how far those borrowing powers should be used; when; and for what purposes, will ultimately be for the Scottish Parliament to make.

4. Early implementation of capital borrowing powers

In May 2011 the Scottish Government received an overwhelming democratic mandate to secure greater economic powers from the Scotland Bill. The Scottish Government is bound to respond to this mandate and to secure early implementation of substantial economic powers for Scotland. This approach is consistent with the position of the Scotland Bill Committee and the Scottish Affairs Committee, which have advocated earlier implementation of capital borrowing powers to bring forward productive capital investment and promote recovery.

The UK Government has argued that the scale of the budget deficit limits the options for early implementation of capital borrowing powers for Scotland. In evidence to the Scotland Bill

\(^2\) Total DEL in the current financial year is £27.9 billion. 2% of this figure equates to £558 million.

\(^3\) Assuming an annual limit of 2% of Total DEL, a stock of debt equivalent to 20% of Total DEL would not be reached until 2026-27 at the earliest; assuming the full limit was drawn down each year. In 2026-27 the nominal value of Scottish Government Total DEL is projected to be £46 billion.
Committee, the Secretary of State for Scotland said: “In the short-term, however, coinciding with the spending review period that we happen to be in, and as we tackle the biggest deficit in post-war history or whatever it is, there will be particular constraints.”

The Scottish Government disagrees with this assessment, both in fact and on policy grounds. In policy terms there is a strong case for additional, immediate targeted economic stimulus through capital investment to strengthen recovery and expand the productive potential of the Scottish (and UK) economy. And in fact, the UK Government has a range of options available to bring forward substantial capital borrowing powers for Scotland, within the current CSR settlement. For example, the CSR settlement set out more than £35 billion of unallocated resources within the overall envelope, comprising £19 billion in the Reserve; an additional £6.6 billion in the Special Reserve (used to fund international operations); and £10 billion to cover overspends on Annually Managed Expenditure (AME).

The use of unallocated funds to support capital borrowing is only one option open to the UK Government within the current CSR settlement. Other options will also be available, including reallocating savings from (AME) programme budgets. Furthermore, if the UK Government chose, for whatever reason, to re-open the CSR envelope then further options would become available. The basic point is that there are no hard practical or technical obstacles to prevent early implementation of substantial capital borrowing powers for Scotland. Given the overwhelming political mandate and strong economic case for doing so, the UK Government should examine all available options and bring forward proposals as soon as possible.

5. Sources of capital borrowing

The Scotland Bill has confirmed that the government will be able to borrow from the National Loans Fund; and from commercial banks, where that offers value for money. In its statement of 13 June 2011 the UK Government also confirmed its intention to introducing a power in the Scotland Bill to allow the UK Government, without requiring further primary legislation, to enable Scottish Ministers at a future point to issue bonds to fund borrowing.

This provision would only remove one legislative obstacle to the issue of bonds, rather than grant the relevant power. The statement by the Secretary of State for Scotland also clarifies that HM Treasury would review the financing cost of bond issuance relative to other potential sources of Scottish Government borrowing, in order to assess any impact on UK borrowing.

Despite offering limited progress, the approach put forward by the UK Government remains deficient on two counts:

- The relative value for money of bond financing cannot be adequately tested, unilaterally, on a once-and-for-all, or even periodic, basis by HM Treasury. It is a dynamic rather than static test and the results will vary according to market conditions and Scottish Government funding requirements. The appropriate value for money tests must be conducted at specific times and for specific funding requirements, when considering the available options to finance borrowing. Thus these are judgments for Scottish Ministers rather than HM Treasury.

- The Scottish Government will be fully liable to meet the cost of debt repayments (whether through loans or bonds) from its revenue raising powers. Therefore no effect can be imputed on the impact of Scottish Government financing costs on UK public borrowing.

In summary, it is entirely appropriate for Scottish Ministers to consider the full range of debt instruments and to select for each tranche of borrowing the option which will best protect the interests of Scottish taxpayers. This position was endorsed unanimously by the Scottish Parliament and was a clear recommendation of the Scotland Bill Committee. The UK Government should not create legal or bureaucratic obstacles to prevent the Scottish Government from issuing its own bonds.

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4 Scotland Bill Committee Official Report, 3 February 2011, Col 389.
Revenue borrowing

1. Rationale for revenue borrowing

The 1998 Scotland Act already provides a limited power for short-term Scottish Government borrowing. The Statement of Funding Policy specifies that borrowing can be undertaken through the National Loans Fund, to provide "sums required for meeting temporary excess in expenditure over income or providing the devolved administration with a working balance." The maximum stock of borrowing permitted through this facility is £500 million.

The requirement for further revenue borrowing powers for the Scottish Parliament is the direct consequence of the substance of the proposals in the Scotland Bill for devolving and assigning taxation – and also the methodology that will be used to adjust for variations in actual Scottish tax receipts relative to UK Government forecasts. The Scottish Government has set out clearly our concerns about the inherent weaknesses in the Scotland Bill proposals.

The Scotland Bill Command Paper identifies the following purposes for revenue borrowing:

- to provide the Scottish Consolidated Fund with an appropriate cash working balance in case of temporary shortfalls between revenues and expenditure; and
- to provide the Scottish Government with the fiscal levers necessary to deal with deviations between forecast and outturn receipts.

The design of the Scotland Bill proposals for devolved taxation, and their economic and financial implications, are considered in the next section.

2. Scotland Bill proposals

Proposals to reform the overall funding framework for Scotland

The current funding framework for the Scottish Government, based on the Barnett Formula, does not provide the economic levers to use to the tax system to promote, and capture the benefits of, sustainable economic growth in Scotland. However the funding framework does provide a high degree of certainty about the scale of future Scottish Government resources over a three year Spending Review period.

The Scotland Bill proposes devolution of the following elements of taxation:

- from April 2016 the Scottish variable rate would be abolished and replaced with the Scottish Rate. This will enable Scottish Ministers to vary by 10p in the pound the basic, higher and additional tax rates on income;
- stamp duty land tax (SDLT), from April 2015; and
- landfill tax, from April 2015.

The proposals in the Scotland Bill would assign income tax revenues of around £4.2 billion annually and devolve SDLT and landfill tax – which have a combined revenue of £400 million – to the Scottish Budget. There would be a commensurate reduction in the block grant. The assigned income tax revenues which will form the basis of decisions on the Scottish Budget will be determined by forecasts, provided by the Office for Budgetary Responsibility (OBR), of Scottish tax receipts. These forecasts would then be reconciled with outturn receipts 12 months after the end of the financial year.

In summary, the Scotland Bill proposals on taxation and reforming the funding framework would effectively expose the Scottish Budget to cyclical fluctuations in revenue and embed a high degree of volatility in Scotland’s public finances. The proposals for revenue borrowing outlined in the Bill offer only a limited means of cushioning against these shocks.
Overview of the Scotland Bill proposals on revenue borrowing

The key provisions in the Scotland Bill in relation to revenue borrowing state that:

- “The Scotland Bill provides Scottish Ministers with the power to borrow up to £500m cumulative current debt to smooth the differences arising when outturn receipts from devolved taxes deviate from forecasts”.

- Scottish Ministers will be allowed to borrow to finance current expenditure up to £200m in any one year when: A temporary mismatch between tax and spending occurs during the course of the year, due to the irregular nature of tax receipts within that year.

- Scottish Ministers will be required to repay their loan within a maximum of four years.”

In a written statement of 13 June 2011, the Chancellor of the Exchequer and the Secretary of State for Scotland proposed the following changes to the Scotland Bill and accompanying package of revenue borrowing powers:

- Removing the requirement for Scottish Ministers to absorb the first £125 million of tax forecasting variation within their budget, giving Scottish Ministers more flexibility to decide how best to respond to any variations in tax receipts compared to forecasts;

- Allowing Scottish Ministers to make discretionary payments into the Scottish cash reserve for the next five years, up to an overall total of £125 million, to help manage any variation in Scottish income tax receipts compared to forecasts in the initial phase of the new system.”

Notwithstanding these proposals, the £500 million cumulative limit and £200 million annual limit for revenue borrowing is unchanged.

Response to the Scotland Bill proposals on revenue borrowing

The Scottish Government is looking for sufficient revenue borrowing powers that ensure budget stability. A range of proposals to strengthen the Scotland Bill provisions have been made by the Scottish Government, the Scottish Parliament, the House of Commons Scottish Affairs Committee, and a number of independent experts. Three principal shortcomings have been identified, and are discussed below.

The proposed annual cap and overall limits for short-term borrowing are inadequate

Under the Scotland Act the Scottish Government can already borrow up to £500 million to cover short imbalance between spending and revenue. Thus the scale of the current proposals has not kept pace with the scale of proposed change to the revenue and funding framework for Scotland. Recent financial outturns show the scale of the potential revenue risks to Scotland. An annual cap of £200 million borrowing would have been insufficient to offset falls of £400 million in 2008-09, minus £900 million in 2009-10, and an estimated minus £1 billion in 2010-11 relative to forecast. Moreover, the overall capital of £500 million would have been fully utilised if the downturn has lasted beyond a year.

In written evidence to the Scotland Bill Committee, Professors Hughes Hallett and Scott highlighted that over the period 1997-2007, the UK Government’s average forecast error on income tax receipts was an overestimate of 1.1%. If future forecasts by the OBR were also, on average, overly optimistic then the Scottish Government would be required to cut spending or to meet any shortfall in actual revenues from its own budgets.
Borrowing to offset forecast errors is not sufficient to offset cyclical fluctuations

Borrowing to offset forecast errors is not the same as borrowing to offset cyclical fluctuations. If the OBR were to accurately forecast a temporary reduction in revenues, perhaps as a result of a slowdown in the global economy, the Scottish Government would not be able to borrow to mitigate the impact on public spending. This is inefficient.

In written evidence to the Scotland Bill Committee, Prof Michael Keating stated that: “Borrowing powers are needed for three purposes: to deal with short-term shortfalls, which the present proposals provide for; to deal with cyclical downturns; and for capital investment. There should be more scope for borrowing to deal with cyclical downturns.”

The Scotland Bill Committee recommended that: “the Scottish budget should not be required to meet the cost if tax receipts fall below forecast levels. The Committee recommends that this condition be removed from the Bill.”

The repayment term should be extended to provide additional flexibility

Given the nature of fluctuations in revenue, the tight repayment period proposed could simply generate greater volatility in future budgets. For example, the £1.3 billion fall in 2008-09 and 2009-10 due to forecasting error would have to be repaid between 2011-12 and 2014-15, when the budget is being cut by around £3 billion. This highlights the risk that repaying high but necessary levels of revenue borrowing over a short time period could damage future economic growth. A longer repayment period, of five years, would be more appropriate.

In summary, the UK Government’s proposals for revenue borrowing require enhancement and improvement in three key aspects:

- the limits on annual and total revenue borrowing;
- the need to borrow to offset cyclical fluctuations in tax receipts; and
- the term of repayments for revenue borrowing.

3. Developing a framework for sustainable revenue borrowing in Scotland

Under the Scotland Bill provisions, future revenue borrowing by the Scottish Government could be serviced from:

- the block grant;
- the Scottish Rate of income tax;
- stamp duty, landfill tax, aggregates levy and air passenger duty – and potentially also corporation tax and excise duty; and
- other sources of income or receipts.

The Scottish Government proposes that, taken together, these funding streams represent the appropriate resource base against which to measure its ability to service revenue borrowing.

The Scottish Government proposes this framework for sustainable revenue borrowing:

- revenue borrowing should be permitted to cover cyclical variations in income tax receipts, as well as differences between the forecast and outturn level of tax receipts;
- borrowing should be subject to a total limit of 5% of the Scottish Government resource base, in order to help provide a meaningful cushion against volatility in tax revenues; and
- repayments of revenue borrowing should be made over 5 years.

The Scottish Government does not seek borrowing powers to fund any structural deficit in the Scottish Budget and will seek to at least balance its revenue budget over the cycle.