DEVOLUTION (FURTHER POWERS) COMMITTEE

AGENDA

6th Meeting, 2015 (Session 4)

Thursday 26 February 2015

The Committee will meet at 9.00 am in the Mary Fairfax Somerville Room (CR2).

1. **Decision on taking business in private:** The Committee will decide whether to take items 6 and 7 in private and all future Committee reports in private.

2. **Subordinate Legislation:** The Committee will take evidence on the Scotland Act 1998 (Modification of Schedules 4 and 5 and Transfer of Functions to the Scottish Ministers etc.) Order 2015 from—

   John Swinney, Cabinet Secretary for Finance, Constitution and Economy;


3. **Subordinate Legislation:** John Swinney, Cabinet Secretary for Finance, Constitution and Economy to move—S4M-12439—That the Devolution (Further Powers) Committee recommends that the Scotland Act 1998 (Modification of Schedules 4 and 5 and Transfer of Functions to the Scottish Ministers etc.) Order 2015 [draft] be approved.

4. **Evidence on Borrowing Powers** The Committee will take evidence from—

   Professor David Bell, Professor of Economics, University of Stirling;

   Don Peebles, Head of CIPFA Scotland;

   Philip Milburn, Investment Manager, Kames Capital and the Investment Association.

5. **Review of evidence (in private):** The Committee will review the evidence taken on borrowing powers at today's meeting.
6. Draft report on the sections 30 and 63 Order on votes for 16-17 year olds (in private): The Committee will consider a draft report.

7. Draft report on the electoral management of the Scottish Independence Referendum (in private): The Committee will consider a draft report.

Stephen Imrie  
Clerk to the Devolution (Further Powers) Committee  
Room T3.40  
The Scottish Parliament  
Edinburgh  
Tel: 85206  
Email: devolutioncommittee@scottish.parliament.uk
The papers for this meeting are as follows—

**Agenda Item 2**

PRIVATE PAPER  
DFP/S4/15/6/1 (P)

**Agenda Item 4**

David Bell Written Evidence  
DFP/S4/15/6/2
CIPFA Written Evidence  
DFP/S4/15/6/3
Investment Association Written Evidence  
DFP/S4/15/6/4
PRIVATE PAPER  
DFP/S4/15/6/5 (P)

**Agenda Item 6**

PRIVATE PAPER  
DFP/S4/15/6/6 (P)

**Agenda Item 7**

PRIVATE PAPER  
DFP/S4/15/6/7 (P)
Scotland’s Fiscal Framework under the Smith Commission Proposals

Professor David Bell
Division of Economics
Stirling Management School
University of Stirling

February 2015
Introduction

This paper discusses the approach taken to Scotland’s fiscal framework as laid out in the Smith Commission report and then subsequently interpreted in “Scotland in the UK: an Enduring Settlement”.

It considers the fiscal framework in general but focuses particularly on borrowing powers.

There are two key elements to a fiscal framework:

- the rules by which fiscal policy is governed
- the institutions which oversee these rules

The role of the fiscal framework is to maintain a sustainable fiscal policy. A breakdown of fiscal sustainability can have serious economic and social consequences. The current events in Greece are a salutary lesson of the need to maintain fiscal sustainability.

I have relatively little to say on the institutional framework, other than to argue that, rather than following the UK approach – i.e. the establishment of a “Scottish OBR” - it might be more suitable to take lessons from other countries, such as the USA, and embed the institution whose role is to support the fiscal framework within the Scottish Parliament. This would strengthen the role of the Parliament and also provide assurance of its independence from governmental influence.

Borrowing powers

Borrowing powers are an essential component of any fiscal framework. The relevant paragraphs from the Smith Commission report and the UK government response are set out in Appendices 1 and 2.

There are two types of borrowing:

1. borrowing to deal with volatility in current revenues
2. borrowing for investment in capital projects

Borrowing has to be sustainable. Politicians have an electoral incentive to increase borrowing since increased spending may improve their chances of re-election. Further, they may not incur the costs of such borrowing which may fall on future generations.

Hence, borrowing to cover current (resource) spending should only be for short-term purposes to deal with unexpected variation in tax receipts. Borrowing for investment purposes will create assets which benefit future generations. Obviously future generations have no power to influence these decisions. The assessment they will make of the costs and benefits of investment by their predecessors cannot be known with certainty. Thus, for example, the building of the new Forth road bridge may be viewed in the future as a wise
investment in Scotland’s road infrastructure or as an unnecessary cost if there is a steep decline in road traffic.

These two types of borrowing were dealt with by the Scotland Act 2012, which provides that the Scottish Government can borrow from the National Loans Fund, commercial lenders or through issuing bonds to fund capital expenditure. Specifically, it can borrow up to 10% of its capital budget each year subject to a £2.2 billion cap. For example, this would enable it to borrow £300 million in 2015-16. We deal with revenue and capital borrowing in turn.

**Borrowing for Revenue Volatility**

To cover volatility in tax revenues, the Scottish government can operate a cash reserve. Clearly it can make savings through underspending its current DEL allocation and it can borrow up to £200 million per year up to a £500 million borrowing limit.

The notion of a cash reserve is somewhat analogous to the End Year Flexibility (EYF) process which used to be operated by the Scottish Government. Treasury rules have always prevented departments from overspending their allocated DEL budgets. It was therefore common for departments to underspend. This created unspent cash reserves which were known as EYF. These could be substantial. In 2000-01, Scotland’s EYF was £718 million. Departments were permitted to retain a proportion of these which reduced the pressure for unnecessary end of year spending and accommodated slippage in spending on capital projects. In effect, EYF played the role of a cash buffer to deal with short run volatility in departmental spending.

Once the Scotland Act 2012 comes into force, there will be an additional source of volatility, namely unexpected variation in tax revenues. This volatility will grow as Scotland becomes more dependent on its own revenues. So the implementation of the Smith proposals would increase substantially the potential volatility in Scotland’s revenues. Hence the provisions to deal with that volatility will also have to increase. This might suggest that the £200 million limit is relatively modest, since it was designed for a different revenue structure.

The additional source of volatility will centre around the independent forecasts of Scotland’s tax revenues. The Finance Secretary will be obliged to use these forecasts as the basis for the Scottish Budget. If the forecasts are incorrect, the budget could be in surplus or deficit at the year-end. The Finance Secretary would then have to adjust the budget for the following year to take into account the overspend or underspend from the previous year. Clearly borrowing will only be required in the case of an overspend.

Consider the experience of the UK economy before the beginning of the Great Recession. This illustrates the dangers associated with errant forecasts. Figure 1 shows the forecasts of income tax revenue made by the UK government at the time of the 2007-08, 2008-09 and 2009-10 budgets along with the outturn values. My focus is on income tax because that will be the major source of income to the Scottish Government if the Smith Commission
proposals are implemented. It indicates that there was a considerable error in forecasting income tax revenues. The 2008-09 budget forecast income tax revenues of £160.1 billion: the outcome was £153.4 billion, an over-estimate of 4.4%. In terms of Scottish income tax revenue this would translate to an error of about £490 million.

The fall in income tax revenues in 2008-09 was among the most extreme shocks that the UK economy has faced in the post-war era. Perhaps lessons have subsequently been learned and such a large forecast error will not recur. Nevertheless, the recent dramatic decline in the oil price was not forecast in last year’s budget. It could potentially have a significant effect on Scotland’s income tax revenues in 2015-16 and if the shock were large enough it is possible that the £200 million annual buffer might prove too small if Scotland were in receipt of the entirety of income tax revenues.

![Figure 1: UK Government Forecast Errors for Income Tax Receipts](source)

The issues associated with volatility are discussed in “Scotland in the United Kingdom: An Enduring Settlement”. However, the mechanisms by which the size and design of the borrowing facility is not specified. Instead, they will have to be agreed “on the basis of the specific risks” that Scotland will face, given the funding arrangements and in particular its sources of revenue. This discussion has illustrated two of these risks - errors in forecasting spending and errors in forecasting revenues - that will form a key part of any such agreement.

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1 Scotland in the United Kingdom: An Enduring Settlement, Para 2.4.23
Borrowing for Capital Spending

The question of borrowing for capital spending is extremely complex. There are international lessons that can be learned from experiences of subnational government (SNG) borrowing. There are also important analogues that can be drawn with borrowing conditions applied to public bodies in the United Kingdom, including local government.

International lessons

It is relatively common for SNGs to experience fiscal distress. Even though fiscal frameworks are intended to minimise this risk and to ensure that national governments macroeconomic policies are not affected by fiscal difficulties at SNG level, such problems do occur.

Von Hagen et al (2000) describe four cases where national governments have bailed out SNGs. These involve Australia, Germany, Italy and Sweden. These countries are not generally thought of as being fiscally irresponsible, each has bailed out some of its SNGs.

Several key issues emerge from this study.

- The first is the “too big to fail” hypothesis. If a SNG is relatively large compared to the central government, it is difficult for central government to commit, ex ante, to refuse to bail it out. However, the evidence does not support this argument. Instead, it is more nuanced. Bailouts are thought to be more likely where SNGs are politically sensitive. Central government will not allow SNG’s to fail if the political cost is too high.
- A second theme is political favouritism. Bailouts are more likely where the central government and SNG shared the same political persuasion.
- A final theme is that institutions designed for the coordination of subnational fiscal policies must be aware of the need to balance the power of central government and SNGs, while also avoiding the need for bailouts.

UK local government

In contrast to the arrangements in other countries, local government in the UK is subject to the “Prudential Code for Capital Finance”\(^2\). Local authorities can borrow from the Public Works Loan Board which is part of the Debt Management Office and tends to offer the lowest rate of interest to local authorities. They can also borrow on the markets or float municipal bonds. Many local authorities therefore have credit ratings.

Such borrowing is not necessarily limited to capital. Under the local government act 2003 local government may borrow for any purpose for “the prudent management of its financial affairs”. Its aggregate borrowings are governed by CIPFA’s Prudential Code for Capital

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\(^2\) This discussion is largely drawn from House Of Commons Library (2014) "Local Government in England: Capital Finance"
Finance in Local Authorities, the purpose of which is to ensure that such borrowings are “affordable, prudent and sustainable”. Borrowing plans must therefore include forecasts and outcomes for the following indicators:

- Capital expenditure;
- Capital financing requirement – a measure that reflects an authority’s underlying need to borrow;
- External debt – gross borrowing and other long-term liabilities;
- Operational boundary for external debt – based on an authority’s working estimate of most likely, ie prudent but not worst-case scenario;
- Authorised limit for external debt – the intended absolute limit that has to be set by the full council. These are related to the revenue streams available, which influence their ability to repay debt.

The code is largely unspecific as to how these indicators are used, but does require authorities to draw up three-year rolling plans for capital expenditure. This process has obviated the need for individual consents for borrowing from central government.

At the end of 2012-13, English local authority external debt stood at £83.3 billion. This debt forms part of general government debt, which in turn forms part of the UK public sector debt. Debt incurred by the Scottish Government would also fall within UK public sector debt and therefore be relevant for international agreements that referenced national deficits or debt.

Both the debate about the international experience of capital borrowing by SNG’s and the UK experience of local government borrowing is relevant to the discussion that will have to take place between the UK and Scottish governments regarding the implementation of the Smith proposals. One key element of this will be the establishment of arrangements which prevent the UK government from bailing out the Scottish government in the case of fiscal difficulty. For this to happen, the fiscal framework and associated borrowing rules will have to be sufficiently flexible to cover as far as possible the fiscal difficulties that a Scottish Government might encounter.
References

APPENDIX 1: Extract From The Smith Commission Report Regarding Borrowing

Scotland’s Fiscal Framework

(5) 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 to accommodate the transfer of taxation and spending powers.

(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.

(6) Implementable and Sustainable: once a revised funding framework has been agreed, its effective operation should not require frequent ongoing negotiation. However, the arrangements should be reviewed periodically to ensure that they continue to be seen as fair, transparent and effective.

(7) Independent Fiscal Scrutiny: the Scottish Parliament should seek to expand and strengthen the independent scrutiny of Scotland’s public finances in recognition of the additional variability and uncertainty that further tax and spending devolution will introduce into the budgeting process.
APPENDIX 2: Extract From Scotland in the United Kingdom: An enduring settlement – Draft Scotland Clauses 2015

2.4.18 Borrowing by governments broadly falls into two categories. One is borrowing for current expenditure and the other is for capital expenditure. Current expenditure is day-to-day spending on public services such as the salaries of teachers and nurses. Capital expenditure is focused on investment in assets, such as the building of schools, hospitals and bridges. For reasons of inter-generational fairness, it is more common for governments (where they choose to borrow at all) to borrow to fund capital spending than current spending i.e. the assets funded by capital borrowing are paid for over the life of the asset by those who benefit from it, whereas current borrowing benefits people today but is paid for in the future.

2.4.19 Different reasons for borrowing will have different impacts on the debt position. Borrowing to finance expenditure to counteract a cyclical economic downturn would enable the government to smooth the impact of lower tax receipts in difficult times. Running an equivalent surplus in good times would offset this borrowing and lead to no long-term debt. On the other hand, running a persistent structural deficit would enable higher spending on public services (or lower taxation) but build up long-term debt.

Borrowing for current spending

2.4.20 A credible fiscal framework does not rely wholly on the provision or use of borrowing powers as there are other tools available to governments. A cash reserve or rainy day fund built up in good years when revenues are above forecast can be used to support the current budget where revenues are lower than forecast. Reprioritising spending can also reduce pressure on the overall budget, and taxes or other fees and charges levied by a government could be increased to address a shortfall in areas where there is less prospect of deepening a recession. Use of these tools instead of borrowing to fund current expenditure gives a government the means to ensure a sustainable fiscal position and support economic objectives particularly during a recession.

2.4.21 The Scottish Parliament’s borrowing powers for current spending (both the total amount of borrowing and the circumstances under which borrowing is permitted) following implementation of the Smith Commission Agreement will need to reflect the fiscal risks that the Scottish Parliament will be taking on in this devolution settlement. The precise risks will be determined by the funding model, which will need to be agreed with the Scottish Government, but the Smith Commission Agreement indicates that the UK Government should retain UK-wide risks (paragraph 95(8)) with the Scottish Government responsible for Scotland-specific risks in devolved areas.

2.4.22 The Scottish Government will not therefore be insulated from all risks, so will need tools to manage appropriate risks. If Scotland experiences an economic shock when the rest of the UK does not, the funding model would not provide the Scottish Government with additional funding to offset its lower tax receipts or higher spending pressures. The tools available to the Scottish Parliament (for example a ‘rainy day’ fund or appropriate borrowing powers) should therefore enable it to respond to such an event, meeting its spending obligations without increasing taxes significantly to balance the annual budget. Borrowing could be undertaken to respond to a shock, but a clear plan will be needed to repay the debt incurred in order to ensure a sustainable fiscal position. This could be in the same year in the case of small and one-off shocks, or over a longer period for deeper recessions.
2.4.23 The appropriate tools and powers of the Scottish Parliament will need to be calculated on the basis of the specific risks that it faces given the funding arrangements, and be consistent with economic principles. Depending on the funding model, the tools available to the Scottish Parliament should be sufficient to respond to its potential financial exposure, without the need for regular agreement between administrations based on specific economic developments.

**Borrowing for capital spending**

2.4.24 The Smith Commission Agreement recommended consideration of a prudential regime for Scottish Government capital borrowing, similar to that which has regulated local authority borrowing in England, Scotland and Wales since 2004.

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).

2.4.26 The prudential regime is governed by a code set out by the Chartered Institute of Public Finance and Accountancy in the Prudential Code for Capital Finance in Local Authorities. In Scotland, local authorities are required by regulation to have regard to the Prudential Code under Part 7 of the Local Government in Scotland Act 2003. Its purpose is to provide a framework for local authorities to take capital investment decisions based on the revenues available to the authority to meet the costs of borrowing.

2.4.27 The Prudential Code was introduced to replace a system of credit approvals being sought by local authorities from central government, which in turn replaced an allocation of funds from central government for capital expenditure. It was not aimed at increasing the amount of capital expenditure rather the Code improved the efficiency and clarity of decision making by local authorities about investment decisions. The application of a similar regime for the Scottish Parliament will be considered as set out in the Smith Commission Agreement.

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.
The Scottish Parliament Devolution (Further Powers) Committee:

A Submission by:

The Chartered Institute of Public Finance and Accountancy

February 2015
**CIPFA, the Chartered Institute of Public Finance and Accountancy**, is the professional body for people in public finance. CIPFA shows the way in public finance globally, standing up for sound public financial management and good governance around the world as the leading commentator on managing and accounting for public money.

Further information about CIPFA can be obtained at [www.cipfa.org](http://www.cipfa.org)

Any questions arising from this submission should be directed to:

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1. **Executive Summary**

1.1 This short submission focuses on borrowing and accountability. CIPFA has previously advocated and fully supports the introduction and implementation of enhanced borrowing powers for Scotland. We consider that any system should be underpinned by a prudential framework which is based on the principles of:

- Affordability;
- sustainability; and
- prudence.

1.2 The draft clauses contained in Annex A of the ‘an enduring settlement document’\(^1\) do not however provide for an extension to the existing borrowing powers contained in the Scotland Act 2012 or any additional clauses. We consider this to be an omission given the recommendations made by the Smith Commission in Paragraph 95(5) of their report\(^2\).

1.3 There is of course a cost to borrowing. The borrowing powers which currently exist under the Scotland Act 2012 if fully utilised could result in an annual cost to the Scottish budget of £288m within eleven years. As an indicator of scale, this equates to more than the proposed resource budget for 2015/16 on the full portfolio for Training, Youth and Women’s Employment.

1.4 The introduction of enhanced borrowing powers provides an opportunity to improve financial reporting to the people of Scotland at a national level. Enhanced financial information which for the wider Scottish public sector could be developed in the form of a ‘balance sheet for Scotland’ or a ‘whole of Scotland’ accounts.

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\(^1\) HM Government – Scotland in the United Kingdom: An enduring settlement 22 January 2015

2. The Prudential Borrowing Framework

2.1 CIPFA was at the forefront of the successful implementation of a prudential framework in local government across the United Kingdom. At that time, primary legislation was required to enable the introduction of a prudential framework. For example, the local government sector in Scotland has supporting legislation through the Local Government in Scotland Act 2003 (Part 7). Supporting regulations then require local authorities to have regard to CIPFA’s Prudential Code.

2.2 CIPFA would highlight that the main principles behind the prudential framework, as used in Local Government, are the affordability, sustainability and prudence of borrowing decisions. The framework supports improved strategic and asset management planning.

Affordability

2.3 The fundamental objective of affordability is to ensure that capital plans remain within sustainable limits and in particular, to consider its impact on revenue resources and therefore taxation. Setting affordable limits for borrowing within a prudential framework is a specific requirement and helps ensure that the further objectives of sustainability and prudence are addressed.

Sustainability

2.4 The sustainability of public finances underpins the overall UK fiscal framework and is supported by the prudential code. Sustainability of public finances relates to the ability of a government to sustain its current spending, tax and other policies in the long run without threatening government solvency or defaulting on of its liabilities or promised expenditures. With increasing devolution to the Scottish Government, this will bring increased volatility in revenues and the need to ensure the consequences of long-term investment in capital assets through borrowing or public private partnerships are fully understood.

Prudence

2.5 The prudent level of borrowing is linked to ensuring that ensuing debt will only be for a capital purpose. External debt should not, except in the short term, exceed the total of its capital financing requirement. This is a figure that represents the total value of prior year capital that remains un-financed. It is also prudent that treasury management activities are carried out in accordance with good professional practice.

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4 CIPFA’s Prudential Code for Capital Finance in Local Authorities 2011
CIPFA Prudential Code, local authorities are required to adopt the CIPFA Treasury Management Code of Practice\(^5\).

2.6 The borrowing levels within the prudential framework are linked to their implications on affordability within the revenue budgets rather than capital budgets. This also helps underpin the longer-term inter-generational affordability and prudence of capital investment plans. This approach is inconsistent with a prescribed limit of £2.2bn as contained in the Scotland Act 2012.

2.7 CIPFA advocates a prudential approach which will provide more flexibility for the Scottish Government to set its own affordable limits within the prudential parameters. This would be consistent with the overall UK fiscal framework as it currently operates across all UK local government. Linking affordability to its impact on revenue budgets is also in keeping with the concepts of Debt to GDP\(^6\) within the overall UK fiscal framework.

**The Cost of Borrowing**

2.8 CIPFA has undertaken preliminary calculations (appendix 1), which are designed to demonstrate not only the principles of borrowing but also the indicative consequences upon the Scottish Government budget of servicing the debt. We estimate that under the powers which currently exist in the Scotland Act 2012, funds of approximately £230m will be available for the relatively low annual cost (interest only) of £6.1m. By year eleven, the first year of debt repayment, the charge to the Scottish Government budget would increase to approximately £288m\(^7\).

2.9 The previous Scotland Bill Committee recommended that borrowing powers within the Scotland Bill should be increased to £5bn\(^8\). We have modelled the consequences of servicing debt at a level of £5bn and estimate that achieving that borrowing level over say, a thirty year period would incur interest charges of in excess of £2.3bn.

2.10 The decision to undertake capital expenditure and subsequently pay interest and to repay external debt will represent a significant opportunity cost for the Scottish Government. Clearly, this will come at the expense of service block revenue expenditure. In terms of scale, the charge to the Scottish budget in year eleven would be broadly larger than the proposed

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\(^5\) CIPFA’s Treasury Management in the Public Services: Code of Practice and cross sectorial guidance notes 2011


\(^7\) Appendix, Table 1

\(^8\) The Scotland Bill Committee, 2011, Session 3
resource expenditure on the full portfolio for Training, Youth and Women’s Employment.  

2.11 Unlike the clarity with the local government legislation, the draft clauses omission of borrowing powers means that it is not clear upon which income source the borrowing by the Scottish government will be secured.  

3. Accountability  

3.1 The importance of financial reporting at a total ‘Scottish public sector’ level has previously been stated by CIPFA\textsuperscript{10} and, separately by Audit Scotland\textsuperscript{11}.  

3.2 At present there is no formal ‘Whole of Scotland’ financial information in place. Given the current powers for borrowing and devolved taxation in the Scotland Act 2012, and with anticipated enhanced powers to come, CIPFA believes that the establishment of a formal process for ‘Whole of Scotland Accounts’ is a vital step to improve financial reporting.  

3.3 Providing for a formal ‘Scottish Whole of Government Accounts’ would support proper financial scrutiny of the financial position and performance of the Scottish Government and wider public services. This supports and underpins any Scottish Fiscal Framework that is put in place, the management of the sustainability of Scottish finances and also supports the management of the Prudential Borrowing Regime.  

3.4 CIPFA also supports the view that a ‘Scottish Whole of Government Accounts’ would provide a number of other benefits such as:  

\begin{itemize}
  \item A means for lenders to the Scottish Government to assess the financial position and financial management of the Scottish public sector as a whole, thereby affecting the interest charges likely to be incurred for borrowing from these lenders.
  \item To support long-term financial planning, for instance by providing information to ensure that sufficient liquid assets are available to settle liabilities and help assess the sustainability of current service provision.
  \item Whole of Scotland Accounts would also be subject to audit and therefore verified and unbiased financial information to demonstrate
\end{itemize}

\textsuperscript{9} The Scottish Government Draft Budget 2015/16 http://www.gov.scot/Publications/2014/10/2706/downloads
Scottish public sector accountability to the Scottish people for the use of taxpayer’s funds.
### Table 1: Maturity Repayment Based on £2.2bn Debt Limit

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<th>Year</th>
<th>Level of Debt £</th>
<th>Estimated Charge to the Scottish Budget £</th>
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<td>Year one</td>
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<td>Year five</td>
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<td>Year eleven</td>
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<td>Year twenty</td>
<td>2,200,000,000</td>
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### Table 2: Annuity Repayment Based on £2.2bn Debt Limit

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<td>Year eleven</td>
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<tr>
<td>Year twenty</td>
<td>1,084,572,000</td>
<td>264,836,000</td>
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### Table 3: Maturity Repayment Based on £5bn Debt Limit

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<th>Year</th>
<th>Level of Debt £</th>
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<td>Year five</td>
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<td>Year ten</td>
<td>2,636,692,242</td>
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<td>Year twenty</td>
<td>3,543,493,891</td>
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<tr>
<td>Year thirty</td>
<td>5,000,000,000</td>
<td>535,806,392</td>
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**Note:**

For the purposes of calculations we have assumed that the most likely borrowing option would likely be in the form of a NLF loan through the UK Debt Management Office (UKDMO).
The Investment Association Preliminary Views on Scottish Borrowing Powers

Evidence to be given by Phillip Milburn, Investment Manager, Kames Capital on behalf of The Investment Association

Phillip is a member of the Investment Association’s Fixed Income Committee

Proposed considerations for the Scottish Parliament

1. Will there be demand for debt issued by Scotland?

   The short answer is an obvious yes, the additional yield relative to Gilts is harder to determine (this additional yield is referred to as a “spread”). There are precedents in the UK for cities and regions raising debt but each one is slightly different to the Scottish case. Ultimately the potential buyers of Scottish debt will need to assess three main risks: normal fundamental analysis (covering credit deterioration and default risk), illiquidity and redenomination. We briefly cover each of these in turn:

   i. There is no reason why Scotland would be treated differently from any other issuer of debt in the markets. Investors would look to undertake fundamental analysis and study such factors as current economic growth and inflation, the diversity of the economy, the strength of the financial system, debt to GDP measures, fiscal deficits, current account deficits, wealth of the population, etc. On top of this one also examines the strength of the institutions, the legal framework, corruption and ease of doing business indices, etc. It would need to be made explicit whether the guarantor of the debt had use of all of Scotland’s tax raising powers (including transfers from Westminster) in order to service the debt or just the tax base covered by those powers that are being devolved. Finally, it would be expected that the issuer of the debt would obtain a credit rating from S&P or Moody’s, preferably both.

   ii. On an international scale Scotland would be a small issuer, you would expect bonds issued to be less liquid than Gilts and investors to demand a small premium for this. Set against this there would be a certain rarity value or diversification benefit of the debt for buyers. One of the harder tasks would be to garner enough investor attention, an initial roadshow by members of a Scottish Treasury would be necessary as well as ongoing investor updates and dialogue.

   iii. Redenomination risk would be viewed as a very low probability event but not one that the financial markets would entirely dismiss. One could mitigate this by stating in the bond documentation that in the event of Scotland leaving the UK the bonds would remain Sterling denominated. A more subtle way of mitigating this fear would be to issue debt with an appropriate tenor (maturity) – e.g. something in the 7-10 year range would ensure that the bond matured before any referendum plus migration period would be realistically completed.

2. Which body should issue debt?

   It is our impression that the debt issued would only be for capital spending purposes. Some members of the Investment Association believe that, if indeed this is the case, then it may be more beneficial to offer some debt guarantees rather than issue generic government debt.

   Through the IIU (Infrastructure Investment Unit) Scotland could create some form of Scottish Development Bank (SDB). Debt could then be raised for either large individual infrastructure projects or collections of smaller projects. An example of this is the Priority School Building Programme that is run by the Education Funding Agency. Under this programme, the EFA will raise funding using an aggregator model to fund 46 schools in 5 batches. The aggregator will be able to access both bank funding and the capital markets.
If the SDB were to guarantee a certain amount of the debt and structure projects appropriately then there would undoubtedly be demand for such bonds. By taking this approach any debt raised would be explicitly ring-fenced for the respective infrastructure projects and risk can be appropriately shared between the public and private sector (this is analogous to the current PPP system, but not identical). If the Scottish Government were to use this approach, there would need to clarity on the conditions under which a guarantee would be used to finance a project to provide certainty to the market.