Building Scotland’s future now

A new approach to financing public investment

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**COMMON WEAL** is a think-and-do tank that advocates policies that put All of Us First. For more information on Common Weal Policy visit allofusfirst.org/policy or email ben@common.scot

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Why public investment?

Investment has become a dirty word in the era of ‘investment banking’. Investment banking is widely considered to be one of the causes of the 2008 financial crash (Varoufakis, 2015). When bankers talk about investing, they mean short-term speculation on stocks, bonds or other complex financial derivatives. That is, a form of trading (or, more accurately, gambling) that contributes nothing to the ‘real’ economy.

Reclaiming investment is a necessary task. The value in the concept of investment is that it is exactly the opposite of the sort of speculative, short-termism in economic thinking that dominates the minds of ‘investment’ bankers.

In economics, investment is the creation of capital or goods that are used to produce more goods or services in the future. For governments, public investment is when the state invests in the nation’s infrastructure for the good of the public realm as a whole in the future. This can take many forms: physical infrastructure investment could be roads and bridges; human infrastructure investment could be training and skills development; digital infrastructure investment could be high speed broadband and open source software; social infrastructure investment could be public rental housing and new x-ray machines.

Usually, governments will seek to prioritise public investment in an area of the economy that the market is failing or is functioning inadequately.

The Scottish Government faces three major barriers to doing this:

- A budget that is mostly fixed (i.e. set by the UK Government) with restrictive powers to borrow money.
- UK Government austerity: the size of the Scottish Government’s budget has been reduced year on year, therefore the amount of the revenue spending budget that can be used for public investment purposes has been increasingly limited.1
- The Scottish Government has no control over government accountancy rules, which means its ability to define legally its own approach to investment is restricted by both EU and UK state rules.

In this paper we analyse each of these problems and propose solutions that can substantially increase Scotland’s investment as a proportion of GDP.

In doing so, we believe there are three key principles which a Scottish Government approach to public investment should follow:

- Public investment should prioritise socially and environmentally useful projects.
- Public investment should not subsidise corporate failure.2
- Public investment should prioritise areas of the economy that have positive ‘multiplier effects’; childcare would be one example of this.3

Brexit and Britain’s chronic under-investment

On an EU scale, Britain is firmly placed on the lower rung of countries when it comes to public investment. Figures from Eurostat (2016) show that the UK invests less than 3 per cent of its GDP, significantly lower than the EU average and the eighth lowest out of 28 EU countries. The UK has a similarly poor result in terms of investment as a proportion of government expenditure (below 6 per cent). Clearly, investment is not a priority of UK public expenditure.

Since Britain’s vote to leave the European Union, the debate around public investment has dramatically shifted. The expected decline in demand in the UK economy saw former Chancellor George Osborne quickly ditch his budget surplus law, which would have restricted expenditure (including public investment) to no greater than revenue by 2020. Osborne’s replacement in the new Prime Minister Theresa May’s cabinet, Phillip Hammond, proposed to increase capital spending by £23bn in the Autumn Statement, funded through additional borrowing, but Office for Budget Responsibility analysis has showed a £14.8bn funding gap in the detail of these plans (Chu, 25 November 2016). Former Business Secretary, Sajid Javid, has argued that £100bn should be spent on infrastructure spending, with UK government gilt rates (the name given to UK Government Bonds) at historic lows. Shadow Chancellor John McDonnell has gone one step further, outlining a plan for £500bn in infrastructure spending as well as the creation of a National Investment Bank. Not to miss out, First Minister Nicola Sturgeon outlined a £100m “stimulus” in new infrastructure spending out of government over-spend

2 That is not to say that government should not support the jobs and livelihoods of workers affected by the collapse of a company or the endangering of a whole industry sector, but that support should not simply come in the form of bailout’s which leave the same company director’s in place and thus create the sort of ‘moral hazard’ we have seen in the UK financial sector. However shocking the risk-taking is, the head of big banks can assume they have the cushion of the taxpayer to fall back on if their gambling doesn’t pay off. Therefore, strategic government intervention into the private sector is needed, rather than reactive intervention. For more on this see Cairns, Cumbers, Danson et al, 2016.

3 The multiplier effect is the knock-on impact on final income that comes from specific spending decisions. Investment in free childcare is an example of this because, apart from increasing employment of childcare professionals, it has the knock on effect of encouraging parents, especially mothers, back into work as well as increasing their household spending power, thus boosting government revenues. For more on this in the Scottish context see Davis, MacNicol, McNair et al, 2016.
from last year’s budget, as well as bringing forward existing infrastructure plans.

The sudden return of public investment to UK political discourse is to be welcomed, but the numbers committed to by the UK and Scottish Government so far will be insufficient in turning around Britain’s chronic investment deficit. Assuming Phillip Hammond’s figure of £23 billion was ever delivered, it would represent only about 1% of UK GDP. As discussed further in part 6, the Scottish Government’s capital budget has been decimated over the past six years and its borrowing powers are very restrictive. Sturgeon’s commitment to an extra £100m in infrastructure investment is worth less than 0.07 per cent of Scotland’s total GDP. A much bigger programme of borrowing to invest is needed to overcome the double whammy of a likely medium-term ‘Brexit’ led reduction in demand and long-term chronic under-investment from the UK Government.

For the Scottish economy, public investment is at the locus of recent economic performance. A report by the Scottish Parliament Information Centre (SPICe) found that between a third and half of all economic growth in 2014 was directly connected to Scottish Government infrastructure investment in the construction sector (SNP, 2015). In June 2016, the Fraser of Allander Institute identified a drying up of major infrastructure projects as a driver of a general economic slowdown. The Scottish Government must now maximise its current tools, and look to forge new ones, in pursuit of an investment strategy that can rise to the big challenges the economy faces.

The ‘Non-Profit Distributing’ model – PPP’s final hurrah?

A major part of the Scottish Government’s investment strategy since the SNP came to office in 2007 has been the ‘Non-Profit Distributing’ (NPD) model, which has accounted for £2.5bn of completed projects, with another £1bn ‘live’ projects from 2015-20 (Pinsent Masons, 2014).

The NPD model was first developed under the previous Labour-Liberal administration as one of a number of ‘public-private partnership’ (PPP) models, but was rarely used as the now much-maligned Private Finance Initiative (PFI) approach was dominant. NPD shares much of the same features as PFI: the Scottish Government contracts out the building of public projects to private providers who in return receive long-term debt repayments based on future Scottish Government revenue spending usually over a 25-30 year period.

**Private Finance Initiative (PFI) and Non-Profit Distributing (NPD) payments, 1999/00 to 2043/44**

Councils’ committed payments on current PFI and NPD contracts continue to rise until 2026/27

![Graph showing Private Finance Initiative (PFI) and Non-Profit Distributing (NPD) payments, 1999/00 to 2043/44](image)

Note: These figures do not take inflation into account


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4 Including a geographic share of Scotland’s offshore resources (Scottish Government, 2015a).

5 PPP is sometimes used as conceptually separate to PFI. In this report we are using PPP as the general rubric for all public-private partnership approaches including PFI, NPD and ‘Hub’.
The term ‘non-profit distributing’ is therefore somewhat misleading. The Scottish Futures Trust (which leads the Scottish Government’s NPD work) is at pains to point this out:

“It is important to note that the NPD model is not a ‘not for profit’ model. Contractors and lenders are expected to earn a normal market rate of return as in any other form of privately-financed PPP deal.”

(Scottish Futures Trust, 2011).

The difference with NPD is that it does not give the private contractors any equity in the projects, and therefore the interest on the debt repayments tend to be at a fixed rate. Many PFI projects carried out at the start of the millennium are still rising in cost to the Scottish Government and local authorities today, and are set to peak in 2024/25 (Audit Scotland, 2015).

The chief executive of Scottish Futures Trust, Barry White, stated in 2014 that the fiscal impact of NPD is that whereas the private sector’s best returns under PFI were around 15 per cent, now they are around 12 per cent. Dr Mark Hellowell, an expert in private-public financing at the University of Edinburgh, is more sceptical of NPD’s, stating that private equity only “made up roughly one per cent of financing under PFI” and therefore it is not a significant change. He added that just because interest on returns is now capped “does not necessarily mean investors are accepting lower returns”, as companies could take a tougher negotiating stance during the procurement process (Gourtsoyannis, 5 May 2014). Even if White is correct, with interest rates at historically low levels, 12 per cent is a huge mark-up for private providers that is totally out of sync with current market rates.

The only major study of NPDs was conducted by Hellowell and Dr Allyson Pollock in 2009, who found that public-sector borrowing was much cheaper than NPDs for all the same reasons that made PFI expensive: high transaction costs in the bidding process; high concentration of market bidders which limits competition; and a procurement process that makes it almost impossible for the contractor to pull out of the deal once preferred bidder status has been established. The interest on repayments for NPD’s are therefore significantly higher than borrowing rates from the UK Government Public Works Loan Board (PWLB).

Since the 2008 recession, all PPP models have become increasingly expensive as the cost of commercial bank borrowing for private providers has risen sharply. A 2011 House of Commons Treasury Committee report on PFI found that it was now an “extremely inefficient” model for public projects as the high borrowing costs were more than double that of UK Government bonds.

Since then, the interest rates on UK gilts dropped to their lowest level on record in early 2016 (Elliot, 11 February 2016) and even since Brexit has maintained a low yield and high total sales (Bruce, McGeever, January 5 2017), in line with global trends. The IMF (2014) has called on governments around the world to take advantage of low interest rates by borrowing for public infrastructure to help the economy grow, and said that for every 1 per cent of GDP invested the economy would grow by at least 1.5 per cent.

None of this in itself discounts the major advantage of NPD’s for the Scottish Government: that rather than having to fund the building of new roads, bridges and childcare centres through current budgets, they can pay for it through future revenue spending. This is likely to be seductive for any government, especially in the context of UK Government austerity, which has reduced the capital budget by 12 per cent from 2010-11 to 2016-17 (Fraser of Allander Institute, 2016b). In that context, even if NPD is more expensive, Ministers may have selected it due to the need to get things done without the immediate cash to hand to do it.

However, the NPD model is now undermined by changes to accountancy rules, as Hellowell and Pollock foresaw in 2009: “The Scottish Government’s ability to keep private finance off the balance sheet, probably the major driver behind its use, is being eroded as a result of the UK public sector’s move from Generally Accepted Accounting Principles to International Financial Reporting Standards (IFRS) from April 2009. In future, more private finance contracts will be accounted for according to IFRIC 12, an Interpretation of IFRS issued by the International Accounting Standards Board, the effect of which will be that most privately financed assets will be recorded on the balance sheet of the public sector and thereby score against the capital budgets of public entities. This will substantially erode the ‘budgetary incentive’ to use private finance...”

The Guardian reported in 2015 (Carrell, 27 July 2015) that the ONS had ruled that the biggest NPD planned to date, the Aberdeen Western Peripheral Route, is a public-sector project and must now count on the Scottish Government’s current balance sheet, rather than on future revenue spend, due to new European accounting system guidance in September 2014 known as ESA10.

The 2017-18 Scottish Government draft budget (SPICe, 2016a) has now made clear what this means in practise. Smaller NPD projects have had “the design” adjusted so that they are now considered private sector projects and are therefore off balance sheet. This change brings NPD broadly in line with ‘Hub’ projects which is a specific form of PPP in healthcare, education and community developments where 40 per cent of the Special Purpose Vehicle (SPV) established for the carrying out of the specific capital investment has to be publicly owned.7

The structural change to the SPV, whether Hub or NPD, which allows for it to continue to be classified as off balance sheet is to lower the public sector ownership to 20 per cent and create a charitable entity that owns 20 per cent of the

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7 Hub projects are another major strand of the Scottish Government’s PPP mix, with £1.2bn completed or under construction and over £2bn ‘live’ projects (SFT, 2016).
project. The public sector ownership is split evenly between SFT and the procuring authority (previously the procuring authority held a 30 per cent stake). The private sector ownership of up to 60 per cent remains the same (Scottish Futures Trust, 2015).

This approach has not been possible for “larger ‘stand alone’” projects. Three of these NPD projects, totalling £932m8 (Edwards, 14 December 2016; Carrell, 14 December 2016), will now have to count on the Scottish Government’s balance sheet, tying up capital that could be spent in other areas. One project is no longer being procured using NPD, but is likely to end up on the Scottish Government’s balance sheet.

A joint inquiry has now been announced by Audit Scotland and the Accounts Commission into whether the Scottish Futures Trust’s PPP model is “value for money”. It is our contention that NPD is now expensive in both the short and long term, negating any credible purpose as a financing strategy for public investment.

As well as accountancy changes, the PPP model is also running up against Scottish Government enforced debt limits. Only 5 per cent of future revenue spend can be used for PPP according to Holyrood rules: the Scottish Government has now committed to spending 4.5 per cent by 2020/21, so has just 0.5 per cent of the cap left to fill (SPANe, 2016a). While it is feasible the limit could be raised, politically speaking how much of future taxpayer revenue can a government commit to giving to the private sector for the building of public estate 25-30 years previously? A new model is now an urgent requirement.

A note on PPP and health & safety

We have focused here on the financial aspects of NPD and PFI, but it is also important to note wider criticisms of the model. The closure of 17 schools from April to August 2016 in Edinburgh built through PFI contracts after the collapse of a wall at Oxgangs Primary school because basic structural ‘wall ties’ were not inserted during the building process, has turned attention to fears over PPP and health & safety.

Value for money and profit drivers frequently sit uneasily at best and in conflict at worst with high public and employee health and safety standards and quality. Delays, poor quality work and public safety issues may of course occur in any construction project but in several respects PFI, NPD and similar schemes were and are especially vulnerable to such problems. Companies can also externalise costs of injuries to the NHS and poor quality, delayed completion and poor maintenance to the users or public purse in the construction, operation and maintenance of public buildings. The mantra of ‘public subsidy, private investment’ has further helped to justify reduced funding of public services again often affecting quality, scope, speed and safety of service delivery directly and indirectly through PPP schemes using up critical resources needed to deliver services.

The Care Quality Commission has flagged a number of concerns over several years relating to understaffing, patient safety and delayed operations in some PFI hospitals for example in London (Lister 2015). And for some sectors, the evidence is clear. As David Hall noted about UK PFI schemes to build waste incinerators: “We shouldn’t be afraid to say it: waste management is simply cheaper and more effective in public hands” (David Hall 2014).

The public and service users may be adversely affected more subtly not only by the high costs of PPP schemes but by another part of the UK Government neoliberal strategy: deregulation by stealth. This has led to the gradual but steady running down of key regulatory and inspection bodies such as HSE that should have been able to pick up quickly and comprehensively poor quality PPP work and any threats to public and worker health & safety they posed. Some schemes have permitted PPP and PFI companies effectively to ‘self-regulate’.9

The quality, public and user safety problems that have emerged in the seventeen Edinburgh PPP schools for example were reportedly linked to the building consortium self-certifying that it met ‘all the relevant building standards’ on completion (The Herald, 14 April 2016). The National Audit Office (NAO, 2011) has spent a great deal of time in the past evaluating for example the performance and management of hospital PFI contracts, yet at times often made minimal reference to quality and patient safety issues and none at all to the health & safety of those building or working in hospitals. Yet other bodies identified how problematic PPP schemes could be in terms of such topics as quality, community engagement and standards of care. Assessments of PPP occupational health & safety practices have proved a particularly contested terrain with unions such as UCATT and ASLEF critical of the London Underground and some hospital builds. UCATT has also been critical of the steady decline in construction inspections by the UK HSE in Scotland – health & safety being a matter reserved to the British Parliament (Construction News, 2015). It is improbable that this will not have affected oversight of PPP construction schemes in the country.

So, for quality, scope, service delivery, public and worker safety, there is evidence to show that PPP schemes contain significant flaws that could be avoided by very different investment and oversight approaches to public services (Whitfield, 2010).

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8 This figure is the NPD-contracted element of the costs for these projects; total capital costs to the government for the projects are £1.32bn.

9 One dimension of the PPP debate that has emerged in recent years is the long standing scandal of blacklisting trade union activists in the construction industry often relating to their past attempts to raise health and safety standards and other working conditions. The Scottish Government needs to fully honour its important manifesto commitment on this matter, and demonstrate and publicise how it has done so.
The original Scottish Futures Trust – an idea whose time has come

The role of the Scottish Futures Trust (SFT) is, according to White, to provide “additionality”: “bringing that additional investment in; collaboration – how do we get people to work together; and innovation – how do we do things differently?” (Gourtsoyannis, 5 May 2014).

To summarise, the SFT is a sort of advice-cum-coordination body for public-private partnerships. Originally, the plan was somewhat different: the Scottish Government issued a paper on its plans for SFT in December 2007 – five months after the SNP’s election victory - that presented the new vehicle as something similar to a national investment company.

The report stated: “For new projects only, the SFT vehicle could design, build, finance, operate and own the facilities created.” Adding that it would “obtain its funding through bonds and other appropriate commercial financial instruments at rates which would be cheaper than those involved in PFI procurements.” (Scottish Government, 2007).

By May 2008 the ambition for SFT had been scaled back significantly. SFT was now “unlikely to be a direct funder of projects in the short term” and would “aim to use combinations of expertise, NPD structures, programme based delivery models, hybrid funding structures, underpinning and aggregation, to be an arranger of funding that is cheaper than PFI.” (Scottish Government, 2008).

It is time to go back to the original spirit of SFT given the fact that the NPD model has now come up against barriers that negate its strengths and accentuate its weaknesses. Without the debt-based financing that characterised PFI and NPD, there is no short or long-term benefit to the Scottish Government of continuing to rely on the private sector to lead its investment in public projects.

The only logical reason for going further towards a private-sector model for public investment projects would be inertia (it’s easier to continue with something similar to what you have been doing than to change) and ideology (the misplaced idea that the private-sector will be a cheaper and more efficient model, which cannot be defended by the evidence).

There are two parts to our plan for investment: a Scottish National Investment Bank and a Scottish National Investment Company. Both are underpinned by the need to maximise the use of the Scottish Government’s capital budget, which we will turn to next.

The capacity and flexibility of the capital budget

The decline of the Scottish Government’s capital budget from 2010-15 was precipitous, as Hellowell (2015) pointed out: “After accounting for depreciation, public capital budgets [were] just 1.4 per cent of GDP [in 2015]…down from 3.4 per cent at the end of the last decade. This reduction in the investment budget is without historical precedent.”

In contrast, the previous decade (2000-2010) saw the capital budget increase 41 per cent in real terms (Audit Scotland, 2010).

The 2016 Autumn Statement saw an 8.9 per cent real terms increase in the Scottish Government’s capital budget from 2016-2020, from £3.22bn in 2016-17 to £3.7bn by the end of the decade (SPICe, 2016). This light relief takes the capital budget just above its 2010/11 figure, opening up some more options for new Finance Minister Derek Mackay in his investment approach.

Additionally, the passing of the Scotland Bill saw the Scottish Government’s capital borrowing powers increase from 10 to 15 per cent of the capital budget (£450m per annum; £3bn cumulative). An Institute of Fiscal Studies report on Scotland’s new ‘fiscal framework’ described this as “barely” an increase and less than the Scottish Government “hoped for” (Bell, Eiser and Phillips, 2016). The Scottish Government has allocated spending for all of its capital borrowing powers in 2016/17 (SPICe, 2016a) and has indicated it will do the same in 2017/18 (SPICe, 2016a). The Government has the right to borrow this money from the UK Government Public Works Loan Board, commercial banks or through issuing Scottish Government bonds.

In total then, the Scottish Government has a possible spend of £3.9bn on capital projects for 2017/18 (once Financial Transactions, payments from the Treasury for the Scottish ‘City Deals’ and under-spend from the previous year’s budget are added). The former Finance Minister John Swinney’s 2016/17 draft budget announced at the end of last year proved that funding allocation of the capital budget can be flexible. Swinney increased Health’s capital spend by 112.8 per cent in real terms, as plans to build hospitals using NPD had to be altered quickly due to the ONS ruling detailed above (SPICe, 2015).

118 projects are on the Scottish Government’s current infrastructure pipeline, of which 30 are at least partly capital budget funded (the rest are NPD, revenue spending or for the schools a combination of ‘Hub’ funding and NPD). The

10 Financial Transactions are Barnett Consequentials derived from UK Government housing related equity/loan financing schemes.
capital budget projects are worth an anticipated maximum cost of £2.46bn, some of which won’t be started until near the end of the decade (Scottish Government, 2016). There is therefore some flexibility in how the capital budget is spent over the next five years, and it’s our contention that a significant proportion should be put towards a Scottish National Investment Bank, which will expand the total funds available for investment by its very creation.

A Scottish National Investment Bank

A Scottish National Investment Bank (SNIB) could significantly boost Scotland’s investment to GDP ratio in three ways:

- Providing long-term, patient capital for investment to the private sector for projects that match a specified social and environmental criteria at lower than market rates.
- Provide capital for targeted public investment in particular sectors, like energy and housing, which would otherwise be on the Scottish Government’s current balance sheet.
- Raise additional capital through accumulated investment returns, leveraging and bank bonds.

Added together, this capital raising strategy could be well in excess of what the Scottish Government could spend on capital investment directly.

The SNIB could be modelled on the various successful examples of national investment banks internationally, most prominently Kreditanstalt für Wiederaufbau (KfW) in Germany, which is the fifth-largest capital issuer in Europe, and has raised capital worth 2.2 to 2.6 per cent of German GDP. If the SNIB sourced funds in Scotland comparatively similar to KfW it would be worth £3.2bn to £3.7bn (Cairns, Cooper, Morgan, 2014).

This could be achieved by using the European Investment Bank and the Nordic Investment Bank’s model for capitalisation, based on a differentiation between ‘subscribed’ and ‘paid-in’ capital.11 Subscribed capital is the amount the governing institution has guaranteed to the bank, while the paid-in capital is the amount that has actually been transferred to the bank. The bank can then leverage 2.5 times the subscribed capital figure.

As Gemma Bone (2016) explains, the Scottish Government’s capital budget could be mobilised to start off the SNIB with a strong capital base:

“If only £225m [5.8 per cent] of the Scottish Government’s capital budget was set aside as ‘paid-in’ capital for the SNIB for six years and that accumulated figure was ‘subscribed’, the bank would have a total subscribed capital of £1.35bn. That subscribed figure could then (like the NIB and EIB) be leveraged at a ratio of 1:2.5, raising £3.37bn of available capital for SNIB loans from year one.”

A capital base of £3.37bn for the SNIB would therefore be (proportionately speaking) of similar size to the KfW.

The SNIB would raise significant sums of capital through bank bonds. As mentioned above, the Scotland Act 2012 gave the Scottish Government the right to issue bonds, dubbed ‘Kilts’ by the Financial Times (15 May, 2015) to contrast with UK gilts. It is possible that establishing Scottish bonds directly could offer limited return: it could not be utilised for non-state sector investment and could be more expensive than borrowing from the UK Government Public Works Loan Board (PWLB) as Scotland would (at least initially) be likely to receive a worse credit rating from rating agencies. A UK Government report estimated the extra cost to be between 0.3-1.5 per cent extra than borrowing from the PWLB (currently the Scottish Government pays 0.2 per cent extra) (Milliken, 19 February 2015).12

SNIB bonds would be more appealing as they would potentially offer higher returns to investors as well as having greater flexibility in how the money is used. In making the case for a British Investment Bank (BIB) to be established that would raise capital through bonds, Robert Skidelsky (2011) states:

“BIB bonds would not be covered by an explicit government guarantee; instead it is the public ownership and the quality of the credit portfolio that would vouch for the institution’s credibility. In an economy crippled by uncertainty and with substantial pools of un-invested savings, BIB bonds would offer an attractive option to investors: they would be less risky than corporate bonds while offering a yield higher than that of government gilts.”

There is no good reason why this would not also be true for SNIB bonds.

A significant investor in SNIB bonds could be Scottish Pension Funds. Pension funds are run by employers and trade union representatives, and collectively amount to the biggest pool of capital in Scotland. Scotland’s largest pension scheme, the Scottish Local Government pension scheme, has £27bn in assets. Pension funds are always

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11 See Bone, 2016 for full details.

12 This should be cautioned by the fact that many local authorities and trade unions are currently unhappy at what they see to be the high rates currently being charged by the PWLB (ibid, 2016), 1 per cent above UK Gilt, when Bank of England interest rates are at an all-time low (0.5 per cent), 57 local authorities have signed up to a plan to issue their own bond that could allow them to borrow cheaper than from the PWLB. The bond will be launched autumn 2016 (Johnstone, R 25 May 2016). Indeed, in 2015 Enfield Council borrowed £80m from the European Investment Bank due to the fact its borrowing rates were 0.5% below PWLB rates (Cross, L 15 May 2015).
looking for safe, long-term places to invest their money with strong, secure returns. Infrastructure based investments often fit the bill (Watson, 2016).

The bank would be government owned. It would be crucial that the bank had an independent governance structure so it was not manipulated by Ministers for short-term goals, rather than the long-term socially and environmentally useful investment it would have written into its constitution as its primary purpose (Macfarlane, 2016). Decisions on whether to give loans to public-sector projects would have to be treated with the same scrutiny as private ones.

An SNIB along the lines proposed above could be transformational to Scotland’s investment potential, both for public investment and lending for socially and environmentally useful private-sector investment.

For public investment, MacFarlane (2016) has looked at what the cost to the Scottish Government would have been if SNIB financing had been used rather than PFI/NPD thus far, by way of comparison. As the following graph shows, a total saving of approximately £26bn could have been achieved.

For the private sector, lending for small and medium enterprises (SME’s) in Scotland has been labelled “highly concentrated” by the Competition and Markets Authority, with only 8 per cent of bank lending in Scotland going to SME’s, among the lowest of any region in the UK and some 25 per cent below London and the South East (Bone, 2016). An SNIB could therefore provide a new option for SME’s in Scotland struggling to find prudent loan options from the commercial bank sector, as well as providing funding for public investment, of which we explain more in the next section.

‘Lobos’ and local authority borrowing

While lending to the Scottish Government from its own bank would not offer much utility due to the strict capital borrowing limits Holyrood must operate to, it could be a prudent option for local authorities which, now more than ever, need sustainable financial planning. The PFI era incurred major debts on councils that are still being paid,

13 Under current UK accountancy rules, it is likely that total assets and liabilities of SNIB would have to be represented on the Scottish Government’s balance sheet. If this were the case, it would be necessary for the Scottish Government to seek Treasury approval for changes to the accounting procedures so that SNIB could be treated off-balance sheet, as is the case with the part-government owned RBS, and with the KfW in Germany (see MacFarlane, 2016 for more). Additionally, the Scottish Government has already sought approval for a similar accountancy change from the Treasury for its £500m Scottish Growth Scheme, which underwrites commercial bank deposits to Scottish small to medium sized exporting businesses. Therefore a precedent exists for the request of such changes.

14 To be clear, this report is focused on alternative means of public financing going forward, rather than how to deal with currently existing PFI/PPP debt. For more on that issue, see Unison Scotland, 2015.
but the most recent and urgent debt repayment problem has risen in the form of ‘Lobo’ loans with commercial banks like government owned RBS and Lloyds, which dominate the lending sector in Scotland.

Lobos undercut government borrowing by offering ‘teaser’ rates to local authorities and housing associations that start the initial loan lower than that offered by the PWLB. However, these loans have predetermined interest reset dates tied to, for example, the LIBOR rate where commercial banks push up the rate of interest, sometimes as high as 7 or 9 per cent, and give the borrower the option of paying back the whole loan (or paying an exit fee), or accepting the new terms. The vulnerability of local government financing, as well as the fact that the rate to borrow from the UK Government PWLB has been pushed up, means local authorities tend to accept the new terms. (Dispatches, 6 July 2015).

It is also possible that local authorities could see advantages in borrowing through establishing its own bond. English local authorities have recently combined to establish their own municipal bond due to high PWLB rates (Johnstone, R 25 May 2016). Aberdeen City Council have announced plans for index-linked bonds to be launched which could raise a potential £1bn for capital investment in the area (Scottish Financial News, 26 October 2016). This approach has been recommended by Unison Scotland (2015). It may be the case that the larger size of an SNIB and backing by the Scottish Government could play a galvanising role Scotland-wide, but establishing the fact that options are available for significant levels of borrowing for local authorities is a positive starting point for moving past Lobos and high PWLB rates.15

Campaign group Debt Resistance UK (2015) has discovered through FOI’s that about one fifth of all UK council borrowing is currently operated through Lobos worth a total value of £15 billion. If Lobo contracts were terminated the total saved for 2015 alone by borrowing at normal market rates would be about £145 million. Scottish councils are as deeply embedded in this practise as those across the rest of UK; Edinburgh City Council alone owes £110m in Lobo debt to RBS (Wray, 24 July 2015).

As discussed in more detail in the following section, the possibility for ‘public-public partnerships’ involving the Scottish Government and local authorities for public investment could be powered by SNIB loans to local authorities.

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15 In 2010, Osborne pushed the rates Councils could borrow from the PWLB up from 20 basis points above UK gilts to 100bp in order “to suppress local authority borrowing and promote a market-facing approach by large borrowers” (Moore, January 19 2016).
above, the NPD model has just about reached its limits. A Scottish National Investment Company (SNIC) could be the answer.

The SNIC would be based on the current Scottish Futures Trust body, but would return to its initial concept that never came to fruition: a company that would “design, build, finance, operate, manage and own the facilities created” (Scottish Government, 2007). The SNIC would be charged with leading Scotland’s public investment strategy, and would have direct Ministerial accountability.

The difference with this new model from the original SFT concept is that part of its role would be to partner with local authorities in regional/public investment. The benefit of this is that whereas the Scottish Government has extremely restrictive borrowing limits, local authorities do not. Local authorities would gain from free access to the SNIC’s team, which would contain cutting edge expertise in public financing, planning, legal issues, energy strategies, architectural design and construction. This model is known as public-public partnerships, and would operate as a key part of Scotland’s public investment strategy, as outlined in the graphic below.

Public rental housing would be a good example of how this could work. A core part of the SNIC’s public investment strategy could be to build sufficient public rental housing over the next decade to meet demand. The SNIC could then carry out an audit across Scotland with a target for housebuilding in each region. It could then come up with a housebuilding strategy that drew on best practice internationally – for example the German house factories model that builds the homes off-site (GWMR, 2004) – and which ensures new housebuilding met wider government targets for example in energy efficiency and quality.

This housebuilding target and strategy would then be pursued in partnership with local authorities which would ultimately fund and own the new homes. The public-public partnership would be established between the SNIC, the local authorities and possibly other non-profit partners (in this case most likely to be housing associations, but it could also be, for example, credit unions or social enterprises) to carry out the project.

Local authorities would have a number of borrowing options to fund the project. They could borrow from the Public Works Loan Board, the newly established Scottish National Investment Bank or by establishing a local authority housing bond. The borrowing costs would likely be cheaper for all of the options if investors were conscious of the fact that the project was connected to a national target and strategy for
feature of all of the loans, unlike Lobos, would be that they would all be long-term, fix-rate loans, at rates of interest below standard commercial rates.

The rent return on the housebuilding project would then go to the local authority: the aim would be for the project to pay for itself over a 30-50 year period. The better quality of the housebuilding, the greater returns will be reaped from each unit both in terms of reduced maintenance costs and extended rent returns from the longevity of the homes. Private sector high-volume housebuilders have the opposite financial incentive: the shorter life-span of the home, the greater requirement for demolition and further housebuilding (Turner, 27 November 2013).

A public-sector led model incentivises quality, and because the most advanced expertise for housebuilding could be centralised in one national investment company that would provide in effect free shared services to local authorities, the means by which to achieve quality would be established. This centralisation of design and planning would also drastically reduce costs in the planning process, as well as eliminating expenditure previously spent on the procurement process. The big win for private sector companies in PPP is the interest incurred on the debt repayment of projects. This cost would be eliminated for the Scottish Government, and substantially reduced for local authorities, in this public-public partnership model.

This investment model for housebuilding could also be transferred to high-quality childcare centres, wind farm projects and more.

The remaining problem may be large-scale national public infrastructure projects, in which, under new ONS rules, the Scottish Government would have to account for the cost of the project over the period in which the asset was being constructed. One way to free up capital in the Scottish Government’s capital budget for large projects would be to try to have a stricter allocation of what projects are regional/local, and therefore could be built through public-public partnerships (thus incurring no or limited capital cost for the Scottish Government), and what projects are essential to national infrastructure and therefore should be prioritised in the capital budget.

Building Scotland’s future now

The contemporary public investment picture in Britain is defined by two developments: the historic fall in government bond rates (a global phenomenon), making government borrowing extremely cheap, and the referendum vote for Britain to leave the European Union, which most economists believe will reduce demand, at least in the medium term. Both developments should lead policymakers towards the same conclusion: now is the time to boost the economy through state-led investment. The continuation of a public investment model based on committing future tax take to paying private-sector companies rates of interest significantly greater than if the government were to borrow the money directly is an unviable and imprudent approach. This report has outlined a workable alternative strategy, one that can help to build a new, dynamic relationship between local and central government in Scotland. It bases its case on ideas that have been proven to work, and have even been advocated for by the SNP Government when it first came to power.

For Scotland, whether it is heading towards independence or not, the need to build institutions for the future of the Scottish economy is essential. A Scottish National Investment Bank and Scottish National Investment Company could be two cornerstones of such a strategy.

ENDS
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