Building Scotland’s future now

A new approach to financing public investment

Executive Summary
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Public investment is crucial to the Scottish economy and is essential in providing Scotland with the infrastructure it needs.

The UK Government has deliberately neglected public investment to the point where the UK’s investment to GDP ratio is among the lowest in the EU. Brexit has seen a marked shift in emphasis towards increased public investment by the UK and Scottish Governments, but the increased finances so far announced are unlikely to meet the size of the economic challenge.

A major part of the Scottish Government’s public investment strategy since the SNP came to power in 2007 is the Non-Profit Distributing (NPD) model, which replaced Private Finance Initiative (PFI) as a key debt financing method used to pay private companies to build public projects.

There are competing arguments about how costly NPD has been compared to PFI, but even on the best estimates companies have recorded 12 per cent profits on NPD projects. The cost to the public purse is therefore considerably higher than if the government borrowed the capital to build the projects directly, with UK government gilt yields still at a historically low level despite Brexit.

Furthermore, the NPD financing model has been negatively affected by recent changes to ONS accountancy rules, which has found that large building projects organised through NPD must count on the Scottish Government’s current balance sheet, costing the Scottish Government at least £1.25bn in current capital expenditure that could have been used elsewhere. The advantages of the public-private partnership (PPP) financing approach have thus been entirely negated.

Additionally, the amount of future revenue expenditure that the Scottish Government can commit to spending on debt repayments is capped at 5 per cent, and the SNP minority administration has already committed 4.5 per cent, meaning the scope for future debt-based financing through NPD or other PPP methods is limited. Quite rightly, Audit Scotland and the Accounts Commission have announced an inquiry into whether the PPP model is “value for money”.

Beyond financing problems, the whole PPP model has come under renewed scrutiny over quality and health & safety issues after the collapse of a wall in a PFI-built school at Oxgangs Primary in Edinburgh led to the closure of 17 schools. A broader analysis of PPP in the UK shows that the profit motive sits uneasily at best and in conflict at worst with occupational public-sector health & safety standards.

A new model for public investment is therefore an urgent requirement. Originally, the new SNP minority government in 2007 planned to use NPD as a stop-gap before introducing the Scottish Futures Trust (SFT) which would “design, build, finance, operate, manage and own the facilities created”. This plan was ditched by 2008 in favour of SFT becoming an advice-cum-coordination vehicle for PPP, including the NPD model. The new context requires a return to the spirit of the original concept for SFT.

The Scottish Government’s ability to directly finance public building projects has been negatively affected by UK Government austerity, but with an increase in the capital budget and in the scope for capital borrowing over the next five years, there is some room for manoeuvre in the SNP administration’s public investment strategy.

Our proposal is to commit £225m (5.8 per cent) per annum of the Scottish Government’s total capital budget for six years to provide the capital base for a Scottish National Investment Bank (SNIB). The benefit of this is that an SNIB can then leverage sums for public investment that are well in advance of what the Scottish Government could raise directly. The SNIB could also accrue further capital through establishing bank bonds, and would likely be an attractive option for investment from Scottish Pension Funds.

The SNIB would therefore be able to provide long-term, patient capital for investment in private and public sector projects with strict social and environmental criteria, but would have to be transparently independent from the day-to-day work of government to ensure its lending decisions were based on the principles in which the bank is established.

SNIB lending to Small and Medium Enterprises (SME’s) could provide a much needed alternative source of funds in a sector that is widely acknowledged to be highly concentrated in Scotland with a low-level of SME lending compared to other regions in the UK.

For public investment, a key benefactor from an SNIB could be local authorities, which have been pushed into taking on expensive ‘Lobo’ loans from commercial banks with high rates of interest. Reducing the cost of debt repayments for local authorities through providing low interest rate loans from an SNIB could free up cash for public services.

The SNIB would be combined with a Scottish National Investment Company (SNIC), which would be based on the Scottish Futures Trust and would lead all of the Scottish Government’s public investment strategy, with direct Ministerial accountability.

The SNIC would be staffed with cutting edge expertise in public financing, legal, planning and building construction and design. It would carry out its public investment strategy in two main ways: first, it would prioritise the Scottish Government capital budget on essential national infrastructure, and secondly it would lead regional/local public investment through public-public partnerships with local authorities.
The benefit of public-public partnerships is that whereas the Scottish Government has strict limits on its borrowing capacity, local authorities do not. Local authorities would gain from free access to the SNIC team, which would reduce planning and legal costs. Local authorities would be the owners and direct funders of the projects, and could borrow from the Scottish National Investment Bank or through local authority bonds to get loans at lower than commercial interest rates.

The contemporary public investment picture in Britain is defined by two developments: the historic fall in UK Gilt rates, 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 policy-makers towards the same conclusion: now is the time to boost the economy through state-led investment.

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, and could be introduced now.