Y Pwyllgor Cyllid
Finance Committee

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Dear Tom

The Finance Committee of the National Assembly for Wales recently undertook an inquiry into borrowing powers and innovative approaches to capital funding. While the outcomes of our inquiry naturally focused on arrangements in Wales, we took evidence regarding arrangements, current and upcoming, in the rest of the UK. We have responded below to the questions raised in the consultation document on which we have taken relevant evidence.

1. **What does the theory of fiscal decentralisation tell us about the merits and demerits of Scottish bond issuances, including, and beyond, the issues covered in this document?**

There are risks associated with fiscal decentralisation if it takes place in the absence of a suitable agreed framework for control. Such risks include moral hazard and a lack of accountability for the impact of sub-national borrowing on the national fiscal and macroeconomic position. However, in our inquiry we took evidence "that it is perfectly proper for national Governments to seek to place reasonable constraints on sub-national or regional Governments' ability to borrow, and it is a matter of agreeing on the appropriate limits."[1]

[1] Record of Proceedings [para 42], 16 May 2012, Finance Committee

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Fiscal decentralisation gives sub-sovereign administrations greater flexibility over the way in which the resources available to them are used. This requires longer term financial planning, and robust assessment of investment requirements, which, if properly carried out, can contribute to the achievement of better value for public money. As a Committee, our view is that to deliver their capital programmes and use investment as an important economic lever, devolved administrations should be given maximum flexibility to manage their resources according to local priorities, within the parameters of an agreed control framework. The particular features of such a control framework are a matter for negotiation between national and sub-national governments.

2. What insights do UK precedents for sub-sovereign bond issuance provide for Scotland?

The Local Government Association and Welsh Local Government Association have explored the potential for local authorities to make use of their powers to issue bonds. More detail about this is given in answer to question 4 below.

3. What are the implications of central governments providing, or not providing, explicit guarantees for the borrowing of a sub-sovereign?

The Scottish Futures Trust, on 2 May 2012, told us that the National Housing Trust in Scotland was funded through a combination of local authority borrowing and private equity. The Scottish Government had provided a guarantee for the local authority borrowing element.[2] The Scottish Futures Trust told us that "the guarantee is provided by Scottish Ministers with its value reflected in budget and accounts on a probability call multiplied by value if called basis".[3] If there were to be an explicit guarantee of Scottish borrowing by the UK Government, it would score against central budgets, and might impact on central borrowing.

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[2] Record of Proceedings, [para 55], 2 May 2012, Finance Committee

[3] Finance Committee, FIN(4)-09-12 Paper 1, *Written evidence from the Scottish Futures Trust*, 30 May 2012

4. **How relevant to Scotland's situation are the interest rate premia that are observed in countries that issue sub-sovereign bonds?**

Our report recommended that, should the Welsh Government be granted borrowing powers, the Minister for Finance should include an expected maximum borrowing level in the annual budget motion.[4] Use of borrowing would therefore be subject to scrutiny by the National Assembly as part of the usual budget process. The Minister would be responsible for demonstrating the prudence and affordability of any proposed borrowing from any proposed source. This would require the Minister to undertake robust value for money assessments of the source of financing. We assume that similar arrangements would be put in place in Scotland in respect of borrowing powers or the issuance of bonds.

The evidence we received is that currently, local authorities in England and Wales undertaken the majority of their borrowing, approximately 75-80 per cent, from the Public Works Loan Board.[5] Our understanding is that this is largely on the basis of cost. The Holtham Commission's final report stated that the Welsh Government, if given the ability to borrow, would be likely to borrow from the Public Works Loan Board, also on the grounds of cost.[6]

The Local Government Association told us on 16 May 2012 that following the increase in the Public Works Loan Board rate by 1 per cent in 2010, the Local Government Association and Welsh Local Government Association undertook work to explore alternative sources of financing. The conclusion of this work was that if local authorities collaborated to borrow from the market, "the market would charge a premium of around 0.75% over the gilt rate". The Local Government Association said that this estimate was supported by evidence from the Transport for London bond issuance, which "got off at around that premium over the gilt rate".[7]

The Scottish Government would need, in considering whether to issue bonds as a product of debt, to take into account the costs of the various borrowing options open to them, and to make use of the option which offered the best value for money. In its evidence to us on 2 May 2012, the Scottish Futures Trust told us that:

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[4] Finance Committee, *Borrowing powers and innovative approaches to capital funding*, July 2012
[5] Department for Communities and Local Government, Statistical Release, *Local authority borrowing and investments – 2010-11*, December 2011
[6] Independent Commission on Funding and Finance for Wales, *Fairness and accountability: a new funding settlement for Wales*, July 2010
[7] Record of Proceedings, [para 176], 16 May 2012, Finance Committee

"For all of the work that we are involved in with [local authorities], we will probably use the Public Works Loan Board, because that seems to be the cheapest finance out there at the minute for local authorities. We have looked at other options with them, for example, local authority bonds, which I know have been talked about, but they seem at the minute to be likely to be more expensive".[8]

However, we heard evidence that the 2010 Spending Review increased the rate of Public Works Loan Board funds significantly, which had a noticeable impact on the levels of English and Welsh local authority borrowing from the Public Works Loan Board.[9] While subsequently the rate has been lowered, in return for the provision of more robust financial information by local authorities, if the rate were to increase to a level in excess of the interest rate premium attached to the issuance of sub-sovereign bonds, or there was to be further uncertainty about the Public Works Loan Board rate, a situation could arise when bond issuance represented better value for money, even taking into account any sub-sovereign bond interest rate premium. Our report recommended that greater certainty about the Public Works Loan Board was required.

5. What are the key risks and benefits to Scotland of bond issuance by Scottish Ministers?

Borrowing, from whatever source, gives governments, local or central, greater flexibility about when and how they make use of resources. The result is that it can become possible, even taking account of the costs associated with borrowing, to finance assets or projects which might not otherwise be affordable from ordinary budgets, particularly in this time of budget constraints, and therefore allow investment in infrastructure to further boost the economy. This represents not an increase in financial settlement, rather an increase in financial autonomy.

The Local Government Association ("LGA") told us that local government's ability to undertake prudential borrowing had increased the flexibility for local authorities to take greater advantage of potential opportunities, and to work in partnership with other funders to make possible capital investment which otherwise could not go forward, for example in relation to proactive road maintenance or housing.[10] Similarly, in its response to our consultation, Carmarthenshire County Council told us that: "Without [prudential

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[8] Record of Proceedings, [para 28], 2 May 2012, Finance Committee
[9] Finance Committee, FIN(4)-07-12 Paper 2, *Written evidence from the Local Government Association*, 16 May 2012
[10] Ibid

borrowing], we would not have been able to build so many new schools nor refurbish many more. [...] We would not have been able to retain and improve our Council housing stock."[11] The power to issue bonds, in addition to other sources of borrowing for capital purposes, would increase the flexibility available to the Scottish Government in the way it accessed borrowing to enable it to take forward its capital investment programme.

We heard evidence from local government directors of finance in Scotland that "the main issue around bond issuance is economies of scale – that is, the size that the bond issue would need to be to make it cost-effective". The directors told us that if local authorities were to collaborate, they could envisage a situation where it could be cost-effective to raise finances through bond issuance.[12]

The Scottish local government directors of finance also told us that local authorities considering bond issuance would need to be mindful of capacity for administration and management of the financial arrangements.[13] The Scottish Government would need to ensure that sufficient capacity and capability was available to ensure robust governance arrangements. The Scottish Futures Trust, an independent body which has a role in assisting the public sector in Scotland to access financing and acts as a centre for expertise, might have a role in this respect.

6. What is the potential source, scale and depth of demand for Scottish bonds?

Our inquiry did not take any evidence in this regard.

7. What would be the size of any yield premium that potential investors would require to invest in Scottish bonds (as a spread to the yield on UK gilts)?

We did not take any evidence in respect of a yield premium for potential Scottish bonds, but as noted above in answer to question 4, we heard evidence that if local government in England and Wales were to issue bonds under normal market conditions, the market would be likely to charge a premium of around 0.75 per cent over the gilt rate.[14]

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[11] Finance Committee, *Borrowing powers and innovative approaches to capital funding*, Consultation response from Carmarthenshire County Council, FIN(4)-DF08
[12] Record of Proceedings, [para 53], 24 May 2012, Finance Committee
[13] Ibid [para 53]
[14] Record of Proceedings, [para 176], 16 May 2012, Finance Committee

8. **How significant are the potential benefits and risks of bond issuance by Scottish Ministers to the rest of the UK, including to the UK gilt market?**

We did not take any evidence in this respect.

9. **Are there any other issues and risks that could impact on the rest of the UK in giving Scottish Ministers the power to issue bonds? If so, how might any such risks be managed?**

Our inquiry recognised that HM Treasury retains responsibility for UK fiscal and macroeconomic policy. We therefore considered some of the risks that might be involved in the granting of borrowing powers to the Welsh Government. As part of this consideration we discussed appropriate controls which might be agreed to ensure that sub-national borrowing did not place national macroeconomic parameters at risk. We were aware that the ability of regional governments to borrow, and, particularly, the ability for sub-national bond issuance, had been discussed at an EU level following the recent Eurozone crisis. The Welsh Government told us that while in some European countries, Spain for example, central governments had not placed restrictions on the borrowing undertaken by sub-national governments:

"The Welsh Government's position is that it is perfectly proper for national Governments to seek to place reasonable constraints on sub-national or regional Governments' ability to borrow, and it is a matter of agreeing on the appropriate limits."[15]

There are a number of different models which can be used to control the borrowing of sub-national governments, although our understanding is that there is no consensus on whether any particular model produces consistently better outcomes. According to the evidence submitted by the Independent Expert Group to the Commission on Scottish Devolution, the control framework models can be summarised as:

- *Market discipline*
  No limits set on sub-national borrowing. Local government is free to decide how much to borrow, from whom to borrow and what to spend borrowed money on. Financial markets enforce discipline and ensure sound borrowing practices through increases in borrowing costs or limiting access to financing;

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[15] Ibid [para 42]

- *Rules-based controls*
  Variety of forms, including restrictions on overall budget deficits, operating budget deficits, indicators of debt servicing capacity, levels of accumulated sub-national debt or levels of spending. Alternatively, rules can limit the purposes for which borrowing can be undertaken;

- *Administrative approach*
  Direct control by central government over sub-national borrowing, including by setting temporal limits on overall debt, reviewing and authorising individual borrowing operations or the centralisation of all government borrowing with on-lending to sub-national governments; and

- *Cooperative approach*
  Negotiated process between central and sub-national government to design sub-national borrowing controls.[16]

In relation to borrowing powers in Scotland and Northern Ireland, we understand that national limits on maximum borrowing levels apply. This is in contrast to the more flexible arrangements in place for local authorities under the prudential code.

The prudential borrowing regime which applies to local government in the UK is a hybrid of the control models set out above. There is no statutory limit on the level of local authority borrowing, meaning that, in theory, local government is free to decide how much to borrow and what to spend that borrowing on. However, there are restrictions preventing local authorities from running budget deficits. Additionally, as a high proportion of local authority borrowing is undertaken through the Public Works Loan Board, the operation of local government borrowing is effectively controlled by central government through the lending rates.

Further to this, HM Treasury retained a 'backstop' to allow it to set a limit on local government borrowing, should the macroeconomic circumstances require it. Arrangements for this reserved ability are set out in an established protocol which was negotiated by local and central government in Scotland, and in a draft protocol negotiated by the Welsh Government and Welsh local authorities.[17]

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[16] Independent Expert Group, *Evidence from the Independent Expert Group to the Commission on Scottish Devolution: Should Scottish Ministers be Able to Borrow?*, June 2009
[17] Finance Committee, FIN(4)-08-12 Paper 1 *Written evidence from CIPFA Directors of Finance Section*, 24 May 2012

We asked local government representatives for their views on the control central government retained over local authority borrowing. The Scottish Local Government Directors of Finance told us that:

"One of the key learning points from the practical operation of the prudential regime is that against that background of local responsibility, government has retained power to impose limits on capital expenditure. Local authorities therefore require to be prepared in the event of any limit being imposed."[18]

This suggested to us that, while the protocol to impose a national limit on borrowing has never been required, local authorities take account of the potential for it to be used in their borrowing considerations. It is therefore a key component of the self-regulation which characterises the prudential borrowing framework.

We believe that it is reasonable for such a 'backstop' to be in place in order to enable HM Treasury to fulfil its fiscal and macroeconomic responsibilities whilst maintaining flexibility and the principle of self-regulation.

As a Committee, we are persuaded that, subject to an agreed framework of controls mitigating against the risk of a negative effect on total UK borrowing or undermining the overall UK fiscal position, the provision in the Scotland Act 2012 which gives HM Treasury Minister the ability to grant Scottish Ministers the flexibility to borrow by way of bonds, if it can be demonstrated to be cost effective and prudent to do so, is sensible. This is a provision which we would want to see replicated in any legislation which granted borrowing powers to the Welsh Government.

If you would like any further information, or have any queries, please contact the Committee's Clerk, Gareth Price, on 029 2089 8409 or at Gareth.Price@wales.gov.uk.

Yours sincerely

Jocelyn Davies AC
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[18] Ibid