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### ***The Scottish Government's capital borrowing powers***

Under its fiscal framework, the Scottish Government can borrow up to £450 million annually to fund capital investment, as long as it remains within a total borrowing envelope of £3bn.

The catch with borrowing of course is that you have to pay back what you have borrowed, with interest. If it chose to use its borrowing powers, the government would be able to borrow via the UK Government through the National Loans Fund (NLF). (It could also borrow by issuing its own bonds, but it is unlikely to face lower interest rates through this channel than through the NLF).

At the moment, the government could borrow for a 25-year period at an interest rate of about 1.9%. On a £450m loan, this would imply total repayments of around £570m, or around £23m per annum. Alternatively, it could borrow for a 10-year term at an interest rate of around 1.5%. Total repayments would be lower (£490m) but the annual repayment would be higher, at around £49m.

### ***The justification for borrowing to invest***

On what grounds should the government use its borrowing powers? Indeed, is there ever a case for funding increased government investment today by borrowing – which has to be repaid by future taxpayers – rather than by raising more tax revenues from today's taxpayers?

The most obvious justification for borrowing to fund capital investment is where that investment will generate a return, through higher future tax revenues, that would pay for the future stream of repayments. Could the government invest £450m today in such a way as to increase economic activity and consequently income tax revenues by £49m (about 0.4%) each year for the next 10 years? Possibly, but this is probably an unrealistic goal for most projects.

Related to this, a temporary increase in borrowing could be justified if the economy was in (or close to) recession. In this case, investment could support recovery, and borrowing could be justified on the grounds that funding the increased investment through a temporary increase in tax rates would both counteract the stimulus effects of the capital spending and be distortionary in its own right.

Can a case be made at the moment for stimulus borrowing? Although recent rates of economic growth in Scotland have been relatively weak, the SFC estimates that the economy is operating at capacity. If this judgement is right, it weakens the case for temporary stimulus borrowing. But judging the economy's capacity for growth is incredibly difficult. Moreover, there is a case for saying that, in the face of significant political and economic uncertainty, additional investment by government may in itself raise the long-run growth capacity of the economy.

There are other justifications for public investment. Even if investment does not pay for itself in a pecuniary sense, it can be justified where it raises social welfare (or quality of life), for a prolonged period into the future. The construction of a new school or hospital is a case in point. Because these investments will deliver public benefits in future years, it is reasonable that future taxpayers should contribute to the costs of their construction. This justification is strengthened when interest rates are as low as they are currently.

***How much to borrow and over what period? Trade-offs***

But if there is a case for funding capital investment by borrowing, does it follow that the Scottish Government should use some or all of its borrowing powers this year or next year, and over what period should it borrow?

It will be up to the government of the day to set itself a borrowing strategy, recognising that the choices it makes will constrain future governments in different ways. An important trade-off is between the total borrowing limit of £3bn, and the level of annual repayments.

If the government borrows over a relatively short period of 10 years, it will effectively never rub up against its total borrowing limit. There will always be capacity to borrow £450m, as past debt is paid off relatively quickly. Therefore the option of borrowing is never closed off to a future government. But the cost is that annual interest repayments are relatively high, even when interest rates low. Under current interest rates, borrowing £450m per annum would result in debt maxing after 10 years at about £2.8bn with associated annual repayments of around £490m. In other words, by the tenth year, the government is borrowing £450m to invest but spending more than this to service current and past levels of borrowing.

On the other hand, borrowing over a relatively longer term (say 25-years) means that, because the government is paying its borrowing off less quickly, it would exceed its £3bn limit by the eighth year, constraining future governments from being able to undertake further borrowing. But annual repayments would of course be lower.

So whilst it is possible to make a good case to undertake some investment through borrowing, borrowing powers will need to be used judiciously and strategically to maximise their longrun effect without constraining future budgetary choices.

The new Medium Term Financial Strategy, due for publication on 31 May, should set out the government’s thinking about how it will manage the use of its borrowing powers over the coming years.