Economic PERSPECTIVE

PUBLIC INVESTMENT AND DEVOLUTION

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SECTION 1: INTRODUCTION

This paper looks at an economic issue that is emerging as one of the most important that will face the new Scottish parliament, namely how to deal with public sector investment. Investment in capital assets is essential to the wellbeing of the population and the continued growth of the Scottish economy. Hospitals, schools, roads and water all require steady investment if they are to deliver the services that the public expects. Devolution will allow the Scottish parliament to develop its own policy on public investment. Hence it is worth setting out the main factors that might influence such a policy. A review is also important at this time because of important changes that are taking place in the way that the UK as a whole deals with public investment.

As a concrete example, suppose that the party or coalition in power in the Scottish Parliament has made a commitment to reduce hospital waiting lists. Early in its term it discovers that this reduction will only be possible if several new hospitals are built around Scotland. However, no additional resources are available, either through the block grant from Westminster or from taxation. How can it proceed? The devolution bill prevents it from incurring long-term debt. Should it bring in private sector finance to build the hospitals? If so, what inducements will be needed to persuade the private sector to invest?

The idea of using private sector finance to fund public projects implies that government may be an *agent* in investment without necessarily *owning* capital assets. Scots have been less enthusiastic about privatisation than those south of the border. The successful opposition to water privatisation is an example of their less than ringing endorsement of the privatisation process. However, privatisations have occurred all over the world during the last two decades, resulting in substantial transfers of ownership of capital assets from the public to the private sector.

The view taken in this paper is pragmatic. It recognises that all forms of investment involve risk as well as potential reward and that government may have an important role in delivering or enabling investment. Growth and improved living standards in Scotland depend on risk-taking. It is often mistakenly thought that public sector investment is relatively risk free. The Scottish experience with local authority housing shows that this is far from the case. The outstanding debt on local authority housing is around £3.9bn. A large proportion of the rental income is being used to service the debt with the result that properties are not being properly maintained. If the housing stock was sold its market value would be substantially less than the existing debt, resulting in a substantial capital loss for the public sector.

Ownership of assets is important only if it affects either the selection of capital projects or their operation. No matter how these assets are financed, it is the case that failure to invest would not only have serious consequences for the Scottish economy but would also be unfair to future generations. The parliament will quickly have to establish a policy on whether and how to support public sector projects. This will have to take account of relevant UK policies. Particularly important are:

1. The Private Finance Initiative (PFI)
2. The change to "resource accounting"
3. The introduction of the "Golden Rule" for fiscal stability

The PFI is the starting point from which any change in policy by the Scottish parliament is likely to be measured. The introduction of "resource accounting" will improve the management of capital assets in the public sector compared with the current norm, which is simple cash budgeting. The Golden Rule will impose a strict fiscal discipline on the UK as a whole. Although it cannot be directly applied to the financing of the Scottish parliament, some of the arguments that lie behind it are relevant to Scotland.

The paper will discuss these issues in some detail but it begins by rehearsing the main economic

arguments concerning the relative merits of public and private finance. In practice, the Scottish parliament may have little choice but to opt for private sector funding for substantial new initiatives, but it is nevertheless useful to consider the arguments for and against public sector funding. Many of these arguments can be found in Flemming and Mayer (1997).

SECTION 2: PUBLIC OR PRIVATE FINANCE?

The Scottish Parliament will control a budget of around £15bn that will be shared between its various departments – health, education, transport etc. In turn these departments will allocate their budgets between capital and current spending. Because of current accounting conventions it is difficult to take an overall view of the balance of Scottish Office spending between current and capital purposes. The change to resource accounting in the public sector will make this information more readily available in the near future. However, the information will be of little value if it is not properly used. This requires an appreciation of the main issues in the debate about whether public projects should be funded by the public or the private sector.

Why should the Scottish Parliament invest in capital assets at all? In the 1970s, such a question would not have been taken seriously, but as privatisation spread during the 1980s the conventional view of government as owner, operator and regulator of services changed radically. Many enterprises were moved from the public to the private sector. Instead of seeking investment finance from government, these now raise funds on the private capital market. The UK public sector is much smaller than it was in the 60s and 70s and while government may have *some* role to play in providing capital assets, it is no longer accepted that this role should necessarily include all three functions – ownership, operation and regulation. A much more mixed view of public sector provision has emerged, though the government has retained the regulation function. Indeed regulation is now more intensive than was the case in the pre-privatisation era and arguably has contributed to improvements in service and reductions in prices for the bulk of consumers of services such as telecommunications, gas and electricity. In contrast, the experience thus far of privatisation in the rail industry has not been as satisfactory.

The standard argument is that government should own and operate industries where no competitive market exists. Enterprises supplying telecommunications, electricity, gas and rail services, for example, were argued to be "natural" monopolies. If owned by the state, these enterprises could be more easily prevented from exploiting their monopoly position than privately owned firms. However, privatisation coupled with active regulation has shown that this is not necessarily the case. The regulators have been able to create markets where none previously existed, thus reducing the scope for the exertion of monopoly power. Markets in telecommunications, in power generation, and in gas distribution have all been created in industries that were previously thought to be "natural" monopolies.

Two arguments have been put forward in favour of the process of privatisation. These are (1) reducing the cost of borrowing and (2) increased efficiency. We consider these in turn before examining the arguments against.

Reducing the Cost of Borrowing

The first argument is that privatisation should be encouraged to reduce the PSBR and so cut the cost of borrowing. The first component of this argument is correct. Under current national accounting definitions, private sector finance reduces the PSBR, but the idea that this in turn will cut the cost of borrowing is largely spurious. Various subterfuges have been suggested to move borrowing off the government's balance sheet. The only plausible rationale for this is to satisfy international bodies that assess public sector liabilities fairly narrowly. But whether its source is the conventionally defined public sector or some alternative body, borrowing to fund investment will not have a substantively different effect on the cost of capital than will private sector borrowing. It may influence the relative demands for equity and loan finance but this will only change the relative cost of raising funds by these mechanisms.

Private finance has an apparently beneficial impact on the PSBR because government, rather than paying to create some new asset, instead contracts to buy the services provided by an asset created by the private sector. Thus, for example, the extension of the M6 between Carlisle and Glasgow has been paid for by the private sector under the Private Finance Initiative (PFI). The government will not own the road, but instead will pay the owners an annual fee based on the number of vehicles using the road. Government has not met the immediate

cost of building the road and therefore there is no immediate adverse impact on the PSBR. However, the government does have a set of liabilities stretching into the future (the annual fees), which must cover the cost of building the road and the risks run by the contractors. The PFI reduces the government's immediate borrowing requirement. It does not reduce its overall liabilities. As we shall emphasise subsequently, it is important that the Scottish parliament's accounts recognise such liabilities.

Efficiency Gains

The more substantive argument in favour of private ownership is that of greater efficiency. Many of the internal mechanisms of a private company, such as profit sharing, performance bonuses etc., can be put in place in public sector enterprises. Attempts have been made by past and present governments to introduce such mechanisms. However, there is one feature of the private sector that the public sector cannot successfully reproduce – the discipline offered by external control, which comes in three forms[1]:

1. direct intervention by external shareholders
2. ownership changes
3. bankruptcy and insolvency

Private sector firms are subject to these disciplines while those in the public sector are not. If there is indeed greater efficiency in the private sector, its origins lie in the differences in the incentives that external control brings about. This is a key argument. Private sector firms that are not making the best use of their assets are subject to the threat of take-over or closure. These dangers provide strong incentives to improved performance and are difficult to reproduce in the public sector.

There are counter-arguments in favour of continuing to use public finance for public sector investment. These are:

1. adverse selection
2. governments' information advantages
3. lower cost of capital in the public sector

We now consider these arguments in some detail.

Adverse Selection

The adverse selection argument has to do with some investors exploiting private information to their financial advantage. A number of privatisations have been to the particular benefit of a small proportion of the population that has made windfall gains from increases in share prices. Where public projects are financed through taxation, all investors (taxpayers) are on an equal footing. The argument is that the distribution of returns (or losses) from publicly financed projects is fairer with public (tax) finance.

Governments' Information Advantages

The second argument lies with the interconnections between projects. Investment in some projects often has important implications for other parts of the economy. For example, investments in all forms of transport infrastructure are interdependent. The private sector may be unwilling to invest in rail because of uncertainty about the road-building programme. The government can exploit its superior information when making investment decisions. The private sector risk premium is increased by lack of knowledge of public sector policy. A counter-argument is that many public projects have a long duration and it is not necessarily the case that current governments are any better at predicting the policy of future governments than is the private sector. Is the current administration really in a better position than the private sector to predict transport policy twenty years from now?

Cost of Capital in the Private and Public Sectors

The final argument in favour of public investment is that the cost of capital is lower in the public sector because governments can borrow more cheaply than private firms. This is based on an incorrect view of what is really meant by the "cost of capital". The true cost of capital for a project is determined not by the cost of borrowing but by cost of borrowing *and* the risk associated with the project. A government may be able to borrow cheaper than the private sector, but this has nothing to do with the inherent riskiness of the projects it selects. The cost of borrowing is lower in the public sector because governments rarely default on their debts. As John Kay puts it:

> "The view that 'private sector capital costs more' is naïve, because the cost of debt to government and to firms is influenced predominantly by the perceived risk of default rather than an assessment of the quality of returns from the specific investment. We would lend to government even if we thought it would burn the money or

> fire it off into space[1], and we do lend it for both these purposes" (John Kay, 1993)

Governments decide whether taxpayers should bear the risk of any project or whether the risk should be sold to the private sector. If they decide in favour of the former (tax finance) they can fund the project at the "risk-free rate" - the rate at which they can borrow. If they opt for the latter, they have to offer the private sector a sufficiently attractive reward for bearing the risk. While private investors expect to receive a greater return the higher the level of risk, governments can coerce taxpayers into accepting risk without any compensating return.

As an example, suppose that a Scottish administration had to attract investors rather than force taxpayers to pay for its investment schemes. It proposed two projects, one to provide a light railway in Edinburgh, the other to build a major international airport on Barra. Treating investors in the same way as taxpayers, it would offer the same returns on both projects. Most sane investors would give the Barra project a wide berth because the return offered by the government would not be sufficient to compensate them for the huge risk associated with this project. Risky projects would not be undertaken so long as government failed to compensate investors for the risks that they might run.

Nevertheless, there is a further argument that the cost of tax finance is lower than that of private finance. It is that taxpayers are better at *bearing* risk than are private investors. Is the "risk premium" of taxpayers lower than that of private investors? If this is correct, then one could argue that the public sector cost of capital is genuinely less than that in the private sector. The standard argument in favour of this view has to do with risk spreading. Where there many investors, risks are widely spread and the premium above the risk-free rate that any single individual might demand for accepting this risk is relatively small. Because of the huge number of taxpayers compared with private investors, the cost of financing a public project using taxation is very close to the "risk-free" rate. Note that with widening share ownership both directly and through pension schemes the difference in the size of these groups is decreasing. However, if this argument is correct then the risk premium is lower for tax finance, and therefore its cost is genuinely lower than that of private finance.

This argument has an important implication for Scotland. Following the Devolution Act the Westminster government will not compensate the Scottish executive if public investment projects in Scotland fail by way of additional funding outside the Barnett formula. Where these are funded publicly, Scottish taxpayers, who comprise about 9 per cent of all UK taxpayers, will bear the entire risk of failure. This implies that for a Scottish taxpayer, the risk associated with a Scottish project funded by Holyrood compared with the same project funded by Westminster is greater by a factor of approximately eleven. This implies that the public sector cost of capital in a devolved Scotland is actually higher than that based on Westminster. The reason is that there are fewer taxpayers over which to spread the risk and therefore the individual "risk premium" is greater.

To give an example, suppose that the Scottish government decided to build another road-bridge over the Forth. This would be a substantial project carrying substantial risks, such as cost overruns, structural failure, unpredictability of revenues etc. If it were funded from the Scottish exchequer, this risk would be borne by Scottish taxpayers. They would receive no compensation for this risk because the government "borrows" from them at the risk-free rate. Further, each Scottish taxpayer would have to shoulder a substantially higher risk than would be the case if the funding came from the UK government. If it were privately financed, these risks would be transferred to the shareholders of the companies involved. If for some reason the bridge failed, it would be the company rather than the government that would have to bear the consequences.

Of course Scots presently bear part of the risk for the failure of projects south of the border. It is not clear that these liabilities will disappear after devolution because the UK government will retain control over almost all tax raising powers throughout the UK. It is therefore at liberty to raise, for example, income tax or VAT to pay for capital projects outside Scotland.

Even if Scottish taxpayers were not forced to bear the risk of projects in England and Wales, there is still an argument that devolution will raise the public sector cost of capital in Scotland. It is that public projects tend to be very "lumpy". Spreading more projects over a larger population (such as the whole of the UK) gives a greater chance that

[1] Note that this example is unrealistic in relation to Scotland because the exploitation of space is a reserved matter under the Devolution Act.

projects that fail will be offset by ones that succeed. The argument is again one of risk spreading. The risk premium is higher the smaller is the tax base.[2]

To summarise, the benefits of private sector finance lie principally in the efficiency gains that stem from the disciplines associated with external control. Against this is the argument that gains and losses from privately funded projects are not distributed as evenly as they are when tax finance is used. In addition, the private sector may be wary of projects whose returns may be influenced by unknown future government policies. Finally, the cost of borrowing does not truly reflect the cost of capital because it does not take account of the cost of risk. Under public finance, taxpayers are simply coerced into holding risk. But in a world of efficient capital markets, the only reason that might suggest a real difference in the cost of capital between private and public sectors is that the cost of bearing risk is lower with tax finance. The reason is that risk is more widely spread than is the case with private finance.
Devolution will reduce the size of the population that will bear the risk of public projects in Scotland. This will increase the risk premium and should shift the balance towards private finance. It is less risky for Scottish taxpayers to buy into services provided by the private sector than to supply these services itself.

Scots have never been particularly enthusiastic about using private finance to provide public services even though many have benefited privately from the purchase of shares in privatised firms. This lack of enthusiasm seems to conflict with the view of the "canny Scot" that would prefer to avoid risk and thus, by implication, to prefer to buy the services supplied by capital assets rather than take the risk of building them and then consuming their services.

We conclude this section by noting that the main implication of the above discussion is that the arguments relating to the efficiency of the private sector compared with the public sector will still hold after devolution, as will the contrary arguments relating to adverse selection and the interconnectedness of projects. The one area that is affected by devolution is the relative cost of capital in the public and private sectors, with public finance becoming relatively more expensive because of the increased risk that Scottish taxpayers might be coerced into bearing.

In the next section, we examine the current UK policy on private/public funding of capital projects – the Private Finance Initiative (PFI), which will be the starting point for the new parliament.

SECTION 3 THE PRIVATE FINANCE INITIATIVE

The last administration introduced the Public Finance Initiative to bring private sector funding into public projects. As a result it reduced the Public Sector Borrowing Requirement (PSBR) by taking some capital transactions outside the public sector's balance sheet. On a cash accounting basis, this improved the government's financial accounts at a time when there was international attention on the PSBR as an indicator of macroeconomic performance. As mentioned earlier, the reduction in the PSBR is unlikely to have had any substantial effect on the cost of borrowing.

The PFI was also aimed at bringing private sector management into areas that had traditionally been a public sector preserve. The Conservatives argued that this would lead to an increase in efficiency.

Each PFI scheme had to have all of the following characteristics:

1. funding had to come from the private sector
2. a substantial amount of risk had to be transferred to the private sector
3. the project had to offer value for money to the taxpayer

Projects could be paid for by the public-sector purchaser – as in the case of the M74 or by direct charges for usage as in the case of the Skye bridge or by a combination of the two.

The take up of PFI has disappointed successive governments. This has been attributed to the complexity of the procedures necessary to set up a project. There have been several attempts to simplify and speed up the process of constructing and submitting applications. The basic structure of the PFI has, however, remained unchanged.

If the Scottish parliament is to maintain support for this approach to funding public projects, it must be convinced that the PFI approach is superior to the alternatives. In other words, it must believe that solutions where assets are owned by the private sector are superior to those where ownership is in

[2] The lessons of history support the view that large projects supported on a small tax base carry substantial risk. The Darien Scheme in the 1690s cost Scotland over 25 per cent of its capital reserves and hastened the Act of Union.

the public sector. In practice, it should not matter where ownership of assets lies providing the following conditions hold:

1. service contracts are complete and
2. the contracting process is efficient.

The first of these conditions implies that, in writing a PFI contract, the client (the public sector) and the supplier (the private contractor) are able to cover all eventualities that might arise in the course of the contract to supply the public sector with a flow of services. The difficulty of writing such a contract, when its length is typically from 25 to 30 years depends on the nature of the service being provided. For example, it would be hazardous to write a long-term contract at present for communication services due to rapid technological change in the industry. In contrast, the services provided by building another bridge over the Clyde would be more predictable and therefore more easy to agree in a contract.

The second condition relates to the idea that the bidding process for any PFI contract should be competitive. It should drive out any excess profits that the private sector might seek to make. At present, public sector agencies are encouraged to keep as many firms as possible involved in the bidding process for as long as possible. This is difficult with provision of some types of asset where the range of assets is rather narrow.

The private-sector price includes a risk-premium that the public sector would not normally incorporate when costing the provision of a capital asset. As mentioned above, taxpayers are simply coerced into accepting risk by government. One would therefore expect that the actual cost of public sector provision would be lower. But the Scottish population would bear the costs if the project fails to meet its objectives.

With the PFI as the starting point, the Scottish parliament will therefore have to decide a policy on capital funding. It has a number of possibilities:

1. It could opt for public sector funding from the Scottish block grant. This would mean paying for capital spending as it occurred. No long-term liability is incurred, but larger projects would put substantial pressure on the Scottish parliament's current spending. All of the project risk would be borne by Scottish taxpayers.
2. It could use its tax-varying powers of 3p in the pound on the standard rate of income tax. In addition to the issues under (1), selection of this option would have to take account of any incentive effects of the change in Scottish tax rates relative to those in the rest of the UK. The size of projects funded from this extra tax revenue would be limited to around £690m per year. For example, it would take more around seven years of the full application of the 3p increase simply to pay off Scottish local authorities housing debt.
3. It could retain the option of private sector funding. Although the PFI has received limited support in Scotland, it is useful to have some examples where the advantages of reducing public sector risk and private sector efficiency can be calibrated. Further, although PFIs may have a role in promoting public investment, particularly when investment funds are scarce, it is inefficient to assume that all public projects should be funded through the PFI mechanism. Adverse selection, the interconnectedness of projects and the difficulty of specifying service contracts are all valid reasons for favouring public funding. Thus, on the grounds of both efficiency and risk-spreading, the principle of having a "mixed economy" where private and public funds are used as appropriate is sound.

Given these options, any policy should take account of the following points from the previous discussion:

1. The relative advantages the private sector involvement are greatest where:

   a) Contracts can be precisely specified over long periods of time
   b) There is the possibility of strong competition between private sector providers
   c) The efficiency of public sector provision is questionable when judged against comparable private-sector enterprises.

2. Increased private sector involvement is dependent on efficient and rapid decision making machinery in the public sector. Many public sector bodies that are at arm's length to the Scottish Office can initiate PFI projects. There is a need to more clearly focus the expertise that does exist so that those bargaining on behalf of the public sector can learn from experience and not negotiate with

the private sector from a position of weakness.

3. As mentioned above, PFIs create future liabilities on the public sector. If many different bodies are able to independently initiate PFI projects, there is a potential loss of control of public sector liabilities. Better control will require that the Scottish Office accounts more clearly reflect future commitments in the form of debt repayments or PFI service contract payments.

4. If a decision in principle is taken to have a mixture of both private and public sector funding, the difficulty will come in deciding how individual projects are to be funded. There is clearly an argument for some independent body to report, say, to a Finance Committee of the parliament as to appropriate funding mechanisms for particular projects.

5. There is also an argument for policy to allow for the possibility of "shared" risk between the private and public sectors. Current policy precludes risk-sharing. So long as contracts can be written that clearly assign risk, there may be advantages in such joint arrangements. For example, efficiency gains may be possible through the adoption of private sector techniques. Clearly, the private sector would expect a realistic return for the share of the risk that they might bear.

Two final issues are worth discussing in this section. The first is a change in the public sector accounting system that will improve policy discussions that relate to the balance of current and capital spending in the public sector. The UK government has been moving towards a system of "resource accounting" for some time. Its purpose is to improve the planning and control of public spending by gaining a clearer perspective on the assets held in public ownership and the costs and revenues associated with these. This approach contrasts with the simple cash budgeting that has been used up to now and which takes no account of capital assets.

The change will result in an accurate inventory of the assets held by government departments. This will enable departments to budget for maintenance and depreciation costs so that they better understand the true costs of capital. It will also allow departments to plan expenditures around their capital assets in a more rational way than has been possible with simple year-on-year cash budgeting. Finally, resource accounting will permit a closer matching of objectives and resource use in each department.

The system will therefore provide much of the information necessary to properly cost existing capital assets in the public sector. However, given the previous discussion, if departments are to budget properly, they also need to include information in their accounts on the future liabilities that they may have incurred through PFI schemes.

This form of accounting will also help in the calibration of the fiscal rules that the UK government plans to introduce in the near future which is the final issue discussed in this section.

The UK government intends to introduce new fiscal rules in the near future that will require explicit identification of the capital and current sides of government spending. These rules were laid out in Gordon Brown's 1998 budget and are called the "Golden Rule" and the "Sustainable Investment Rule".

The Golden Rule has the closest parallel to the activities of the Scottish parliament. Its essence is that over an economic cycle the government should only borrow for investment purposes. It should not borrow to fund current spending. In a recession, government revenue falls and welfare payments increase. Some increase in borrowing is therefore likely. Averaged out over the cycle, however, borrowings for current spending should be zero. Thus, during the boom phase of the cycle, the government should be repaying the extra borrowings it made during the recession to pay for higher welfare payments.

"The Government is determined to build a fiscal framework that encourages sound and responsible decision making so that policy is set in the UK's long-term interest. *The golden rule and the distinction between current and capital spending lie at the heart of our new approach to fiscal policy.*" Gordon Brown, Chancellor of the Exchequer, HM Treasury News Release 8/6/98 (italics added)

Although the Scottish parliament will have no long-term borrowing facility, the golden rule does carry an important message for a devolved Scotland. It lies in Gordon Brown's motivation for introducing this discipline to UK fiscal policy. Two main arguments have been used in favour of the Golden Rule. First it is suggested that the financial probity that it forces on the public sector will

promote a stable, low-inflation, high-growth environment. Second it is argued that it is unfair to future generations to burden them with debt which gives them no corresponding flow of benefits. Borrowing to spend money on this generation's unemployment benefit has no direct impact on the wellbeing of future generations, but they will become at least partly responsible for its repayment if it is debt-financed, most probably through higher taxes. In the jargon of economics, the Golden Rule will promote inter-generational equity.

Both these arguments have relevance to Holyrood. First, transparent probity in its use of the public purse will be necessary, if not sufficient, to reassure parts of the private sector who have been deeply sceptical of the devolution exercise. Without full co-operation from the private sector, it is difficult to see how a growth agenda can be pursued successfully. Second, just like Westminster, Holyrood has a duty to future generations. Too much current spending and too little public investment will place an unfair burden on our descendants. It is important for Holyrood to take this duty seriously.

Some help for this process is at hand. Future reports on government spending in Scotland will distinguish between current and capital spending. This will be made possible through the introduction of resource accounting. This will mean that shortly after it has been set up, the Scottish Parliament will have available to it a breakdown of the spending which it controls not only by department but also by its purpose - current or capital. This process will permit both the parliament and the Scottish people to take a broad view on how government is allocating its spending between current and capital purposes and on its current and future liabilities.

SECTION 4 – CONCLUSIONS

This paper has considered some of the issues relating to the treatment of public investment by the Holyrood parliament. At a theoretical level, there are arguments both for and against using the private ownership of projects that supply services to the public. The strongest of those in favour is that the private sector faces efficiency-promoting incentives that cannot be fully applied to the public sector. Against, there is the problem that using taxpayers to fund projects is generally equitable and the government may have an information advantage where projects are interconnected. The final theoretical issue is the relative cost of capital in the private and public sectors. The cost of capital has to be distinguished from the cost of borrowing. The essence of the difference is the premium that is paid for risk in a private market. Public sector projects are not immune from risk, but governments are able to coerce taxpayers into bearing this risk. When Scotland has a devolved parliament, the risk associated with any project will be spread over a much smaller number of taxpayers than is the case with the UK parliament. Individual risk will rise sharply and therefore the argument for "selling" the risk to the private sector is strengthened. In essence this suggests that the parliament should be more amenable to arguments that the public sector should buy services from the private sector rather than taking the risk of constructing capital assets to provide these services.

Note that under Schedule 5 of the Devolution Act, the Scottish parliament would not be able to regulate any public enterprise that it might decide to privatise. Hence, for example, if the Parliament took the decision to privatise the water industry in Scotland, it would be regulated by OFWAT. This somewhat anomalous position arises because competition and the regulation of industry is a reserved matter. One partial solution would be for the appropriate regulator at UK level to establish direct links with the Scottish parliament. The regulator could then provide a useful service to the Parliament by investigating restraints on trade within Scotland as well as acting as conduit for Scottish views on regulation.

In practical terms the starting point for the new parliament will be the existing PFI policy. Although this policy has been beset by difficulties, it does provide a framework for transferring risk from the public to the private sector. The Holyrood parliament may find its block grant and tax powers so limiting that it has no option but to look to the private sector for project funding. There are anyway arguments for maintaining a "mixed economy" of private and public funding to provide the maximum flexibility for the taxpayer and to provide efficiency comparisons. However, private sector funding is unlikely to be successful where it is difficult to specify precisely the contract for the flow of services that the public sector is to receive over the 25 to 30 year lifetime of the investment. It is also unlikely to offer best value in areas that might be affected by other aspects of government policy. In contrast, private funding should be favoured where there are strong efficiency arguments in favour of the private sector and where there is a strong argument that the risk should be transferred to the private sector.

Two changes in UK government policy should help to make these arguments less opaque. The first is the switch to resource accounting, which will force government departments to identify the assets that they own and the associated costs. The second is the introduction of the "Golden Rule", which will govern public sector borrowing. One of the arguments in favour of this is that of equity between generations. It is not fair to future generations to encumber them with debt associated with either current spending or with non-performing assets. The Scottish parliament will be inundated with proposals to increase the level of current spending. It is important that these pressures do not lead it to fail in its duty to those future generations that do not yet have a vote. This can only be done if the appropriate information is available. Hopefully the change to resource accounting will facilitate this process.

Taking all of these arguments together would seem to suggest the following:

1. The parliament should (and may have to) use both public and private finance to support public projects.

2. For reasons of risk-spreading, the balance will swing in favour of private finance once the Scottish parliament comes into existence

3. The parliament should set up an independent body with a remit to examine the options for the funding of all public projects in Scotland and report to a Finance committee of the parliament. This body should also consider how the rules for agreeing private sector funding may be simplified and how competition between private sector bodies for public projects can be encouraged.

4. The parliament should establish links with industry regulators so that the Parliament's as a conduit for Scotland's views on regulation and so that the regulator can be called on to deal with issues that directly affect Scottish enterprises.

5. The annual accounts of the parliament should distinguish clearly between capital and current spending. They should also show interest payments on previously incurred debt and the implied liabilities for the public sector that are associated with long-term contracts to buy services from assets provided by the private sector.

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