The Scottish Parliament

LOCAL GOVERNMENT COMMITTEE

AGENDA

28th Meeting, 2001 (Session 1)

Tuesday 6 November 2001

The Committee will meet at 2.15 pm, in the Chamber, Assembly Hall, the Mound, Edinburgh

1. **Items in Private:** The Committee will consider whether to take items 3 and 4 in private.

2. **Local Government Finance Inquiry:** The Committee will take evidence from—

   COSLA:
   Councillor John Pentland, Finance Spokesperson
   Councillor Drew Edward, Chair of Capital Task Group
   Norie Williamson, Director of Finance
   Brenda Campbell, Financial Policy Officer

3. **Community Care and Health (Scotland) Bill:** The Committee will consider a draft Stage 1 report.

4. **Scottish Local Government (Elections) Bill:** The Committee will consider a draft Stage 1 report.

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The following papers are attached for this meeting:

Agenda item 2

COSLA submission	LG/01/28/1

Agenda item 3

Letter to the Health and Community Care Committee on the Community Care and Health (Scotland) Bill [PRIVATE]	LG/01/28/2

Agenda item 4

Draft Stage 1 Report on the Scottish Local Government (Elections) Bill [PRIVATE]	LG/01/28/3

The following papers are attached for information:	LG/01/27/M

Minutes of the 27th Meeting 2001

Agenda item 2

Local Government Committee

6 November 2001

FOREWORD

The McIntosh Commission recommended that an independent inquiry into local government Finance should be instituted immediately. COSLA was extremely disappointed over the Scottish Executive's rejection of this recommendation and welcomes the Local Government Committee's decision to undertake an Inquiry.

COSLA has long campaigned for a full and independent review of local government finance and welcomes the opportunity to contribute to this important Inquiry.

This evidence contains considerable detail on local government finance arrangements. However, COSLA recognises that within that detail there are a number of key issues and messages which need to be addressed. The Executive Summary to this evidence outlines these key issues and whilst I would commend the full detail of the report, I would hope that readers take the opportunity to study and think in particular about the key messages set out in the Executive Summary.

This evidence is a product of detailed research and a commitment from all of local government to address the difficulties in the current system. It has been prepared on a fully inclusive basis and as such carries the wide support of local government across Scotland.

Local authorities are best placed to know what their communities want and, together with their partners and appropriate funding, they can deliver on priorities. In particular following reorganisation, it should be recognised that local government in Scotland is diverse and solutions cannot be dictated from the centre. There needs to be parity of esteem in partnership arrangements and local government needs to be trusted to deliver on priorities.

I hope readers will find this evidence helpful and informative in addressing and proposing arrangements which are aimed at breaking down the complexities of local government finance. A number of complex issues will always need to be dealt with, but I would hope that a commitment to the development and implementation of the issues set out in this evidence will result in an end product which delivers on what is important. At the end of the day, it is the services which are provided to the public which are paramount; what matters is what works.

I hope this evidence assists in the Committee's Inquiry and promotes consideration of a number of critical local government finance issues which need to be addressed as a matter priority. Changes are needed and these should be directed to restoring local democracy and local accountability.

John Pentland.

Councillor John Pentland
<u>COSLA Finance Spokesperson</u>

October 2001

CONTENTS

PART 1 - INTRODUCTION

BACKGROUND

1. COSLA has long campaigned for a full and independent review of local government finance to be undertaken. **The present system confuses accountability, creates dependency and has too many central controls**. We, therefore, welcome the Local Government Committee's decision to initiate an Inquiry.

   On the back of calls for a review, the previous Minister for Finance in addressing the COSLA Conference in March 2000, issued "a challenge" for consideration to be given to modernising local government and in particular the finance system. From subsequent consideration, significant and positive developments in local government finance systems were introduced:-

   - a firm 3 year revenue grant settlement for each council;
   - a firm 3 year capital allocation for each council;
   - the abolition of spending guidelines, subject to councils' agreement to publish indicative 3 year council tax levels;
   - the piloting of local outcome agreements; and
   - the initial development of prudential safeguards on capital investment as a replacement to existing Section 94 controls.

   The current position has only been achieved through co-operation and commitment from both sides and is a demonstration of partnership working between central and local government.

2. Whilst the revised arrangements were welcomed (albeit that COSLA has significant concerns over a continuing under-funding of local government and the unacceptable level of central direction in the use of resources) this cannot be regarded as the full independent review promoted by COSLA. It is, however, recognised as a significant step in the right direction. There could be a danger that unless the review of local government finance is considered in a holistic manner, what might be seen as solutions for particular aspects of the system may be at odds with the overall direction the review of the system as a whole should take. The benefit of the Committee's Inquiry, therefore, will be to take this wider perspective and in doing so, take into account both the developments already introduced and other changes to the finance system which need to be considered.

STRUCTURE OF EVIDENCE

3. In January 2001, COSLA submitted written evidence to the Committee to assist in its Inquiry. That evidence provided an outline or framework of the various issues which COSLA wished to develop further. It was recognised that the necessary further policy development should be taken forward on a fully considered and thought through basis.

4. This written evidence builds on that earlier framework and, on the back of research, comments in detail on a number of local government finance issues. Whilst for sake of presentation the various issues have been dealt with in separate sections within this report, in considering this evidence it is essential to recognise that all of these issues interlink. **This evidence therefore needs to be considered in its entirety to fully comprehend the nature of the various complementary issues.**

PROCESS

5. It was recognised from the outset that appropriate mechanisms needed to be put in place to further develop COSLA policy and link into this important Inquiry. To enable this, three elected member

   task groups were established to take forward the necessary work and four parallel officer groups were established to develop the practical issues and inform and advise elected members' consideration. Each member council was invited to have an elected member representative on one of the task groups. The composition of each group was established on a balanced basis taking account of geographic, political, etc factors. The officer groups were similarly established on a fully inclusive basis. The groups provided progress reports on a regular basis to meetings of council Leaders and the Convention. **The end product of this written evidence reflects the fully inclusive nature of the process.**

6. In parallel with the officer working groups, a secure network group for all local authority officer representatives was set up on the internet. This enabled access to papers for all working groups and not just the one group the council was a member of. A discussion board facility was made available to enable representatives to post comments on papers which allowed all representatives on groups to access these comments and add further comments if they wished. This arrangement reinforced the inclusive nature of the process with the written evidence benefitting considerably from this fully considered process.

THE WAY FORWARD

7. This evidence promotes a number of significant changes to the current local government finance arrangements. They are designed to simplify a complex system with a view to putting in place arrangements which will assist in restoring local democracy and local accountability.

   The proposals in this evidence need to be acted on at an early date. COSLA would therefore wish to discuss, as a matter of priority with all interested parties, how this may be achieved.

PART 2 – EXECUTIVE SUMMARY

1. COSLA has been campaigning for a long time for a full and independent review of local government finance to be undertaken. **The present system makes it difficult for local people to know how local government spending is funded and who provides local services. It makes councils too dependent on central government and there is too much central control over how money is spent. It restricts investment taking place rather than making it happen.**

2. We welcome the Local Government Committee's decision to undertake an Inquiry. We need to work together to break down barriers and make local government finance simpler and easier to understand. **What matters is what works.**

LOCAL GOVERNMENT IS LOCAL

3. The UK Government has given its approval to The European Charter of Local Self-Government. This charter makes clear that people should have the right to make decisions for themselves at the most appropriate local level. COSLA and the Scottish Executive have signed up to a Partnership Framework Agreement. This Agreement recognises that local government is democratic and representative of local people. It also defines working relations between local and Scottish central government as well as setting out arrangements for consultation.

   Both of these are valuable documents. It is crucial however that the **words are translated into action.**

4. Local government **delivers vital services to local people from the cradle to the grave.** Local councils are not just there to administer services in ways decided by others, they are an effective decision-making structure, too. Local councils are elected by local people; they are best placed to understand the needs of their communities. Councils can work out local solutions to meet those needs.

PARTNERSHIP AND TRUST

5. Central government makes decisions about what it wants to happen throughout Scotland and some of these are priorities. National and local priorities such as education and social inclusion (making sure that the same opportunities are available to everybody) are linked together and can't be split up. **The Scottish Parliament and the Scottish Executive need local government to make sure that their priorities work and that things happen throughout Scotland.**

6. There should be agreement between central and local government which will allow national and local priorities to be developed together. To do this, change is needed.

   At the moment, too many decisions which have direct consequences for local spending are made at national level and the central government gives too many directions about how things should be done. There should be talks between central and local government about the most important priorities before final decisions are made. There should also be talks about how important priorities can be made to happen and paid for. These talks need to be open to all partners in each issue.

   Before any of this can happen, everyone needs to recognise that local government needs to be an **equal partner. With this, local government will deliver on the priorities.**

7. COSLA are proposing a way of making sure that everyone agrees upon which issues are the top priorities and how much money should be spent on each of them. This can only happen when there is a full and open assessment of how much money is needed for local government to spend on providing local services and how this money can be raised. This assessment needs to allow for the costs of keeping going the services we all take for granted. It also needs to show how extra money can be made available so that any new priorities can also be paid for. This must be done in a way that allows sufficient money for every area of service and so that it can be afforded both now and in the future.

   The financing of local government and the setting of priorities needs to be **realistic; not idealistic.**

RING-FENCING AND CENTRAL DIRECTION

8. **Ring-fencing and central direction means that money is given with strings attached. When government provides "ring-fenced" money, it means that the money can only be spent on things which fall into the specific area included within the "ring-fenced" grant monies. Central direction means central government telling councils where to spend, whether spend in that area is needed locally or not.**

   30% of all the money local authorities get comes with these strings attached. This is **£6.6bn** over the next three years.

9. The total amount of money available to provide local government services is not enough at present. Because such a large part of the total "cake" has to be spent on the "ring-fenced" areas, there is less money to devote to other services and some important "core" services get less money than they really need, meaning that these services have to be cut back.

   Ring-fencing also means that councils have to set up systems to prove that they are spending money on the ring-fenced services leading to increased bureaucracy and less flexibility. This in turn means that new projects are held back because there is no flexibility in how money can be used to pay for them and it is difficult to plan ahead because money is often only given for one year at a time. The result is a system which reacts to short-term issues when it should be dealing with longer-term priorities and working together within a bigger overall picture.

   Targeting resources at very specific projects has been increasing and is now at an unacceptable level. The problems it is causing are well known and the Scottish Executive acknowledges them.

   There is no conflict between the national and local priorities, but **local government needs to be allowed more flexibility to deliver local solutions in the right way for local people.**

10. There should be more partnership working and local agreements should be put in place which will set out what is expected at a local level for each of the most important area-wide issues. These will help to right the imbalance in funding arrangements which exist at the moment. They would also demonstrate **trust** in local authorities to deliver on priorities and provide best value based on the needs of each local community.

    The basic message is that "one size fits all" solutions don't work. This is what we have to work within at the moment and the present system should be replaced by one which recognises the different priorities and differing needs of individual areas and communities.

REVENUE DISTRIBUTION

11. **Revenue distribution means the system which is used to give central government money to each local authority.**

    The basic problem with the system is that there is not enough money to provide for all the issues that need to be dealt with and that the tax system which raises the money is inadequate to raise enough cash.

12. A **fair** and **simple** formula for distributing money, which is easy for everyone to understand is needed. It should let councils know in advance their grants for three years at a time, which means that local government finance could be placed on a **predictable** and **stable** footing. The formula used at present to decide how much each local authority receives is over-complicated and needs to be simplified. Because it is very technical and complicated, the decisions reached using it are open to challenge and this has resulted in a lack of progress in refining the present system or developing a new one.

    The grant distribution arrangements are bound to be subject to political judgements. This is particularly true in Scotland since the establishment of the Scottish Parliament. Arrangements need to be put in place so that political influences on the process are subject to proper political debate with the outcome being fully open and easily understood.

    The present arrangements for the distribution of grant money must be simplified. It should be possible to keep the best of the present system and take action to resolve its weaknesses. But there is no way of deciding exactly how much each council needs to spend. We shouldn’t be searching for the Holy Grail.

13. A simplified basic system could be amended by special allowances or safety valves which would recognise the specific and special needs of individual councils. The introduction of such allowances would demonstrate a clear commitment from the Scottish Executive to tackling priorities such as social inclusion in communities.

14. We need to create a stable and simple but robust system which will not be affected by short-term changes and instability. This is important in order to allow individual councils to plan for the longer term.

COUNCIL TAX

15. The local taxation base is too low and we need to think about how to expand the tax base. This would mean that people would have a greater stake in paying for their local services through local taxes. We need to think carefully about whether it is appropriate to introduce **new taxes** which may be seen as a supplement to the Council Tax.

16. In addition, other **changes are needed to Council Tax arrangements** to avoid it running the risk of being seen as out of date or unfair.

    The present "banding system" for Council Tax is inappropriate because there are too many properties in the two lowest bands, A and B. There should be, say 10 or 12 bands instead of the present 8 with its concentration of properties in the lower bandings.

There should be revaluations of all properties at regular intervals to make sure that the system stays up to date.

CAPITAL

17. **Capital means money which is spent to provide or improve physical assets, like buildings and roads**.
Local government is committed to capital investment, but the existing identified needs for investment in capital projects, which total around £3 billion, **can't be delivered because of constraints on capital expenditure imposed under the current system.**

Councils are already looking at novel ways of encouraging investment. This work needs to be supported by relaxing the controls which currently exist. **The present system tends to prevent projects taking place rather than enabling them to happen. It is based too much on inflexible rules and is over-complicated.** One major failing is that the system does not allow for the longer term nature of capital investment.

18. The Scottish Executive is increasingly using what are referred to as top-slice and holdback arrangements. This means that some capital funding is only available to a selected number of authorities through bureaucratic competition. At present, 38% of all capital resources are targeted by the Scottish Executive in this way. There needs to be **more discretion, trust and local flexibility** and a balance between national and local priorities.

19. **Existing controls should be abolished** and replaced by a system of safeguards endorsed by professional bodies and designed for use at the local level. These could be designed to allow for the different needs and requirements of each council.

National government needs to support these changes with **sufficient and sustainable revenue funding.**

HOUSING RECEIPTS SET ASIDE

20. **Housing receipts set aside is the system which requires councils to use most of the money received from the sale of council houses to repay outstanding debt on the housing stock, meaning that only a very small part of the total can be used to pay for services needed by local people.**

COSLA has major concerns about the **lack of progress** being made to resolve this issue. Change is needed so that all of the money received from the sale of council houses can be kept by local authorities to invest in the modernisation and improvement of council houses.

21. Set aside for receipts of capital for projects other than housing was abolished some time ago. For it to be continued only for receipts from Council House sales is an anomaly which should be put right.

The climate in which set aside was introduced has changed very dramatically. The majority of councils are either actively pursuing a transfer of all their council housing to "community ownership" or are considering other alternative models of housing provision in their areas.

22. The current arrangements are not beneficial for the overall financial arrangements for public services. In addition, they do not help in taking forward a shared commitment to deliver social inclusion. **Set aside needs to be abolished with immediate effect.**

WHAT'S NEEDED NOW

Local authorities are best placed to know what their communities want.

Investment in local government will deliver on priorities, such as in education and social inclusion.

Under partnership arrangements, local authorities need to be trusted to deliver on these priorities.

PART 3 – CONSULTATION MACHINERY

Section 1 – Planning System in LGF
Section 2 – Organisational Structure of the Scottish Executive
Section 3 – Three Year Rolling Programme v Current System
Section 4 – Spending Review 2002

INTRODUCTION

1. This Section of the evidence develops a paper produced last year for SOLACE and submitted jointly by a number of professional associations on proposals for a future planning system in Scottish local government finance. Its purpose is to bring the discussion to a point where an effective Planning Framework can be agreed, comprising the Executive, council members, COSLA and professional associations.

2. The SOLACE paper raised a number of issues concerning the relationship and potential tensions between local government and the (then) new Scottish Executive. Some of these are being worked through and jointly resolved:-

   - Some of the potential tensions with national Treasury over council spending and tax levels is settling down (although council tax increases since 1999 have been on average higher than the prevailing rate of inflation but not significantly different from those in England).
   - There is an increasing expression of the view that national and local priorities are inextricably linked; the extension of this is that we need an understanding that local solutions can be tailored around national priorities and indeed that local solutions are permissible in their own right.
   - Financial stability is capable of delivery using the three year settlement as a starting point.
   - Partnership arrangements are recognised as being necessary to deliver on both local and national priorities.

3. But the major conclusion of the paper was the absence of a framework to plan priorities jointly, efficiently and effectively. Whilst we all agree on the need for such a framework, only its shadow outline has emerged over the past year. We have moved on the following:-

   - The three year settlement did to some extent recognise pay awards but the Best Value process needs to be more clearly set out and accepted by all concerned. All of us in Scottish government – both locally and nationally – are in a continuous state of financial pressure given the nature of the block grant arrangements and a model for dealing with efficiencies and investments is vital.
   - Work is now ongoing to identify ways of increasing the proportion of spending funded locally.
   - Discussions are underway on the shape and purpose of Local Outcome Agreements. (see Part 6)

4. The existing financial structure is intended to ensure that common standards of local government service are provided across Scotland. An emerging issue is the extent to which strategic themes should be introduced in place of service and functional targets. In a fragmented way, this is, to some extent, already happening through Scottish Executive driven initiatives in the field of health and social care and in economic development where structures are being put in place to promote joint service and financial planning against the background of meeting the Scottish Executive objectives and priorities. These need to be more jointly developed to achieve lasting success, but not at the expense of core business.

5. The existing system consists of a Ministerial/Local Authority Forum supported by a joint Local Authority/Scottish Executive Working Party of officers. This is in turn supported by three specialist Committees – on Distribution, Expenditure and Capital Planning. Table 1 summarises the roles of the structure, which is acknowledged as being somewhat unwieldy.

Table 1: Existing Arrangements

Mechanisms	Role & Responsibilities
Ministerial Meetings with Councillors	Political policy forum concerned about aggregate levels of financial settlements, the distribution of the Aggregate External Finance and items passed to it for consideration by the Committees.
Working Party	Deals with the detailed issues about local government finance before they go to the Ministerial Meetings. Includes representation from all authorities.
Expenditure Committee	Considers expenditure totals, council spending plans and budgets and issues likely to affect aggregate spending levels – including burden of changes.
Distribution Committee	Considers the needs-based methodology to distribute Aggregate External Finance to councils on an equitable manner and considers any other distributional issues as and when they arise.
Capital Planning Committee	Considers matters relating to all council non-housing capital, the allocation of Section 94 consents, the single allocation formula and technical aspects of the capital control system

6. **The concerns around this system are that it has tended to become very structured and formal with a focus on technical issues.** Conflict remains around obtaining an appropriate balance between maintaining confidentiality whilst being open and transparent and involving as many councils as possible. Yet the 'need' to involve as many as possible can make the structure unwieldy. In simple terms, significant amounts of time and effort go in to safeguarding individual positions (despite the overarching concept of acting for the benefit of local government). This is to some extent understandable because of the way grant distribution has worked. One gain is another loss. There is presently little scope for consideration of mutually strategic issues; the agenda is very much led by the Scottish Executive. **Any partnership arrangement between local government and the Scottish Executive should be of equal status**. The foundation of the Partnership Framework Agreement agreed with the Scottish Executive is based on parity of esteem and the principles of subsidiarity underlying the European Charter of Self-Government; each party recognises and respects each others role and functions, which are distinct and complementary.

7. There is also a need to recognise that such a change in emphasis necessarily will mean that the system has to be able to bring together those public sector organisations that work in partnership with local authorities in order to achieve these outcomes.

8. The paper for SOLACE focused not so much on the detail of any new structure for local government finance, but more on the development of a more coherent and strategic planning framework which would set the context for issues around aggregate resource requirements, equity and distribution. The paper did not specify whether membership of the forums and groups would be on a representative or all-embracing basis.

ORIGINAL SOLACE PAPER

Table 2: SOLACE Paper

Mechanisms	Role & Responsibilities
Strategic Policy Forum	Political policy forum concerned about considering and agreeing jointly to both national and local priorities and target outcomes. It would also consider the financial resources necessary to deliver on these priorities. As such it would consider aggregate levels of financial settlements to local authorities, the Executive and its agencies.
Planning Forum	A joint officers group – which would include representatives of agencies involved in delivering services across a number of themes. The forum would identify and agree tasks and timescales for theme-based groups. The forum would also have to prioritise between expenditure programmes under each theme.
Theme Groups	These would be involved in prioritising and costing 3-year plans for consideration. They would set out agreed frameworks that would drive resource allocation and within which councils would develop their own detailed plans for that theme.

9. **The suggestion was that the Policy Forum would develop a three year plan as the basis for development with some form of outcome specified agreement** (either with councils as a whole or with individual councils). The emphasis should be on outputs and outcomes. What was missing from the SOLACE paper was a "Resources and Outcomes Committee" to achieve effective results from all deliberations.

10. The paper indicated six possible Theme Groups:-

    Children and Families (Social Inclusion)
    Community Safety
    Support for Vulnerable People
    Community Care, Economic Development and Employment
    Sustaining/enhancing the built and natural environment
    Public Transport and Infrastructure

    The social inclusion theme could be expanded as social justice.

11. To a certain extent, some of the groundwork for such a system is already in place. On Local Economic Forums, the Scottish Executive has established what is in effect a Theme Group; all councils have submitted Local Transport Strategies and have responded to Local Agenda 21, and are working on joint Health Action Plans. All these policies and plans are now also placed in the context of local Community Plans.

    What is lacking is the national strategic context - A Strategic Policy Forum could provide this, with the main thrust on social justice.

12. There are four main issues with this approach:-

    - Firstly, it proposes the adoption of a system that follows policies and issues rather than directly related to services as in the existing system.
    - Secondly, it widens the discussion away from finance to the consideration of the range of public resources that can be targeted at these policies and issues from a range of agencies.

- Thirdly, a risk is highlighted that the structure could be less of a partnership and more of a process that sees councils as local administrators of national priorities rather than reflecting local issues and opportunities in their plans and programmes. The spirit of the Partnership Framework Agreement between local government and the Scottish Executive should provide the drive to create an effective partnership which can address this issue.
- Finally, if the structure is too strategic and complex, it will lose focus on one of the requirements of such a structure – the 'delivery' of a system that enables councils to plan and deliver services effectively and efficiently with as little uncertainty as possible. Councils are familiar with the present system.

THE NEXT STAGE

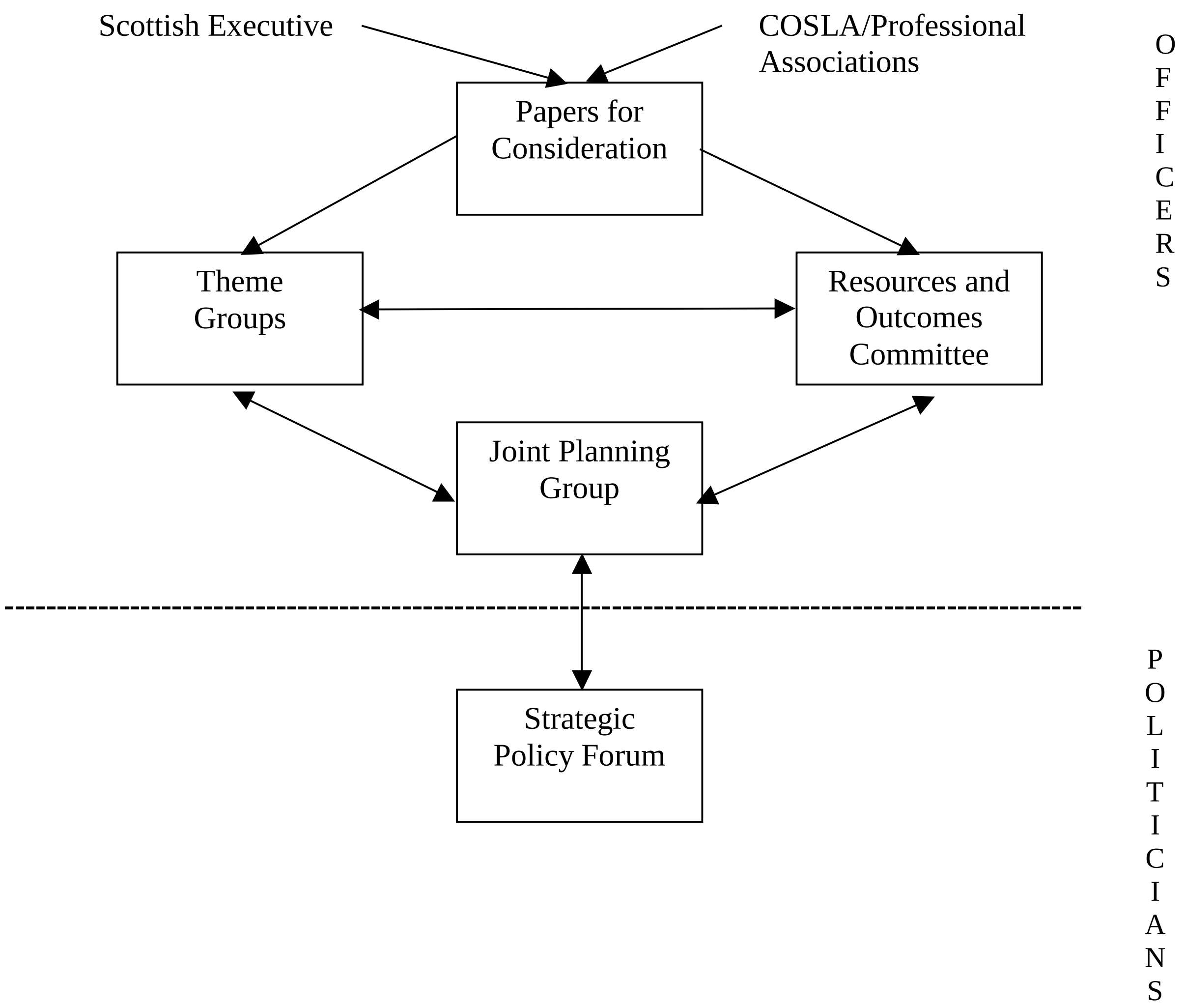
13. To look at strategic themes as opposed to local council functions will require considerable work. Funding for Health Boards will be refocused following the "Fair Shares for All" Review by Professor John Arbuthnott. The principles in this Review could be referred to a Strategic Policy Forum for development on local authority areas.

14. In Wales there is an effective Partnership Council which has powers written into the Welsh Act. We could learn from the experience of local councils in Wales which would help in our development of a planning and target setting system in Scotland. This is another area which could be referred to a Strategic Policy Forum.

15. In terms of operating principles, theme groups could, for instance, be: Children and Families, Community Safety, Health and Social Care, Economic Development and Enterprise, Social Justice and Housing, Planning and the Environment, Transport and Development Infrastructure and Rural Sustainability. It may be possible to combine some of these themes to reflect the level of resources that follow each theme.

16. Critically, however, the proposed Planning Framework is predicated on genuine partnership arrangements being in place with an open and realistic recognition of the spending pressures being faced by local authorities and the capacity for local government to generate ongoing efficiency savings.

Diagram 1 : Possible Structure of a Planning Framework



17. There is a real opportunity for local and central government to work together in an effective and meaningful manner.

18. **The Strategic Policy Forum would operate as a political policy forum which would set the strategic direction of the work.** It would consider and agree jointly realistic national and local priorities and target outcomes. It would also consider the financial resources necessary to deliver on these priorities and the aggregate levels of financial settlements to local authorities.

19. The Joint Planning Group would be a joint Scottish Executive and COSLA officer group. The group would prioritise between expenditure programmes across and under each theme. This group would also identify and agree tasks and timescales for theme-based groups.

20. Theme Groups would be involved in prioritising and costing 3-year plans under each theme and provide a context in which councils (and through the local community plans, their partners) would develop their own detailed plans for that theme.

21. The Resources and Outcomes Committee would consider the methodology to be adopted and developed to distribute Aggregate External Finance to councils on an equitable basis in respect of emerging themes and priorities agreed through the other mechanisms.

    It would also consider the development of outcome and evidence based systems to ensure local and national systems were complementary and the issues arising in respect of distribution of additional resources.

    There is an obvious role for COSLA and professional associations in developing these groups, which in turn will require more effective co-ordinated joint working to provide a unity of purpose.

POTENTIAL BENEFITS

22. **By creating a new structure, more effective input can be given by both local and central government to achieve genuine consensus on priorities, strategic themes and the methods of allocating any new funding for these.**

23. **By focusing on new funding distributed on a thematic basis, the risk of internal disparity can be avoided.** Under present arrangements, it could be argued that local authorities with more affluent and less rural communities may find it easier to achieve outcomes than those with more deprived and remote communities.

24. **By jointly setting clear and realistic efficiency targets linked to the Best Value process, local and national government will identify resources for reinvestment and help with ongoing performance measurement.** Research has shown that around 0.5% is at the upper end of achievable targets. This issue was recently raised by Professor Arthur Midwinter in his submission to the Local Government Finance Inquiry; his specific comment confirmed this position.

25. **By accepting the full funding of pay awards, central government will set a stable financial base and create the necessary climate for successful partnership.** It is acknowledged that partial funding is in place but achievable financial plans need the certainty which would follow full funding of pay awards.

26. **By involving other agencies such as Health Boards and Enterprise Companies, outcome based agreements can be agreed locally with partner agencies.** This will put greater emphasis on the Community Planning process.

INTRODUCTION

1. This Section provides an outline of the present structure of the Scottish Executive and a list of its targets and objectives identified in the 2001 Annual Budget. Its purpose is to begin an assessment as to whether or not the present structure works with local government and can develop a co-ordinated approach on both policy formulation and the implementation of strategy within an agreed framework which recognises the value of each partner.

ORGANISATIONAL STRUCTURE

2. Overall, the Scottish Executive consists of seven Departments – including a Finance and Central Support Department – the semi-autonomous Crown Office and Procurator Fiscal Service and a non-ministerial department (the General Register Office for Scotland).

3. The naming structure under each Department varies – some have Divisions, others Groups. To simplify matters, terminology used in this note is Departments/Divisions /Groups.

4. On this basis, the Departments are divided into 34 Divisions that are divided in turn into 96 Groups and 13 Professional Units. There are, in addition, 11 Scottish Executive Ministerial Agencies and 2 Non-Ministerial Agencies.

5. The following table shows a brief summary of the structure in each Department.

Table 1: Organisational Structure of the Executive

Department	**Divisions**	**Groups**	**Ministerial Agencies**	**Professional Units**
Health	7	28	3	1
Rural Affairs	4	17	3	3
Development	5	19	-	1
Enterprise/Lifelong Learning	3	15	1	2
Justice	3	9	2	4
Education	4	8	2	2
Finance/Central Support	8	-	-	-
TOTAL	**34**	**96**	**11**	**13**

6. The ‘most complicated’ departmental structure is in the Health Department, with 39 different elements. Next comes the Rural Affairs Department with 27 and the Development Department with 25. The ‘least complicated’ departmental structure is in the Finance and Central Support Department with 8 elements.

7. A number of Departments have a series of Divisions covering the same overall area of activity. For example, the Development Department has four Transport Divisions, three Housing and 3 Planning Services Divisions. The Justice Department has two Police Divisions and the Health Department two Primary Care Divisions.

8. The general policy and spending responsibilities of each Department are shown in Table 2.

Table 2: Departmental Responsibilities of the Executive

Department	**Responsibilities**
Health	NHS in Scotland, Health Finance (including PPP), Health Improvement/Health Issues, Human Resources, Health Planning
Rural Affairs	CAP, Land Use and Rural Policy, Fisheries, Environment Protection, Agriculture and Farming, Countryside, Water, Natural Heritage
Development	Housing, Trunk Roads, Transport, Planning Services, Building Control, Social Inclusion, Voluntary and Equality issues
Enterprise/Lifelong Learning	Energy, Enterprise/Industrial Policy, Further and Higher Education, New Deal, Adult Training, Enterprise Network, Tourism, Skills, Lifelong Learning
Justice	Judicial appointments, Criminal Justice, Fire, Police and Emergencies planning, Inspectorate – Fire, Police, Prison, Prison and Court Services, GROS, Archives, Register
Education	Schools and Teachers, 21st Century Government, Arts, Sports and Culture, Children, Families and Young People, Childcare, Chief Architect's Office, Historic Scotland, Inspectorate – Education, Social Work Services
Finance/Central Support	Finance, Analytical Services, Secretariats – Cabinet, Constitution and Parliament, Media and Communications, Offices – Parliamentary Counsel, Solicitor to the Executive, Local Government/Europe /External Relations

SCOTTISH EXECUTIVE OBJECTIVES AND TARGETS

9. The Scottish Executive is pursuing a number of objectives and priorities but these have been internally developed with little meaningful consultation with local government and a resultant lack of 'ownership' by local government. To some extent, this is understandable in a young parliament, anxious for achievement.

10. Table 3 lists the objectives which relate to local authorities and which might require a contribution at local level to achieve success.

Table 3: Executive Objectives and Targets with Local Authority Interest

Department	Objectives/Targets
Health	Delivery of the new National Health Action Plan Children's health initiatives – breakfast clubs, healthy eating schemes, help to vulnerable families New mental illness needs framework New Social Services Council and care inspection regime Development of council food safety enforcement auditing
Rural Affairs	Increased agri-environmental schemes and land covered by woodland Forestry linked – core path network, community forests, town woods, recreation and tourism initiatives
Development	Rural transport initiatives Reduction of deaths and injuries on roads and to children Homelessness issues – including advice from councils to all homeless Housing investment and community ownership transfers Tackling dampness and condensation Support for SIPs Locality budgeting and local statistics initiatives Support for voluntary activities and organisations Translation and interpreting standards framework Establishing of National Parks Rights of responsible access Preparation of Area Waste Plans Sustainable development initiatives Environmental awareness campaigns Flood prevention and coastal protection schemes
Enterprise/Lifelong Learning	New operational performance targets for the Enterprise Network, the tourist network and Learn Direct Scotland Increasing use of renewable energy sources
Justice	New community fire safety strategy Local crime prevention initiatives Community drug tackling schemes – including to under 16s Emergencies planning Reform of Common Police Services Expansion of CCTV schemes Processes for dealing with witnesses Educational opportunities for sentenced child offenders Expansion of Probation and Community service orders Increase number of accused on to social work and related diversion projects

Department	**Objectives/Targets**
Education	Review of initial teacher training Consideration of future demands on teaching and learning skills Framework for continual teacher professional development Strategic approach to improving the school estate Achieving all 3 year olds into pre-school education Increase number of classroom assistants Reduce all class sizes in P1-P3 Increase the ratio of computers to both primary and secondary school pupils Develop more New Community Schools Development of informal education and social services National training initiatives for social workers Competence drives for community care and child and family workers and social work managers Development of school culture co-ordinator programme Audit of Scotland's museums and galleries Support for creative industries and architecture events Expansion of Active Primary School programme Expansion of local coaching Development Office network Development of school sports co-ordinators in secondary schools

11. The Scottish Executive's focus is on Social Justice with major increases planned for a Central Heating initiative, the Integrated Transport Fund, Housing Community Ownership, Homelessness, Empowering Communities, Young People and Looked After Children initiatives and the Strategic Waste Fund. A recent addition is funding for implementation of Sutherland proposals on care for older people.

12. There is a shift of resources away from areas such as Scottish Enterprise, the Housing Revenue Account, Rail Services in Scotland, Grants to Local Authorities for Transport, CAP support and the Scottish Parliament.

13. Where liaison has taken place on priorities, there is a perceived, and sometimes real, lack of integration within the Scottish Executive; often divisions are unaware of contacts and arrangements which exist between local government and the Scottish Executive (e.g. Scottish Executive advice on developing projects for Better Neighbourhood Services Fund). **A more corporate approach would help everyone and could be developed in the context of broad themes rather than departmental initiatives.**

OPPORTUNITIES FOR AREAS OF ENGAGEMENT

14. Local government services do not wholly mirror the structure of the Scottish Executive departments. Whilst each council will have individual issues from its relationship with the Scottish Executive, the broad impression is that improvements could be made in communications:

- dialogue between the Scottish Executive and COSLA and professional associations could be improved. COSLA participates in the financial management process which is presently driven by the Scottish Executive. This process is highlighted and challenged in Part 3 – Section 1.
- Leaders' meetings take place at regular intervals; on occasion, these meetings could be held jointly with the Scottish Executive and could consider taking forward priorities emerging from the Executive, on the understanding that co-ordination within the Scottish Executive is effective.

15. There are many areas where closer links would be mutually beneficial. **Both Scottish Executive and local councils want the best services possible and links at the highest level would be productive at a political level between Ministers and Leaders and also at officer level.**

NEXT STAGE

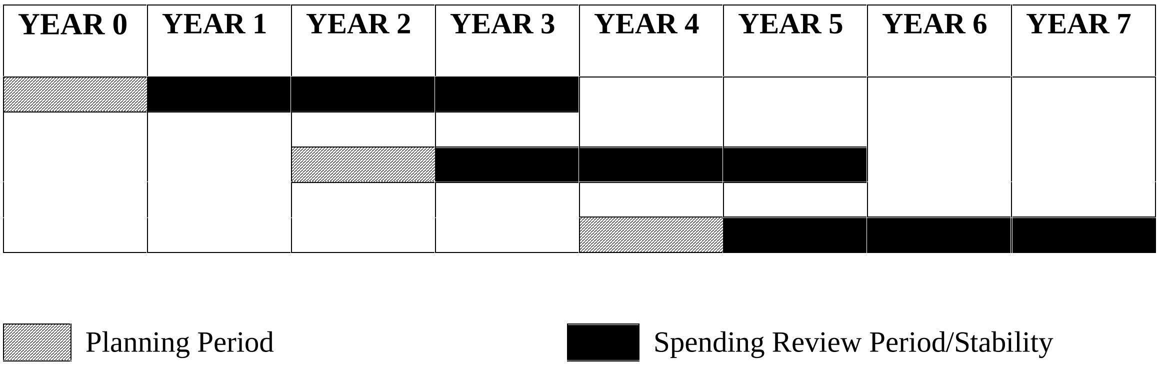
16. Work is underway to develop the financial arrangements, which although complex in mechanism, are capable of effective dialogue because of the relatively small numbers in both the Scottish Executive and in COSLA. Dialogue has resulted in significant negotiated change being taken forward this year in local government finance systems, this resulting in greater stability and certainty for individual councils. The need for, and benefits deriving from, an effective Planning Framework are set out in Part 3 - Section 1.

17. **These building blocks can be developed to pick up as many as possible of the other priorities and work areas to try to bring them together in a policy planning environment of mutual trust and respect. This would lead to achievement of consistency of policy and understanding and acknowledgement of shared national and local objectives.**

INTRODUCTION

1. Current debate centres on the advantages and disadvantages of the current three year allocation compared with a rolling three year review. The three year allocations which we have at present are more or less fixed for those three years. The alternative to this is a rolling three year review which would see the first year 'drop off' and a 'new' third year added on an annual basis.

Diagram 1 : Spending Review Timescales



THREE YEAR ROLLING PROGRAMME V CURRENT SYSTEM

2. Table 1 lists a number of advantages and disadvantages relating to each system.

Table 1 : Advantages and Disadvantages of Three Year Rolling Programme and Current System

Three Year Rolling Programme	**Current System**
Advantages - Under best value, fits in with three year revenue and capital budgets - Avoids the problems encountered with annuality - Avoids the problems of later notification of resources - Allows a more strategic approach which can also reflect local priorities - With Local Outcome Agreements and closer joint working with the Executive, planning for year 3 in the middle of a spending review can be more effective.	**Advantages** - Can fit in with three year budgeting - Avoids the problems encountered with annuality - Avoids the problems of late notification of resources - Allows a more strategic approach which can also reflect local priorities - Fits in with Central Government Spending Reviews - GAE reviews are carried out every three years
Disadvantages - Does not fit with the time of central government's spending reviews - Will always mean GAE is reviewed annually for three years hence	**Disadvantages** - Risk of turbulence every three years, depending on criteria for distribution. This may require continuation of mechanisms to smooth changes from year 3 to new year 1.

3. A three year review of distribution would minimise year on year instability and allow phasing in of changes across the three years. It would also allow time to consider and review changes and this is preferable to the annualised crammed work programme that a three year rolling programme would entail.

4. Under the current arrangements, the timing of the settlements are linked to the Treasury's spending reviews. This allows local authorities 18 months/two years to plan for the first year of the spending review, which then lasts three years. Although local authorities do not have firm figures for years 2 and 3, they do have at least an indication of their settlement, which will allow for future planning.

5. The present three year spending review allows focus on new and additional funding, although it is recognised that a bridging or smoothing arrangement is needed.

CONCLUSIONS

6. **There are a number of advantages which would further assist councils in their longer term planning by putting in place a three year rolling programme and COSLA would advocate its further consideration at the relevant time in the future. To make this effective, however, such arrangements need to extend beyond local government to other areas of the public sector. It is only through this that the joining up of resources may effectively operate.**

7. **While, therefore, there are operational advantages for councils in rolling programmes, early changes to the current national system perhaps seem unlikely and we should allow it to settle in and prepare a bridging arrangement to smooth turbulence, keeping the focus on new funding.**

INTRODUCTION

1. The Treasury is carrying out a Spending Review in 2002 and the need for local government to influence this is unquestioned. This Section considers how this process can be taken forward.

PREVIOUS REVIEWS

2. Much effort has been directed into previous spending reviews (2000): COSLA provided input which identified pressures resulting from previous legislation and initiatives which had not been fully funded; SOLACE also co-ordinated information, asking each professional association (ADES, ADSW etc.) for their funding requirements.

3. This approach yielded some positive results in that a three year settlement was announced, with some recognition of the pressures resulting from pay awards. It also drew on the expertise and efforts of a wide number of stakeholders with well-intentioned efforts. However, improvements could be realised in co-ordination, realism and resourcing.

WAY FORWARD

4. **At the earliest stage, we should identify the following factors:-**

   - **our shared objectives**
   - **communication/joint working arrangements with the Scottish Executive**
   - **timescale and resourcing**

5. Clarity around common objectives has brought about results: local government has succeeded in retaining its share of the national budget; partial funding of pay awards has been recognised. **Both partners need to be realistic, not idealistic**. It could be argued by some that local government has been guilty of bidding for an over-ambitious amount of resources; equally it could be argued that the Scottish Executive's efficiency targets have not been practicable. **It is essential, however, that as a part of the process, realistic consideration is given to the resources needed to maintain core services as well as those which may be available to address new initiatives**.

6. Structures exist which could be utilised to facilitate communication and co-ordination. From a local government point of view, **COSLA should assume a role of directing a timetable and co-ordinating all other professional organisations.**

7. **This work should commence as early as possible to allow a considered, co-ordinated approach to be adopted.** A project plan should be drawn up identifying timescales and required resources. It is essential that the Scottish Executive plays an active part in this process and this clearly links to the Planning Framework outlined in Section 1. Joint identification of strategic objectives at both local and national level should be an integral part of the process.

CONCLUSIONS

8. **Given that Spending Reviews are a permanent, frequent feature of national financial planning, it is essential that local government has a mechanism for reviewing, refocusing and identifying new priorities. The Planning Framework should take this on board, allowing the agenda to be refreshed and updated, keeping the focus forward-looking.**

PART 4 – RING-FENCING AND CENTRAL DIRECTION

INTRODUCTION

1. This section focuses on the ring-fencing and central direction of resources. It illustrates the full extent of ring-fencing and central direction and the perverse effects it has, and promotes the minimising of this and the case for local and national priorities to be taken forward on a partnership basis.

EVIDENCE OF EXISTENCE OF RING-FENCING

In order to demonstrate the existence of ring-fencing in the current Local Government Settlement, a list of ring-fenced funds has been compiled and this is attached as **Appendix 1**. Table 1 summarises the findings:

Table 1: Ring Fenced Funding 2001-02 to 2003-04

	2001/02 (£m)	2002/03 (£m)	2003/04 (£m)	Total (£m)
Ring Fenced Funding				
Included within AEF	634.222	668.288	686.453	1,988.963
Outwith AEF	449.151	516.052	609.952	1,575.155
No Detail of Split over 3 years	-	-	-	491.700
Total Ring Fenced Funding	**1,083.373**	**1,184.340**	**1,296.405**	**4,055.818**
AEF	6,048.791	6,361.642	6,717.542	19,127.975
% Ring-Fenced	*10.49%*	*10.50%*	*10.22%*	*10.40%*
Total Scottish Executive Local Authority Spending	6,832.252	7,304.452	7,700.452	22,328.856
% Ring Fenced	*15.86%*	*16.21%*	*16.84%*	*18.16%*

2. Table 1 confirms the statements made by Ministers that ring-fencing of AEF accounts for approximately 10% of central funding. However, it can be seen from Table 1 that, if funding for local government outwith the AEF settlement is included, over 18% of total local government funding can be categorised as ring-fenced.

3. It should also be noted that, a number of the Specific Grants received do not cover 100% of the expenditure requirement for the given service, e.g. Police Grant covers 51% of eligible police expenditure. This results in additional expenditure being committed by local authorities. This is estimated to be £413.076m for 2001-02, £432.045m for 2002-03 and £445.213m for 2003-04 based on the percentages shown in Appendix 1. This increases the percentage of total local government funding to be 23.94% as shown in Table 2.

Table 2: Ring Fenced and Committed Funding 2001-02 to 2003-04

	2001/02 (£m)	2002/03 (£m)	2003/04 (£m)	Total (£m)
Total Ring Fenced Funding	**1,083.373**	**1,184.340**	**1,296.405**	**4,055.818**
Additional Committed Expenditure	413.076	432.045	445.213	1,290.334
Total Ring Fenced & Committed	**1,496.449**	**1,616.385**	**1,741.618**	**5,346.152**
Total Scottish Executive Local Authority Spending	6,832.252	7,304.452	7,700.452	22,328.856
% Ring Fenced & Committed	*21.90%*	*22.13%*	*22.62%*	*23.94%*

IMPACT OF CENTRAL DIRECTION

4. In addition to the ring-fencing of funds, earmarking of GAE allowances was introduced in 1999-2000. The Scottish Executive 'Local Government Finance System: General Guide' stated that this involved provisional GAE shares being allocated to local authorities who were invited to take up their full allowances. It was made clear that failure of local authorities to utilise the resources for the intended purpose would jeopardise their allowances in subsequent years.

A list of centrally directed funds has been compiled and this is shown in **Appendix 2**. Table 3 summarises the current level of centrally directed or earmarked funds. It can be seen that the percentage rises over the Spending Review period demonstrating the increasing extent of the Scottish Executive's central direction on the use of funds.

Table 3: Impact of Central Direction

	2001/02 (£m)	2002/03 (£m)	2003/04 (£m)	Total (£m)
Centrally Directed Funding	**370.634**	**414.812**	**486.338**	**1,271.784**
Total Scottish Executive Local Authority Spending	6,832.252	7,304.452	7,700.452	22,328.856
% Centrally Directed	5.42%	5.68%	6.32%	5.70%

TOTAL EFFECT OF RING-FENCING AND CENTRAL DIRECTION

Table 4: Summary of Ring-Fencing and Central Direction

	2001/02 (£m)	**2002/03 (£m)**	**2003/04 (£m)**	**Total (£m)**
Total Ring-Fenced, Committed and Centrally Directed Funding	**1,867.083**	**2,031.197**	**2,227.956**	**6,617.936** (includes £491.7m unallocated over 3 years)
Total Scottish Executive Local Authority Spending	6,832.252	7,304.452	7,700.452	22,328.856
% Ring Fencing, Committed and Centrally Directed	*27.33%*	*27.81%*	*28.93%*	*29.64%*

5. **It can be seen from the above tables that almost <u>30%</u> of Government funding to local authorities can be considered to be ring-fenced or centrally directed. This is much greater than the 10% quoted during earlier discussions on the subject.**

6. Almost 6% of the above figure is due to expenditure committed by councils where Specific Grants do not cover the total expenditure requirement of the service provided. Even if this committed expenditure is excluded, the total Government funding that is ring-fenced or centrally directed is almost 24%.

PROBLEMS EXPERIENCED THROUGH RING-FENCING

7. In its submission in January 2001 to the Local Government Committee, COSLA produced an annex, which made reference to specific examples, a number of which have been repeated in this submission in order to highlight the specific problems, which have been identified.

8. The problems of ring-fencing have been well documented.

   The Local Government Committee has stated that as a general rule, the presumption is against the extension of specific grants, as they are expensive to administer and they restrict the freedom of authorities to order their priorities and allocate their resources.

9. The Department of Transport, Local Government and the Regions (DTLR) has recently completed a similar review of local government finance in England and produced, in September 2000, a Green Paper on the Modernisation of Local Government Finance. The paper includes consideration of the problems of ring-fencing, and notes that:

   'it [ring-fencing] could weaken local accountability and democracy and encourage some local authorities to give less attention to their proper responsibilities for strategic planning and quality improvement;
   - *It could erode local authorities' financial responsibility and freedom;*
   - *It could lead to weaker co-ordination between local services;*

- *It might create pressure for ring-fencing of other services.'*

10. **In previous submissions, COSLA has argued that the current system creates '*too much dependency on central government, confuses accountability and contains too many central controls*'. It has concluded the problems of ring-fencing to be that:**
    - ***it can and does generate perverse outcomes;***
    - ***the process is rigid and bureaucratic;***
    - ***it is fragmentary and militates against a strategic and joined-up approach;***
    - ***it is disingenuous to place so much focus on particular initiatives through displacement of funding from other high priority areas.***

11. The major issues arising from consideration of the impact of ring-fencing include:
    Erosion of Core Services

    The overall increase in ring-fencing of resources since 1996, within a declining local government settlement, has lead to the erosion of core services. Although the settlement for 2001-02 to 2003-04 has shown a substantial increase, once this has been stripped down to its constituent parts the increase for core services is relatively small. The proportion of Specific Grants within the Total AEF has itself risen from under 8% in 1996-97 to almost 10% for 2001-02.

    In some areas, council priorities are no longer being addressed appropriately by core services. This is a direct result of cuts in these services, as resources have been squeezed to make way for high profile central government initiatives. However, the effectiveness of these initiatives in meeting council priorities is, in some cases, debatable.

    The greater the proportion of total funding which is ring-fenced or centrally directed, the smaller the amount which is available in general funding. Hence, **councils may be in danger of having such a high level of hypothecation that they will have increasing difficulty in delivering core services.**

    In addition, there is concern that almost all real funding increases have been ring-fenced or ear-marked for the Scottish Executive's priorities and to compensate for this, local authorities will need to continue to find savings in other services.

Practical Example : Roads and Transportation It could be argued that since 1996 the money available for roads and maintenance has been in decline due to increased ring-fencing at the expense of core services. A ring-fenced Public Transport Fund was established to assist local authorities in providing *enhancements* to the public transport networks. This seems to be contradictory, at a time when there are no additional monies for essential road maintenance despite the crumbling state of the road infrastructure.

Practical Example: Public Transport Fund

Additional capital consents have been received through the Public Transport Fund to invest in specific schemes. That investment is welcome but it does not address the impact of years of under funding on roads expenditure that is the result of limited mainstream capital consent and restrictions on revenue expenditure.

Road dressing in the area, for example, is being undertaken on a 30-year cycle rather than the recommended seven-year cycle. That is very serious and is leading to the gradual deterioration of all the roads. By ring-fencing resources for new initiatives, the Scottish Executive has tied the council's hands in addressing the underlying problems in its road network.

Practical Example: The Excellence Fund

There is well documented evidence on the crumbling state of schools. Other examples of reductions in areas of education spend include reduction in non-essential fabric work, reduced staff development, reduced resources to schools through per capita and specific allocation and removal of enhanced staffing allocation to schools in areas of deprivation.

Where ring-fenced resources are used for staff costs, it becomes increasingly difficult for Councils to fund the effect of pay awards. Hence, significant reductions may become necessary in other areas, the inevitable result being the further erosion of core services.

Bureaucracy

A major criticism of ring-fencing is that it requires councils to submit development plans that address the objectives of the particular fund, for plans to be reviewed and approved by the Scottish Executive and for councils to produce evidence of the impact of the grant funding on the delivery of services.

One of the most recent and most extensive uses of ring-fenced funding has been the Excellence Fund for Schools, which was announced by the Government in 1998. Although this was welcome funding for education, the process by which local authorities received the funding was seen as being unnecessarily bureaucratic and time consuming.

Ring-fencing of resources means councils have to account to the Scottish Executive in detail for how the money is spent. This increase in bureaucracy will require more management time to be devoted to accounting for work being done rather than to developing the service. **The administrative burden, which results from ring-fencing of resources, is onerous and results in valuable resources being tied up in bidding, form-filling, submission of grant claims etc. Such efforts could be better deployed both within central and local government.**

Inflexibility

Much of ring-fencing is specifically directed to detailed programme initiatives. There is limited, if any, scope for re-allocating funds from one programme to another. This means, for example, that councils cannot divert funds from one programme into another that they consider a higher priority. Strict regulations govern the use of ring-fenced resources. In many cases, spending on existing services is specifically prohibited even when these services meet the policy objectives. **As an increasing proportion of total budget is ring-fenced, councils' scope for creativity and the introduction of innovative working practices and projects is inhibited by lack of flexibility in the use of resources. More flexibility may result in more efficient use of scarce resources.**

The Excellence Fund is split into a number of individual programmes, reflecting particular government initiatives. Councils have experienced major problems because of the lack of flexibility between programmes. A number of councils have provided specific examples of problems relating to the Excellence Fund. Such problems include:

- the failure of the Scottish Executive to consider local conditions when establishing ring-fenced funding
- the expansion of new initiatives without evaluation of their success
- the prescriptive nature of regulations that govern the use of the Excellence Fund and does not permit virement between programme headings.

Practical Example : Social Inclusion Partnerships

Many Social Inclusion Partnerships (SIPs) and local authorities have already prioritised community empowerment in SIPs – this is a well accepted aspect of good practice. Funds to support this are limited and local authorities have to comply with national programme requirements. However, having freedom to target particular issues would be preferable.

Local authorities are heavily involved with established networks of community organisations and local capacity building activity (eg. around support to community & voluntary sector support organisations). Many of these organisations operate with minimal funds, there is insufficient flexibility to allow the council to allocate funds in such a way as to support particular local issues (eg. training and capacity building at local level for SIPs and other priority groups such as disabled or elderly people).

Similar concerns have applied to other areas of Social Inclusion Partnership activity. For example, additional monies have been ring-fenced to SIPs to tackle drugs. It is up to local partnerships to decide how this work will fit in with the Drug Action Team activity and Community Safety Partnerships, which also focus on drug issues, but it may be difficult to avoid confusion and the threat of overlap in an already complex field of activity.

The principle issue is that more flexibility in the use of these resources would be beneficial. Funds could be allocated at a strategic level for local strategic partnerships (eg. Community Plan Partnerships) to disburse according to needs at local level, reflecting targets that have been set by the Scottish Executive in the Social Justice report rather than create a situation of potential overlap with existing activity.

Additionality

Linked to the inflexibility of ring-fencing of resources, in some instances, Councils feel they have suffered unjust treatment due to the additionality ruling. This has occurred where councils have implemented initiatives before they were adopted by government as its priorities. As a result they are either not eligible for ring-fenced funds to support these initiatives or are forced to spend the money in low priority areas. Hence, these councils are, in effect, being penalised for leading the field in initiatives that have been identified by central government as priorities.

Practical Example : The Excellence Fund (Early Intervention)

One council fully supported the introduction of the early intervention scheme, so much so that it set up an element of early intervention before the Excellence Fund was announced. Because of the additionality ruling, the council cannot reduce this element of its core budget.

Annuality

Problems have also resulted from the annuality and late notification of resources. **Annuality has meant that there is no guarantee of ongoing funding in future years. This militates against a strategic approach to addressing priorities and contrasts with the development of three-year budgeting following the three-year financial settlement for 2001/02 – 2003/04.**

Timescales for planning and implementing projects and services can result in underspends due to lead-in times. The fact that money requires to be spent by 31 March does not always recognise the need to comply with EC Procurement Directives and also individual Councils' own tendering and financial regulations.

Where ring-fenced funding is only provided for a limited period of time, appointments can only be made on a temporary basis. This can lead to difficulties in the recruitment and retention of suitable staff. Ensuring continuity of staff in post also becomes a problem because of the lack of permanent basis for posts established.

The following example provided to COSLA by one Council during the Summer 2000 Survey shows how practical difficulties can result from annuality.

Practical Example : Late Notification

The council's spending guideline was estimated in November, which was fairly accurate overall. The amount distributed through ring-fencing was, however, considerably greater than had been originally estimated and as a result of overall control totals, this necessitated additional late savings being identified from elsewhere in the council's budget.

Other examples of similar problems were highlighted, as follows:

- Funding for reducing class sizes notified too late to allow building work to be carried out during school holidays.
- Late notification of mental illness specific grant causes uncertainty for voluntary organisations.
- Allocation of Children's Services Development Fund resources results in uncertainty until continuity of funding is made clear.
- Fixed nature of funding and lack of continuity may result in councils avoiding the option to lease hardware for the National Grid for Learning, which may be the most economical procurement method.

Lack of Strategic and Joined-up Approach

The increased use of ring-fencing of resources has been criticised because it is seen as a reaction to short-term issues rather than a means of addressing priorities from a strategic point of view. The lack of a strategic and joined-up approach can be seen in a number of different ways.

The ring-fencing of funding in some instances has been shown to result in councils funding one initiative or project from different sources. This can lead to managerial and reporting difficulties and opposes a joined up approach.

Practical Example : The Excellence Fund (Alternatives to Exclusion)

Funding is received to provide support to schools to reduce the number of pupil exclusions. However, councils have also made available significant sums to drive down exclusions by taking a multi-disciplinary approach together with Social Work Services, Local Health Boards and other support agencies. These councils are effectively running two separate initiatives which relate to the same strategic Government and council priority.

Alternatives to exclusion and study support initiatives can also create long term staffing implications. The approach taken by many schools is to create additional posts to cover both areas and so contractual obligations will be built up over the period of these initiatives. It may be that had councils been given greater freedom, it may have resulted in a better, longer term investment potential from putting funding into early intervention strategies, rather than being faced by a direct initiative to reduce numbers of excluded pupils as a short term measure.

In its submission in January 2001, COSLA also highlighted the following example where a strategic approach was lacking.

Practical Example : The Excellence Fund (New Community Schools)

One council felt it had taken a strategic whole-authority approach to becoming a new community authority. But the progress of this strategic approach has been impeded by the bureaucracy associated with ring-fencing. For example, there is Education Action Plan funding and new Community School funding through the Excellence Fund special programme. There is Early Intervention and Alternatives to Exclusion Funding through the Excellence Fund Core Programme

"The strategic and visionary approach to this major development would be made much easier to implement and much more effective if the ring-fencing of these monies from the Government was completely removed with the focus being directed to the delivery of outcomes.''

Ring-fencing may also mean that councils have to take forward projects to attract funding, whether or not these are considered to be a local priority. This may mean money is diverted from core services into particular initiatives favoured by the Scottish Executive. The following examples of this have been provided by local authorities.

Practical Example : Park and Ride Scheme

One authority has stated that a park-and-ride scheme was introduced because challenge funding was made available by the Scottish Executive to fund the project almost entirely. This was not an initiative on which the council would have placed a high priority if it had to be funded from it own resources.

Practical Example : The Excellence Fund

Substantial new funding has been made available through the Education Excellence Fund to support initiatives such as after-school clubs and increased numbers of classroom assistants. Although the money is welcome it is, perhaps, incongruous where there is a need to spend significant sums on the maintenance of properties simply to bring them up to a reasonable standard.

A number of councils have provided specific examples of problems created by the prescriptive nature of the Excellence Fund due to initiatives already established within their local authority. This demonstrates that in establishing ring-fenced funding, the Scottish Executive failed to consider existing local conditions.

Practical Example : The Excellence Fund (Study Support)

Certain clusters within one council area had difficulty spending their allocation of this part of the Fund. It is felt that the reasons for this were :

- good parental support and supervision of study aids at home eg. computers
- a good starting point of services already in existence prior to the Excellence Fund monies.

In other words, centrally determined priorities failed to take account of existing local conditions. The inability of Head Teachers to move the funds to address a higher priority created frustration and encouraged a perception that some initiatives "get money thrown at them" whilst other greater priorities are deemed not to be important by those "up on high". It does not help local authorities build good managerial relationships with Head Teachers.

Practical Example : Development Fund for 3 Year Olds

The Scottish Executive has encouraged the creation of nursery places for all 3 year olds whose parents want them and has encouraged a mixed economy of public, private and voluntary provision. However, council efforts to develop partner provision with the private and voluntary sector have been hampered by rules which restrict the use of these funds to registered centres ie. those that already exist. There is a failure to allow councils to make local judgements on supporting the development of new centres based on their local knowledge.

In addition, it is the view of local authorities that the introduction of new initiatives, for example Classroom Assistants, should be evaluated before being rapidly expanded. Again, the prescriptive nature of the Excellence Fund does not allow the movement of funds between programme headings to reflect local conditions.

Practical Example : The Excellence Fund (Classroom Assistants)

This programme is expanding rapidly without evaluation of the effectiveness of classroom assistants. Some Head Teachers have argued that targeting resources at employing more teachers would produce better results by reducing class sizes. One council tried in 1999/00 to claim for 3 additional teachers with this argument but the Scottish Executive did not agree.

Other examples of the apparent contradictions which result from ring-fencing of resources which have been previously identified by COSLA include:

- Deletion of teaching posts while employing classroom assistants using ring-fenced funds
- Reduction of permanent community posts whilst temporary project leaders have been employed for SIP projects
- Closure of library facilities whilst opening a new internet café with SIP funds

The examples detailed above show problems created by ring-fencing at two levels:

- **National control cannot take account of local factors and needs**. These grants lead to a distortion of priorities, with lower priorities sometimes being progressed ahead of more pressing local issues. While it is possible that national and local priorities can coincide at a strategic level, too much prescription at local level by the Scottish Executive will result in less effective use of public money.
- **Local efforts to manage resources are undermined**. Much effort is going into seeking the views of users in developing services through Best Value Service Reviews and local management initiatives. Ring-fenced funding cuts across this whole approach.

In general, ring-fencing does not help in the development of a modernised government in which the views of all stakeholders are sought and taken into account. Rather it imposes a singular view of priorities which can be manifestly wrong by the time they reach the local level at which the initiative is to be implemented. When this happens it undermines the credibility of all levels of government.

PROBLEMS EXPERIENCED THROUGH CENTRAL DIRECTION

13. The current GAE system was established as a means of distributing grant. Values were assigned to individual GAEs as a measure of relative need and allocated across councils in a way that was designed to ensure that all authorities could provide a relatively consistent standard of service. Their prime purpose is, therefore, to arrive at one figure per council which may be used as a basis to inform the distribution of AEF. **However, it has been observed that GAEs are increasingly being used to influence local spending decisions and being treated as a guide to the expected level of spend on a given service rather than the relative need.**

Practical Example: Drug Rehabilitation Service

In the latest settlement, the Scottish Executive provided £6.8m for local authorities for drug rehabilitation. This amount was new and additional to councils, over and above provision in 2000/01 and was provided within the GAE settlement under Remaining Social Work Services.

The Scottish Executive stated that "*Ministers expect your Council to ensure that this additional funding is reflected in enhanced drug rehabilitation services, over and above its previous provision of substance misuse services*." In effect, the Executive was directing the Council to increase its drug rehabilitation budget in 2001/02, where the Council had already agreed an estimated spend for that year.

The Scottish Executive wrote to Councils on 19 April 2001 voicing concerns that "*some social work services are having difficulty in securing funding to enhance drug rehabilitation services in their areas… …If additional funding for drug rehabilitation is not made available, there will be difficulty in implementing the national drug strategy through Drug Action Teams.*" Reassurance was sought that this was not in fact the case.

One local authority expressed concern that the Executive had not used the normal route of providing specific grants (ring-fencing) when they wished to direct Council spending priorities. Instead, an amount equivalent to a specific grant has been provided through

GAE. The Green Book, however, makes it clear that GAE should not be used to determine the level of any specific service. GAE is a general provision which, combined with Council Tax receipts, should allow the Council to meet locally determined priorities.

The view of the council was: *"..in setting the budget…. the relative priority of all Social Work services has to be assessed and overall expenditure contained within the overall budget available. Given the range of Social Work Services provided …. and the growing demands on the budget from other client groups, it is not possible to allocate additional resources to drug rehabilitation work in line with Scottish Executive expectations."*

The council concluded that locally determined assessment of relative need for Social Work services should be adhered to.

If councils were to accede to such requests from the Scottish Executive, it is possible that central direction would be extended such that the Scottish Executive could have discretion to direct how all RSG should be spent.

Practical Example: Road Maintenance

On 28 September 2000, the Minister for Transport stated in a press release :

"Years of neglect have left our local roads and bridges in an appalling state. To tackle the backlog of repairs I am allocating an extra £70 million to local authorities up to March 2004."

"I expect councils, at the very least, to maintain this year's level of current and capital spending on roads, street lighting and bridge maintenance."

In short, the Minister said that the new spending must be used as additional funding, not as a way to make up the existing budget. No provision has been made in the settlement calculations to assist councils in addressing and restoring much needed on-going revenue maintenance to roads.

CASE FOR MINIMISING RING-FENCING

13. COSLA accepts that the Scottish Executive wishes to ensure that its priorities are delivered. The Scottish Executive considered that the only way to ensure that money was directed by councils to address these particular priority areas was to develop an increasing structure of ring-fenced grants. The implication is that, unless central government strictly controlled where money is spent, local government could not be trusted to address these priority areas. However, it is COSLA's contention that **national and local government can agree on strategic priorities but that local authorities are better able to judge how services can be delivered in a best value manner at a local level to meet the needs of their communities**. Too much direction from central government limits the scope for councils to direct resources to areas of greatest need.

14. The allocation of ring-fenced funds for particular services or initiatives often relies on bids or proposals being made by local authorities, to which Central Government respond in a discretionary way. This approach is perceived by some academics to create a more competitive environment. The increase in ring-fencing and central direction is seen as a

move towards a more competitive allocation at the expense of the formulaic method adopted on the introduction of the Client Group Approach. Formula-based systems are generally likely to be fairer in allocating resources in relation to need than competitive distribution. Therefore, competitive distributions should be restricted wherever possible, but if employed should be time-limited and rolled back into mainstream distribution.

15. The case for minimising ring-fencing is based on the issues raised in Paragraph 11. This highlights how local authorities consider that ring-fencing restricts their ability to deliver services to meet local needs. If the Government were to set objectives in discussion with local authorities but with local discretion in the means by which this would be achieved, the effect of these problems would be mitigated.

16. There is scope for minimising ring-fencing by developing joint planning between the Scottish Executive and local authorities. This may be assisted by the establishment of the Planning Framework between the Scottish Executive and COSLA proposed in Part 3 – Section 1, which recognises the shared responsibility of the Scottish Executive and Local Government in serving the people of Scotland.

17. It would appear that there is developing consensus between local authorities and the Scottish Executive towards the production of Local Outcome Agreements between individual local authorities and the Scottish Executive, linking national priorities with specific local service targets. Local Outcome Agreements are seen as a means of ensuring that local government delivers the national policy priorities and commitments while providing the flexibility required to respond to local circumstances and needs. The Minister for Finance and Local Government has stated that he sees this as '*offering the scope to reduce reporting requirements on local authorities and, potentially, the need to ring-fence resources*'.

SUMMARY

18. **Evidence of Existence of Ring-Fencing**
- Ring-fencing accounts for an average 10.40% of *AEF funding* for years 2001-02 to 2003-04.
- 18.16% of Total Scottish Executive Local Authority Spending is ring-fenced.
- Council commitments as a result of ring-fencing accounts for almost £1,300m over the three years to 2003-04.
- Ring-fenced and local authority committed expenditure equates to 23.94% of Total Scottish Executive Local Authority Spending.

19. **Impact of Central Direction**
- A further 5.70% of Total Local Authority Spending is centrally directed or ear-marked (years 2001-02 to 2003-04).

20. **Total Effect of Ring-Fencing and Central Direction**
- Overall, 29.64% of Total Local Authority Funding is ring-fenced, committed or centrally directed.

21. **Problems Experienced through Ring-Fencing**
- Increased ring-fencing leads to an erosion of core services funding.
- System is rigid and bureaucratic.
- Innovative working practices and projects are inhibited by the lack of flexibility in the use of resources.
- Additionality ruling results in forward-thinking councils being penalised for leading the field in addressing central government priorities.

- Annuality of funding can lead to underspends, short lead in times for projects, etc.
- Reacts to short-term issues rather than addressing priorities from a strategic point of view.
- Results in councils taking forward projects to suit available Scottish Executive funding.

22. **Problems Experienced through Central Direction**
    - Undermines the client based approach to GAE distribution by using GAE to influence local spending decisions.

23. **Case for Minimising Ring-Fencing**
    - Central Government direction limits scope of councils to meet local needs.
    - Formulaic approach is more equitable.
    - Greater partnership working between local authorities and the Scottish Executive.
    - Establishment of Local Government Partnership Framework.
    - Production of Local Outcome Agreements.

CONCLUSIONS

24. **The report establishes that almost 30% of local authority funding from the Scottish Executive is either ring-fenced or centrally directed.**

25. **The proportion of central government funding being ring-fenced or centrally directed has been steadily increasing, is at an unacceptably constraining level and is hindering councils in delivering agreed priorities.**

26. **The problems of ring-fencing and central direction have been documented by local authorities and acknowledged by the Scottish Executive.**

27. **The priorities of central and local government are not contradictory. Both would like to achieve similar outcomes and the Scottish Executive has stated that it believes that local authorities are better placed to identify and meet the particular needs of their own local communities. The establishment of the Planning Framework and the joint development of Local Outcome Agreements provide the means for developing a joint approach to delivering national priorities while recognising the diversity of local circumstances and thus eliminate the need for ring-fencing of council funding.**

Ring-Fenced Fund	Purpose of Fund	Scottish Executive Total 2001/02 £million	Scottish Executive Total 2002/03 £million	Scottish Executive Total 2003/04 £million	Scottish Executive Total 2001/02 – 2003/04 £million	Issuing Department
Specific Grants (included in AEF)						
Police (51%)	To make sure that the police service has sufficient funds to discharge its duties and to promote local authorities preparedness for emergencies of any kind.	399.665	417.731	430.395	1,247.791	Local Government
Civil Protection Grant for the Police (100%)	As above.	0.574	0.574	0.574	1.722	Local Government
Supported Employment (56%)	To support people with a variety of needs, including people with physical disabilities, sensory impairment and mental health problems during employment.	4.348	4.348	4.348	13.044	Local Government
In-Service Training of Teachers (SEN) (90%)	To raise standards in schools and improve the quality of teaching and learning for our children by ensuring our teachers are fully equipped to deal with the challenges of modern education.	5.386	10.886	10.886	27.158	Local Government
Gaelic (75%)	To provide funding for up to 75% of the costs of Gaelic-medium education.	2.834	2.834	2.834	8.502	Local Government
Housing Benefit and Council Tax Benefit Administration (50%)	To provide for the administration of benefits	17.482	18.482	19.483	55.447	Local Government
Mental Illness (70%)	To enable more people with mental health problems to return to or remain in the community and to avoid inappropriate hospitalisation	13.300	13.300	13.300	39.900	Local Government

Ring-Fenced Fund	Purpose of Fund	Scottish Executive Total 2001/02 £million	Scottish Executive Total 2002/03 £million	Scottish Executive Total 2003/04 £million	Scottish Executive Total 2001/02 – 2003/04 £million	Issuing Department
Specific Grants (included in AEF)						
Social work Training (70%	To ensure Social Work Services are delivered by a highly trained and motivated workforce.	2.200	2.200	2.200	6.600	Local Government
Excellence Fund Core Programme (100%)	To raise attainment in schools through a number of initiatives identified by the Government	125.600	124.000	125.000	374.600	Local Government
Excellence Fund Special Programme (100%)	To focus spending on specific projects identified by the Government ie. Community Schools, Action Plans etc.	30.959	27.959	25.559	84.477	Local Government
Unallocated Excellence Fund (100%)		31.874	45.974	51.874	129.722	Local Government
Other Ring-Fenced Funds						
Pre-School Provision for 3 and 4 year olds	Expanding the pre-school education provision to all 3 and 4 year olds	137.000	137.000	137.000	411.000	Education
Childcare	To increase the availability of quality, affordable and accessible childcare	4.800	4.800	4.800	14.400	Education
Additional Resources for Schools	To ensure schools provide the highest quality of education through improved standards, IT, curriculum development, pupil support, etc.	105.100	133.400	145.200	383.700	Education
Care and Repair		5.000	5.000	5.000	15.000	
Better Neighbourhoods Services Fund	To improve the provision of services in deprived areas, through the support of pilot initiatives identified with communities.	20.000	30.000	40.000	90.000	

Ring-Fenced Fund	Purpose of Fund	Scottish Executive Total 2001/02 £million	Scottish Executive Total 2002/03 £million	Scottish Executive Total 2003/04 £million	Scottish Executive Total 2001/02 – 2003/04 £million	Issuing Department
Flood Prevention & Coast Protection	To reduce the risk of flooding of vulnerable communities and the damaging effects of coastal erosion.	8.020	9.000	9.000	26.020	Environment
Strategic Waste Fund	To improve waste management services and begin implementation of the National Waste Strategy.	4.200	16.000	30.200	50.400	Environment
School Buildings Investment	To demonstrate the Scottish Executive's continuing priority for improving the fabric of school buildings.	10.000	10.000	40.000	60.000	Education
Changing Children's Services Fund	To provide the catalyst for ensuring better outcomes for children. 2001/02 funding is for drugs related projects only. (Previously Children's Change Fund).	4.000	33.000	44.500	81.500	
Police Capital Grant		1.252	1.250	1.250	3.756	Justice
New Roads Grants	To develop access roads to industrial premises in Assisted Areas.	1.000	1.000	1.000	3.000	Transport
Piers and Harbours Grants (75%)	To support the development of piers and harbours in the Highlands & Islands owned by local authorities.	2.000	2.000	2.000	6.000	Transport
Active Primary School Programme	To address the concern about the limited provision of regular physical education and sport in primary schools. Allocated through SportScotland.	-	-	-	2.800	Sport & Culture
Social Inclusion Partnership Fund	To promote social inclusion by supporting the work of Social Inclusion Partnerships.	79.300	69.400	71.900	220.600	

Ring-Fenced Fund	Purpose of Fund	Scottish Executive Total 2001/02 £million	Scottish Executive Total 2002/03 £million	Scottish Executive Total 2003/04 £million	Scottish Executive Total 2001/02 – 2003/04 £million	Issuing Department
Rural Public Passenger Transport Rural Community Transport Grant Scheme Rural Petrol Stations Grant Scheme	To enable authorities to introduce new or improved rural transport services.	4.300 - -	4.700 - -	5.100 - -	14.100 2.700 1.200	Development Department (Transport Division)
Public Transport Fund	To assist local authorities in developing their public transport networks and give the travelling public real choices in how they go about their daily lives.	40.000	50.000	60.000	150.000	Development Department (Transport Division)
Central Challenge Fund	Final Instalment of funding for the Perth Flood Prevention Scheme.	0.479			0.479	
Additional Financial Resources for Schools (Revenue)	To address the National Priority of ensuring school environments are conducive to teaching and learning.	17.200	-	-	17.200	Education
Supporting People	To assist local authorities in undertaking preparatory work associated with the introduction of the new 'Supporting People'.	2.000	5.000	8.000	15.000	
New Opportunities Fund	To boost priorities of improving education standards, childcare and the health of the Scottish People. (Lotteries Fund which is required to take account of government policies and strategies relevant to its work).				100.000 over 5 years from 1998/99	Lotteries Fund directed by Scottish Executive

Ring-Fenced Fund	Purpose of Fund	Scottish Executive Total 2001/02 £million	Scottish Executive Total 2002/03 £million	Scottish Executive Total 2003/04 £million	Scottish Executive Total 2001/02 – 2003/04 £million	Issuing Department
Modernising Government	To support new and innovative projects from across the public sector.				25.000 (2000/01 & 2001/02)	Scottish Executive (for all Public Services)
Rough Sleepers Initiative	To reduce the number of people sleeping rough.				36.000 1997 to 2002	
Empty Homes Initiative	To bring existing empty properties back into use.				24.000	
New Housing Partnership	To promote a new approach to housing in Scotland.				300.000 1999 to 2002	
Land Decontamination	To assist local authorities develop inspection strategies, carry out site investigations and take forward enforcement action.	3.500	4.500	5.000	13.000	Environment
Total Ring-Fenced Scottish Executive Funding		**1,083.373**	**1,184.340**	**1,296.405**	**4,055.818** **(**includes £491.7m unallocated over 3 years**)**	
Council Commitment due to Specific Grants		*413.076*	*432.045*	*445.213*	*1,290.334*	
Total Ring-Fenced and Committed Funding		***1,496.449***	***1,616.385***	***1,741.618***	***5,346.152***	

Ear-Marked/Centrally Directed Funding GAE/ESE	Purpose of Fund	Scottish Executive Total 2001/02 £million	Scottish Executive Total 2002/03 £million	Scottish Executive Total 2003/04 £million	Scottish Executive Total 2001/02 – 2003/04 £million	Issuing Department
Social Work Community Care		30.000	30.000	30.000	90.000	
Social Work Sutherland Response		30.000	36.000	60.000	126.000	
Delayed Discharge		10.000	10.000	10.000	30.000	
Drug Rehabilitation	To assist in the funding of drug projects as prioritised by the Drug Action Team	6.800	6.800	6.800	20.400	
Youth Crime	To consider scope for improving the range and availability of options aimed at addressing the actions of persistent young offenders within the Children's Hearings system and the Courts.	5.000	5.000	10.000	20.000	
Childcare Strategy	To support new childcare places and new information helplines and provide targeted support to families with very young children, in order to give them the best possible start in life. (Assumed to be the same for each of the 3 years).	15.750	16.750	16.750	49.250	

Ear-Marked/Centrally Directed Funding GAE/ESE	Purpose of Fund	Scottish Executive Total 2001/02 £million	Scottish Executive Total 2002/03 £million	Scottish Executive Total 2003/04 £million	Scottish Executive Total 2001/02 – 2003/04 £million	Issuing Department
Sure Start Scotland	To provide broad-based support for families with very young children. (Assumed to be the same for each of the 3 years).	19.000	19.000	19.000	57.000	
Learning Disability Review	To produce a strategic framework for the development of social and health care for adults and children with disabilities.	8.000	12.000	16.000	36.000	
Adults with Learning Incapacity	To assist the Health Service and Local Authorities to identify the skills necessary to comply with the Adults with Incapacity (Scotland) Act 2000, and to train staff as required.	1.000	1.000	1.000	3.000	
Concessionary Fares		34.271	57.449	85.975	177.695	
Fire		202.513	212.513	222.513	637.539	
SPTA Capital		8.000	8.000	8.000	24.000	
Air Quality Management	Specific Capital Consent Scheme to assist local authorities to purchase air quality monitoring equipment.	0.300	0.300	0.300	0.900	Environment
Total Ear-Marked Scottish Executive Funding		**370.634**	**414.812**	**486.338**	**1,271.784**	

PART 5 – RESOURCES NECESSARY TO TACKLE DEPRIVATION & POVERTY

INTRODUCTION

1. This Section presents the background to the treatment of deprivation and poverty in local government finance and summarises the recent history of events that have led to the current position. It presents key arguments to support the promotion of an independent assessment of the resources necessary to tackle deprivation and poverty.

BACKGROUND

2. In November 1999, Scottish Ministers and COSLA agreed that a review of the treatment of deprivation and poverty within the local government finance distribution arrangements should be undertaken as a priority during the year 2000. The review fulfilled one of the Scottish Executive's pledges made in its 'Programme for Government' to investigate services to deprived communities. Research had been undertaken by COSLA and the Scottish Office in the preceding few years but this did not result in any changes to the distributions and there remained a desire to see these issues addressed effectively.

3. Pending completion of the review, the Scottish Executive introduced, for 2000-01, one-off payments of £6.5 million for a Special Deprivation Payment and £15 million set aside by Ministers for policy priorities, which were to be targeted towards councils with high levels of deprivation and poverty. These resources were expected to return within the main settlement distribution for 2001-02.

4. The result of the 2000 Deprivation Review was a net reallocation in funding of £10 million, which was small compared with the £21.5 million for deprivation made available by the government pending the result of the Review. However, it is recognised that, in addition to these alterations to GAE distribution, the Scottish Executive announced the creation of the Better Neighbourhoods Fund, aimed at tackling poverty and deprivation, which allocates £90 million across 12 local authorities over a three-year period 2001-02 to 2003-04. A further £81 million will be allocated for deprivation through the Changing Children's Services Fund over the same three-year period.

CASE FOR INDEPENDENT REVIEW

5. It could be argued that, because an examination of the links between deprivation and local government expenditure was carried out during 1998 and again in 2000, there is no advantage in revisiting these issues, especially at such an early stage.

6. However, it has been observed that there was a lack of sufficient data and an extremely short period of time in which these reviews had to be carried out, which resulted in the reviews being curtailed. The previous reviews had considered deprivation in the context of service GAEs: there is scope to examine other approaches.

Scottish Executive Commitment – Social Justice Agenda

7. As noted above, in November 1999 the Scottish Executive and COSLA agreed arrangements to review the allowance made for deprivation within the distribution of grant to local authorities. This was on the basis that the Scottish Parliament had pledged to tackle poverty by creating work and reforming the welfare state, eliminating child poverty and publishing a Scottish Social Inclusion Strategy. The Scottish Executive

published its long-term strategy for tackling poverty and injustice in "Social Justice…a Scotland where everyone matters".

8. The allocation of a one-off £21.5million special deprivation payment by the Scottish Executive was seen to demonstrate their belief that deprivation and poverty resulted in additional expenditure being incurred by local authorities.

Pro-active Role of Councils in Dealing with Deprivation

9. On announcing the Special Deprivation Allowance in December 1999, the Minister for Finance stated that *"the review of deprivation indicators and the special deprivation allowance reflects the priority which we give to tackling poverty and deprivation in Scotland by working in partnership with local government"*.

10. The Government has stated its belief that local authorities are best placed to deliver the services required to meet their local needs. The recognition of the cost to local authorities of tackling deprivation would allow councils to address their specific deprivation problems while realising the Government's goals of eliminating child poverty, providing full employment, securing dignity in old age and building strong, inclusive communities.

11. The use of ring-fencing and the establishment of specific funds such as the Special Deprivation Payments and the Better Neighbourhoods Services Fund suggests that Ministers do not view traditional GAE methodology as an effective way of distributing funding to address deprivation. However, COSLA has argued elsewhere that councils are best placed to determine local needs and to identify the services that will meet these needs. Ring-fencing of funds limits the ability of councils to deliver services tailored to local circumstances (See Part 4)

12. A single Deprivation GAE may provide a way of maintaining the existing needs based distribution system, giving local authorities discretion on how to spend this, whilst also addressing the Social Justice agenda.

Financial Recognition

13. Many service GAE assessments already contain adjustments for deprivation but the net effect of these adjustments is small compared with the significant additional costs arising from the effects of deprivation. An exercise carried out by the Scottish Executive estimated that £74 million out of a total GAE of £5,900 million in 2000/01 was directed at deprivation. Yet, over the same period, for example, one council spent an estimated £64 million on deprivation-related services. This suggests that the level of funding for deprivation, at least through the GAE system, bears little relationship to the true levels of deprivation-related need within local authorities and the cost incurred by them in meeting this need. An independent review would assess the adequacy of this amount and the means by which it is distributed.

14. With the exception of the Teachers for Deprivation assessment, the 2000 Review did not address issues about the adequacy of overall grant allocation linked to deprivation. Without a review of overall grant levels, it is likely that there may be resistance to major changes to the distribution of existing grant.

Previous Reviews did not Review Deprivation Comprehensively

15. COSLA has previously stated that deprivation should be identified, with the cross cutting issue of social inclusion as a key priority at a national level. COSLA contended that additional resources were required to help address the causes of deprivation.

16. **Previous reviews have addressed the symptoms of deprivation but have not considered its causes. The issue of whether local authorities should be partners with central government in tackling the roots of deprivation was side-stepped.**

17. The present GAE system does not provide funding to enable councils to deal with the causes of deprivation and poverty. Once spending on demand-led services is accounted for, relatively small sums remain for discretionary spending, which might be directed by councils at addressing the causes of deprivation.

18. A review of the funding to tackle deprivation is required that takes into account the causes of deprivation.

Existence of Deprivation – Unmet Need

19. It has been stated that, although the terms Poverty and Deprivation are often used interchangeably, a clear distinction can be made between them. ‘Poverty’ essentially means not having the financial resources required to meet your needs; ‘Deprivation’ refers to unmet need caused by a lack of all kinds of resources, not just financial.

20. As noted above, the 2000 Deprivation Review used traditional GAE methodology, which is needs based. To date, studies of deprivation have not looked at council provision in the context of unmet needs related to deprivation. Therefore, the review of the resources required to tackle deprivation must be able to take into account the cost of needs that are presently unmet.

21. Previous reviews based on the traditional GAE methodology have assumed that actual, or historical, spending on services will necessarily reflect any additional costs associated with deprivation in the local area. This will not be the case if needs are unmet. As noted above, local authority spending is subject to constraints and funds available for discretionary spending are limited. Much spending specifically targeted at deprivation is discretionary, for example the provision of Clothing and Footwear Grants (including their monetary value), and the provision of concessionary schemes for swimming and leisure. The fact that local authorities have not spent in these or other areas does not indicate the absence of need. Similarly, spending reductions in these areas in recent years has often been the result of other pressures and is not a reflection that there is reducing need.

22. The use of existing expenditure data could explain why, in the most recent Deprivation Review, a statistical relationship with deprivation could not be found in some cases. For example, it may have been expected that there would be a link between the Special Education GAE and dependants of Income Support recipients and the number of Free School Meals. However, no statistical relationship was found.

Issues Raised requiring Further Investigation

<u>Rural Deprivation</u>

23. In the review of deprivation undertaken in 2000, DTZ Pieda Consulting identified the main issue in rural areas as being one of sparsity rather than deprivation and so discounted this in its final recommendations. However, geographical isolation may be an important aspect of “deprivation” in rural areas and have an impact on the demand for, and the cost of, delivering local authority services. This factor, which takes account of proximity/access to basic services, has been included in the new Deprivation Index in England and Wales and there are arguments for an independent review to consider these issues.

Distribution Mechanism

24. The review should look at all types of government funding targeted at poverty and deprivation, including GAE, specific grants, SIP funding and ring-fenced funding. This would enable an assessment of the most appropriate and effective method of future funding to tackle the causes and effects of poverty. This was the approach initially favoured by the Distribution Committee but the 2000 Review was restricted to consideration of a small number of elements of Education and Social Work GAEs. The decision to look at GAE funding in isolation prevented a holistic approach being taken, and did not allow the merits of different types of distribution methods to be assessed.

Indices of Deprivation

25. The use of Deprivation Indices would resolve one of the basic difficulties of traditional GAE methodology: that of identifying a suitable deprivation indicator for use in assessments. The statistical methods used require the presence of an indicator of deprivation – either a measure of the 'deprived' client group itself, or a proxy for poverty or deprivation, such as the number of recipients of state benefits. However, where a suitable proxy cannot be found, then it is impossible to establish a statistical relationship between service costs and deprivation and no progress can be made. This was a major factor preventing change resulting from the 2000 Review. For example, it was the case with Special Education, where it was not possible to find an acceptable indicator to serve as a direct measure of the client group involved, or a secondary indicator related to education. As a result, the main driver remains the school age population, which all parties acknowledge does not reflect the characteristics of the small group of children who require special education services.

The 1999 Index of Deprivation for England and Wales developed for the DETR by Oxford University is now generally respected and there have been calls for this to be used for grant distribution purposes. The development of Deprivation Indices on the same basis for Scotland, in partnership with local authorities and other public agencies, could be equally useful.

The Scottish Executive has plans to develop a revised Index of Deprivation for Scotland in tandem with the development of Neighbourhood Statistics. The preliminary date for completing this is mid-2003.

CONCLUSIONS

27. **A full independent assessment is now required to determine the full extent of deprivation-related need and to determine the resources that are required to address the need. This should also include an appraisal of all current forms of government funding targeted at deprivation.**

28. **Prior to embarking on the exercise, an initial feasibility study should be undertaken to make sure that progress can be made with tangible results being achievable at the end of the process.**

29. **The assessment should be based on a partnership between central and local government to meet the Social Justice agenda.**

30. **The assessment should consider the cost of addressing the causes of deprivation as well as alleviating its symptoms and identify the existence of needs that are presently unmet.**

31. **In order to assist local authorities to deliver services that reflect the needs of their local areas, funding should be by means of general grant rather than by the use of ring-fenced funds.**

PART 6 – LOCAL OUTCOME AGREEMENTS

INTRODUCTION

1. The concept of local outcome agreements was developed as part of the work of the joint Scottish Executive/COSLA Strategic Issues Working Group, which considered refinements to the local government finance system during 2000. The Group recommended that local outcome agreements be established to better link national policy priorities and targets with local priorities and circumstances, to reduce the reporting requirements on councils and to reduce hypothecation and the ring-fencing of resources. The essential elements of a local outcome agreement were identified as:

- They are agreements which focus on delivering outcomes and not on inputs (how much money is spent) or processes (how the money is spent).

- These outcomes should reflect shared priorities and there are agreed targets for improvement.

- Councils are given greater flexibility in using resources by allowing them to pool specific grants in a way that reflects local needs and priorities and the money is spent in such a way that reflects local circumstances.

- There could also be potential for achieving a better integration of services – such as in relation to community care – by pooling funding streams across the public sector.

- Rationalising planning requirements and pooling funding streams will reduce the management costs of specific initiatives and release resources for improving services.

- There is potential to link agreements to targets in Best Value improvement plans and priorities agreed within community plans.

- Existing monitoring and reporting frameworks should be used to avoid additional burdens being placed on councils.

CURRENT POSITION

2. The Working Group also recommended that the pilot outcome agreements should be on the basis of a policy theme or themes where there were potentially significant benefits to be obtained from greater flexibility. Two key policy themes were identified – education attainment and children’s services – and councils have been invited to develop pilot agreements. Three councils have also been invited to develop pilot agreements covering both children’s services and pupil attainment.

3. Since the Working Group reported, a number of additional funding initiatives have been identified by the Scottish Executive for which the outcome agreements approach is being explored. These initiatives are:

- **Better Neighbourhoods Services Fund**
  The 12 local authorities which have received funding of £90m over 3 years from the Better Neighbourhoods Services Fund, have been asked to

set out their proposals for providing improved services in deprived communities, in the form of local outcome agreements. Ministers have not been prescriptive about the types of services the Fund should support, although the pathfinder projects should be developed in consultation with the communities involved and must be consistent with the Scottish Executive's wider social justice targets.

- **Rough Sleepers Initiative**
  Draft guidance has been issued inviting local authorities to develop local outcome agreements to deliver on Ministers' commitment that no one should have to sleep rough from 2003. In return, £10m of annual ring-fenced funding from the Rough Sleepers Initiative would be transferred to mainstream RSG from 2002-03.

- **Adult Literacy**
  The Scottish Executive has agreed to allocate £18.5m over 3 years to local authorities to support a local outcome agreement for Ministers' commitment to raise levels of adult literacy. It is hoped that this will assist an additional 80,000 people nationally over 3 years.

- **Community Care Services for Older People**
  The Scottish Executive has proposed that all local authorities establish local outcome agreements for delivering improved home-based care services for older people, following from the recommendations of the Joint Futures Group. Total resources of £100m over 3 years have been allocated to support this commitment.

THE WAY FORWARD

4. COSLA, in partnership with the Scottish Executive, arranged a seminar in July to discuss progress so far and consider how the concept of local outcome agreements might be developed in the future. A number of issues were identified which need to be addressed if local outcome agreements are to realise their potential.

   Firstly, there is a need to ensure that there is a shared understanding and a consistency of approach across the Scottish Executive and local government about what local outcome agreements are. More particularly, there is a need for all outcome agreements to reflect the essential elements set out in paragraph 1.

   Secondly, there is a concern that there could be a proliferation of single issue outcome agreements substituting for ring-fencing and we should be looking to consolidate the various agreements. Agreements need to be on high level strategic issues. Also, expectations need to match the resources available.

   Finally, we should be developing local outcome agreements to include other public bodies where the delivery of improved outcomes is dependent upon partnership working – for example in relation to the many cross-cutting issues such as health improvement, sustainable development, community safety and social justice. This should be a key role for community planning.

5. One way of meeting these concerns is to develop a model outcome agreement similar to those being developed in England and in Wales. In England these agreements are called

'Public Service Agreements' and they cover 12 targets across both national and local policy priorities. In Wales they are called 'Policy Agreements' and cover targets across four key policy areas; education and learning, health and well-being, stronger economy and quality of life. In both countries there is a clear link with the policy priorities established in the Community Plan and in Wales there is a direct link with the Welsh Assembly's Strategic Plan. The advantages of developing this approach in Scotland are:

- One agreement can cover a range of policy priorities and thereby reduce the dangers of a proliferation of agreements;
- There is a much clearer link to community planning and the need for more integrated approaches to service delivery both within and between agencies; and
- There is a much more direct link between national and local priorities and the effective delivery of cross cutting issues to communities across Scotland.

6. In England and Wales resources are also available to support the development of local agreements and to reward performance against the agreed targets. COSLA has taken the view that improved performance through additional flexibilities, reduced reporting requirements and savings in management costs should provide sufficient incentive. There is also a concern that performance payments may not relate to need and that the process of monitoring and evaluating progress against the targets may become overly bureaucratic.

CONCLUSIONS

7. **The concept of local outcome agreements and their focus on the service delivered rather than how and how much is spent is to be applauded. As with any new arrangements, however, it requires to be tested and steered in the right direction. Otherwise there is the danger of it becoming a further, unnecessary, bureaucratic initiative. To ensure this does not happen, COSLA proposes that: -**

- **There is agreement not to develop any further local outcome agreements until the outcome of the pilots has been evaluated and the future approach agreed as a result;**

- **Ministers and elected members jointly oversee and steer the development of local outcome agreements; and**

- **A joint COSLA/Scottish Executive officer working group should be established to take forward the detailed developmental considerations.**

PART 7 – BALANCE OF FUNDING

INTRODUCTION

1. This Part of the evidence addresses the question of the Balance of Funding of local authorities in Scotland, that is, the percentage of council spending which is met by Scottish Executive grant compared to the percentage met from locally-raised revenue.

2. This is not a new issue: at U.K. level, it first appeared exactly 100 years ago in the Report of the Royal Commission on Local Taxation 1896 – 1901, and, according to Layfield at intervals of about 10 years thereafter, interrupted only by World War 2.

3. This paper comments initially on the "problem" of the current imbalance. It then considers the role of central government funding, addresses the "obvious solutions", looks at the practice in other OECD countries, and reviews the current position on fees and charges, before coming to a conclusion.

BACKGROUND

4. The ability to meet variations in local needs is curtailed where the responsibility for provision rests with one entity, but the control of funding rests with another.

5. This is the case in Scottish Local Government, where the spending by councils on local need (excluding HRA) was £7,175m in 2000/01. This was financed by local resources (mostly council tax and excluding house rents) to the extent of £1,566m (22%) and from central government grant to the extent of £5,609m (78%).

6. This causes the "gearing effect", whereby a small percentage increase in spending, if not matched by an equal increase in grant, leads to a disproportionate increase in council tax. This is illustrated below:

Spend	**Government Grant**		**Council Tax**		
100	78	+	22	=	100
Spending increased by 3% …					
103	78	+	25	=	103
3% increase			**14% increase**		

7. The assertion that the current broadly 22:78 local: central balance is a problem begs the question of what the ideal balance should be? A target to aim at might be assumed as 50:50 for no other reason than that it would demonstrate an equal partnership between central and local governments, and that any higher proportion of locally-generated income is likely to be unrealistic in the short to medium term. This balance has also been recommended by at least three official enquiries into local government finance over the last 25 years.

8. Doubt has been cast on the present imbalance as being in fact any problem at all. A recent Fabian report asserts that the nub of the problem of local finance is not the percentage of total revenue raised locally, but rather the ability of councils to vary their budgets at the margins.

   That report acknowledges and very clearly articulates the problems associated with the present imbalance – gearing, democratic deficit, accountability – as well as recognising that the real problem is the inability of local government to easily vary its total spending by changes at the margins. This latter point is then taken up, correctly, as the main driver of reform, and a number of additional sources of revenue and tax varying powers are suggested, along lines similar to those in this Section.

   These would, of course, alter the balance of funding. The conclusion to be drawn by the reader is therefore that, while dismissing balance of funding as a problem, the Commission's report then goes on to propose solutions which in fact represent a change in the balance of funding, i.e. the report, despite itself, supports the case for a change in the balance of funding. There is, therefore, a clear case made for an equal balance of funding between local and central governments.

50:50 Target

9. There are basically two ways to move towards a 50:50 target:

- Increase locally-raised income at the expense of government grant.

- Reduce the gross spending by councils, keeping the locally-raised revenue at the same level, but reducing government grant accordingly (a sort of "reverse-gear" scenario).

10. These options are not, of course, mutually exclusive. The impact of the first option, using 2000/01 CIPFA figures, would be to shift some £2bn from central to local sources of revenue, as illustrated.

	£m				**£m**	
Local funding	1,566	(22%)	+ 2,021	(increase of 129%)	3,587	(50%)
Central funding	5,609	(78%)	- 2,021	(reduction of 36%)	3,588	(50%)
	7,175				7,175	

The impact of the second option would be to transfer £4bn of services, or 56% by cost of current services from local control to central control as illustrated:

	£m			**£m**	
Local funding	1,566	(22%)		1,566	(50%)
Central funding	5,609	(78%)	- 4,043	1,566	(50%)
	7,175		- 4,043	3,132	

A number of possible "obvious solutions" exist for each of these two options and these are set out in paragraphs 17 – 19.

11. It is arguably the present imbalance of funding which places the greatest strains on revenue grant distribution arrangements. At a 78% funding level, councils are too reliant on central government grant and any variations in an individual council's level of grant has a disproportionate impact on its council tax. This position has been exacerbated in recent years by the continuing trend of relative decline in grant levels compared to the recognised spending needs of local government. Addressing the balance of funding could well resolve many of the difficulties experienced in grant distribution.

THE PURPOSE OF CENTRAL GRANTS

12. Grant systems for local authorities have evolved over time. Although it is important for the proper functioning of local government for it to have its own sources of income, successive governments have taken the view that it would not be appropriate to expect the whole cost of providing local authority services in each area to be met solely by the local taxpayers of that area. This reflects a continuing policy that services that are national in character, such as education, or of national importance, such as the police, should be provided at an acceptable standard country-wide whether or not the taxpayers of particular areas can afford to pay for them. Over the last 40 or so years, government grant systems have sought to achieve this objective by three different means: compensating for differences in *expenditure needs* between local authorities; compensating for variations in local authorities' *taxable* resources; and paying a substantial proportion of local authority expenditure out of *national taxation*.

Equalising Needs

13. Some local authorities inevitably face much greater calls on their services than others. The proportion of the population which is of school age, for example, varies across the country: primary and secondary school children make up 13% of the population at one end of the range and 17% at the other. At the other end of the age scale, the proportion of pensioners ranges from 10% to 18%.

It also costs more to educate a child or provide support for an elderly person in some parts of the country than in others. One reason is the nature of the area. Sparsely populated areas face higher transport costs, for example. Other reasons relate to the socio-economic characteristics of the area.

Where a local authority has a concentration of needy people, or is faced with higher costs, it would be unreasonable to leave the entire financial burden to be met locally. To do so would mean that local residents would have to pay higher levels of local taxation than those in other local authorities for an equivalent standard of service.

Equalising Resources

14. Under the present local government finance arrangements, the taxable capacity of local authorities is measured in terms of Band D equivalent properties. This varies greatly from council to council. For example, as a result of out-of-town dormitory areas, this has been exacerbated by greater acceptance by the public of commuting distances which span two or more council areas.

Block grant is used to compensate authorities with low council tax bases in relation to their populations. If they had to finance their services wholly from local taxation, those local authorities would have to set much higher rates of tax than other local authorities.

National Taxation

15. In principle, the combined effect of equalising both needs and resources is to enable all local authorities to finance a comparable level of service for the same Band D equivalent Council Tax. But in addition to the equalisation process, successive governments have also provided general grant support for local authority expenditure. This is because they have taken the view that the burden of such expenditure should not be borne by local taxpayers alone. This view rests on two considerations. First, many of the main local authority services have a wider "national dimension" and reflect national policies on such things as standards of service; it is only right that, in these circumstances, a proportion of the costs should be borne by the national taxpayer.

Second, Council Tax cannot bear the full weight of local authority expenditure, since it is not directly related to ability to pay. In these circumstances, if local services were met entirely out of local taxation, the provision of satisfactory standards of service could be inhibited in some authorities. Providing exchequer grants to local authorities avoids this problem.

CONCLUSION

16. **The foregoing suggests that there must always be a case for a significant share of local spending being financed centrally, but the degree of that support will be a matter for discussion depending upon circumstances which pertain at any time.**

COMMENTARY ON THE "OBVIOUS SOLUTIONS" TO THE BALANCE OF FUNDING QUESTION

17. As mentioned in the "Background" Section, there are a number of "obvious solutions" to the balance of funding problems which are currently the subject of debate. This section sets out to identify these and assess their merits and drawbacks.

Increase in local income.

- Very large increase in council tax
- Transfer control of NDR back to councils
- Assign central revenues to council control
- Broaden tax base, e.g. tourist tax, sales tax, parking place tax
- New charges – e.g. congestion charges

Reduction in overall expenditure.

- Transfer responsibility for Education to Scottish Executive
- Central funding of Joint Boards
- Transfer Social Work to Health Boards
- Housing and Council Tax Benefit transferred to Department for Work and Pensions (DWP)

A more detailed examination of each of the above follows:

18. **INCREASE IN LOCAL INCOME**

- **Very large increase in Council Tax**

To achieve a move to 50:50 funding by this method within a reasonable time of, say, five years, would require year-on-year increases of some 20% above inflation. This could only be made publicly acceptable if there was a commensurate and tangible reduction in national taxation which was perceived to benefit the taxpayer directly, for example, a reduction in the income tax rate in Scotland, using the tax varying powers of the Scottish Parliament. This would allow a one-off only increase in Council Tax of 44% from £1,566m to £2,256m if the tax varying powers were exercised to the maximum extent of -3p. This is itself sufficient to move from 22:78 to 29:61.

- **Transfer of control of NDR back to Councils**

The suggestion of returning the revenue from non-domestic rates to council control is deeper than at first might appear (see Part 9 – Section 5). As the redistributed amount of NDRI is included within the AEF envelope, any variation in NDRI paid to a council will result in a compensatory adjustment of RSG. Under these current arrangements, therefore, there would be no direct financial benefit or disadvantage to a council in returning control to councils.

The balance of funding would, however, change to 43:57. This would only be of significance if NDRI were under the control of councils, with poundages free to be increased or decreased at their discretion.

However, it is important to remember how the pooling arrangements came about. They were set up to facilitate the levying of a uniform rate poundage across Scotland, and to create a level playing field north and south of the border for all British businesses. Any change to this without taking full account of the interests of the business community would likely be resisted.

- **Assign central revenues to council control**

If some centrally-based revenues were to partly replace grants, these would have to be assigned without strings. By their nature, any such assigned revenues are not likely to be responsive to local circumstances and may not be buoyant.

As an example, and the antithesis of the first bullet point above, if the tax-varying powers of the Scottish Parliament were invoked to their full extent and the proceeds assigned to councils, this would be akin to a local income tax, but is estimated to generate only £690m.

- **Broaden tax base**

There may be scope for the introduction of new taxes. These might include, for instance a tourist tax, workplace parking place tax, and local sales tax (see also Part 9 – Section 1). Acceptance of these by taxpayers is, however, generally viewed as difficult to secure.

Furthermore, the variations in the socio-economic background of different councils means that the ability to raise significant revenue would not be evenly spread. For example, a tourist tax would be of little help to a council experiencing industrial decline, and a workplace parking place tax would more likely help urban councils, but not rural ones.

These taxes would tend to lead to a need to strengthen the resource equalisation element of central grants, which itself would tend to push the balance of funding in the opposite direction to that in which the introduction of these new taxes was intended to move the balance.

- **New charges**

The Accounts Commission paper "The Challenge of Charging" indicates that in 1997/98, Councils raised over £330m from fees and charges, excluding house and other rents. A combination of more rigorous charging policies and the deregulation of some fees and charges might allow this to be significantly increased. But this would require full consideration of all related issues, including socio-demographic factors, the legality of charging for certain services and the economic and market influences.

19. REDUCTIONS IN OVERALL EXPENDITURE

When considering the wholesale transfer of any blocks of expenditure from local to central control, it is essential to recognise that the service(s) concerned are at present partly funded locally. It would not, therefore, be appropriate to simply reduce the overall spending total of councils by the cost of the service and to reduce central government grant by the element of AEF which relates to the service concerned. It is assumed in this section that if any block of expenditure was transferred, reductions in spending by councils would be matched by a corresponding and exactly equal reduction in AEF. This is exemplified in the first bullet point below.

- **Transfer responsibility for Education to Scottish Executive**

Education accounted for spending of £2,717m in 2000/01 (excluding financing costs). The element of AEF attributable to Education is £2,009m. Thus the removal of this service would change the balance of funding.

However, as set out above, it is unrealistic to assume that if this transfer took place, the Scottish Executive would accept a spending commitment of £2,717m but only reduce AEF by £2,009m, a difference of £708m, currently met by council tax. It is, therefore, assumed that the transfer of any service would result in a reduction in grant equal to spending. Using Education as an example, the balance of funding would change as shown:

	£m		£m	£m	
Total spending	7,175		-2,717	4,458	
financed by:					
Local funding	1,566		-	1,566	(35%)
Central funding	5,609	-	2,717	2,892	(65%)

The above assumes that financing costs remain with councils, and continue to be 100% funded by AEF. If this is not so, and using an estimate of financing costs for education, the balance of funding would change to 37:63. Because of the very small impact this would have on the balance of funding, it has been assumed hereafter that financing costs relating to any transferred services would remain with councils on the present basis.

- **Central funding of Joint Boards**

It has been asserted, by Arthur Midwinter, that Joint Boards are "poor instruments of local accountability", and that their central funding would not erode local democracy. This, however, ignores the very real and developing links into community planning.

The budgeted expenditure on the three categories of Joint Boards in 2000/01 was £959m, and associated AEF was £799m.

	£m		£m	£m	
Total spending	7,175		- 959	6,216	
financed by:					
Local funding	1,566		-	1,566	(25%)
Central funding	5,609	-	959	4,650	(75%)

- **Transfer Social Work to Health Boards**

Using the same approach for Social Work, the figures are:

	£m	£m	£m	
Total spending	7,175	-1,233	5,942	
financed by:				
Local funding	1,566	-	1,566	(26%)
Central funding	5,609	-1,233	4,376	(74%)

There remains the question of whether education, social work and the responsibilities of joint boards are best subject to national or local democratic control. Services are delivered on a local basis and are matters which often unite local opinion on issues, the impact of which is limited to relatively small geographic areas. COSLA strongly argues for retention of local control within the community planning framework, recognising the inter-relationship between services. There are significant service delivery benefits in retaining the present locally-based arrangements.

- **Housing and Council Tax Benefit transferred to DWP**

The Housing and Council Tax Benefit scheme is strictly controlled by the Department for Work and Pensions (DWP). A case could be made to unify all payments, reliefs and rebates under the DWP, with the appropriate local liaison arrangements being put in place. Because the bulk of expenditure is met by direct subsidy, not grant, the net figures involved are too small, at about £80m, to make any impact on the balance of funding, and this is not pursued further in this Section.

CONCLUSION

20. **This Section has examined the so-called "obvious solutions" to remedy the imbalance of funding between central and local funding. Some "obvious solutions" may appear more acceptable than others, but none are without their disadvantages. Significant consideration of these issues and their impact on wider moves to restore local democracy and accountability, in particular given the Government's commitment to subsidiarity under the European Charter of Self-Government, would be required.**

LOCAL GOVERNMENT FINANCE IN OTHER COUNTRIES

21. This section looks at how local government is financed in other, non-UK countries. The purpose of this is to compare the balance of funding with the Scottish position, and also to look at practices in other countries to see if any of these might be applicable to Scottish Local Government.

22. This was the subject of a very comprehensive report for DETR by PriceWaterhouseCoopers, published in 2000. A summary of revenue distribution systems in 20 OECD countries is given in the table overleaf.

The report covers 20 countries, including England, but not Scotland or Wales. It contains a wealth of detail, but little in the way of conclusions.

23. Points noted in the report are that central government grants vary from 15% of spending in Finland to 95% in Italy, with the mode lying in the 40-49% range. Most non-UK countries make greater use of specific grants. All countries except Australia, New Zealand and Iceland allocate education to the local authority level, either exclusively (10) or in part (6).

24. The initial impression is that the balance of funding in Scotland is significantly more biased to the centre than in other developed countries; that the split of service responsibility is much the same; and the use of specific grants is more common outside the UK. If account is taken of the 30% of AEF which is ring-fenced, (and subject to central control) Scotland probably falls into the "Medium" or possibly the "High" category for use of specific grants. (see Part 4)

25. Further study of the document would be needed to extract any useable ideas on additional sources of revenue, better distribution arrangements, and trends in the central/local provision of specific services. Crucially, however, any such further analysis would have to take full account of the European Charter of Local Self-Government which has been ratified by the Government, and sets out a number of principles for the financing of local authorities, including the following:

- local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers;
- local authorities' financial resources shall be commensurate with the responsibilities provided for by the constitution and the law;
- part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have power to determine the rate;
- the financial systems on which resources available to local authorities are based shall be of sufficiently diversified and buoyant nature to enable them to keep pace as far as practically possible with the real evolution of the cost of carrying out their tasks;
- as far as possible, grants to local authorities shall not be earmarked for the financing of specific projects. The provision of grants shall not remove the basic freedom of local authorities to exercise policy discretion within their own jurisdiction;
- for the purpose of borrowing for capital investment, local authorities shall have access to the national capital market within the limits of the law.

EXTRACT FROM LOCAL GOVERNMENT GRANT DISTRIBUTION – AN INTERNATIONAL COMPARATIVE STUDY PRICEWATERHOUSECOOPERS 2000
LOCAL GOVERNMENT GRANT DISTRIBUTION – AN INTERNATIONAL COMPARATIVE STUDY

Revenue distribution systems in 20 OECD countries: key characteristics

Country	Population (millions)	Area (1000 sq km)	Federal (F) or Unitary (U)	No of local government tiers	Grants as % of total local government revenues	Use of general grants	Use of specific grants	Needs equalisation	Resource equalisation
Australia	18.4	7,682	F	2	40	M	M	M	M
Austria	7.8	84	F	2	21	M	M	H	H
Belgium	10.2	31	F	3	42	H	L	M	M
Canada	29.8	9,922	F	2	24	M	M	L	H
Denmark	5.2	43	U	2	18	H	L	H	H
Finland	5.2	338	U	1	15	L	H	H	H
France	56.6	544	U	3	30	H	L	M	M
Germany	82.0	357	F	3	46	M	M	M	H
Greece	10.3	132	U	3	68	H	M	M	M
Ireland	3.6	70	U	1	26-54	M	M	M	M
Italy	57.6	301	U	3	45-95	M	M	M	M
Japan	125.0	378	U	2	32	M	M	H	M
Netherlands	15.5	41	U	2	71-83	M	M	H	M
New Zealand	3.6	265	U	2	20	L	M	L	L
Norway	4.4	324	U	2	33-52	M	H	H	H
Portugal	9.9	92	U	3	39-95	H	L	M	M
Spain	39.3	506	U	3	30-70	M	M	M	M
Sweden	8.7	411	U	2	19	H	L	H	H
United Kingdom	58.6	241	U	2-3	73	H	L	H	H
USA	264.3	9,363	F	3	40	L	H	M	M

Note to Table:
"The quantitative data are drawn from a variety of sources and relate to different years in the last decade. They, therefore, present a broad picture for comparative purposes. In some countries, such as Spain, the extent to which grants account for local government's total revenues varies significantly between tiers of local government. In these cases, we provide a range of figures to reflect the different positions at different tiers. Our ranking of High, Medium and Low is based on the results of our profiles."
(PriceWaterhouseCoopers)

CURRENT POSITION ON FEES AND CHARGES

24. Since the publication of "The Challenge of Charging" by the Accounts Commission, work to increase income from charges has been done in most Councils.

    Some internal analyses suggest that there is little scope for further significant income generation within individual councils. However, figures for fees and charges are not shown in CIPFA's Rating Review, so there is no conclusion to be drawn on how the increase in fees and charges over a period of time compares to the retail price index. If income from fees and charges had been rising significantly ahead of the retail price index, this might suggest that sources of income were being actively maximised. Otherwise, it might suggest that scope exists to use additional sources of income to move the balance of funding. Further investigation of the trend in income since 1996 could be undertaken to establish the position. Such an exercise could also establish the extent to which councils have actually implemented the recommendations of "The Challenge of Charging".

25. There are three further possibilities which could be explored: firstly, there are some sources of income from fees which are set by statute, or for other reasons are not able to be varied by individual councils. Consideration could be given to the deregulation of some fees, for example, Planning Application and Building Warrant fees, although local circumstances might result in pressure to reduce, rather than increase, some fees.

    Secondly, new areas for charging could be explored. One of the current candidates as a new source of revenue would be congestion charges. These have been in operation for nearly a decade in Norwegian cities, and there are currently proposals for their introduction in London. The latter proposals involve a very modest charge of £5 (modest compared to parking charges in Inner London of £6 per hour) which would raise about £200m.

    It has been suggested that such charges could raise about £400m if introduced across England as a whole. However, due to the different legislative position in Scotland the potential for raising revenue would be significantly limited and would likely be at best in single figures.

    Thirdly, proceeds of the National Lottery could be partially earmarked for council funding. The use of lotteries for this purpose has been extant in the USA since 1612, and widespread since then. Since contributions to the National Lottery tend to come more from poorer socio-economic groups, there could be an argument for assigning some of the revenue to local authorities, some of whose expenditure is directed towards the same groups.

26. There is also the more fundamental question of the fairness of using any additional income to reduce the level of government grants rather than use this to develop services. This question is likely to be particularly pertinent to congestion charges.

CONCLUSIONS

22. As is often the case, this investigation has raised more questions than answers:

- How important is the balance of funding in reality, compared to the ability of Councils to vary their budgets at the margins?
- If 22:78 is not an acceptable balance, what is?
- Given the need to equalise resources and needs, and to recognise the costs of national priorities imposed on local councils, how should this be reflected in the balance of funding?
- How realistic is it to expect national government to give up some of its own sources of revenue?
- What are the implications for local democracy of suggestions that some services be transferred from local control to central control?
- How relevant is the international picture, where the balance of funding lies closer towards 40:60?
- Is it defensible to use additional income to simply displace government grant, rather than use it for new services (e.g. congestion charges)?

23. While these questions remain to be addressed, some preliminary conclusions can be deduced from the work done so far.

- **The current 22:78 split is too extreme. It gives rise to the gearing effect which has a severely limiting effect on local discretion, and is far out of line with the position in most other developed countries.**
- **There are strong arguments for retaining a centrally-funded share of local expenditure, probably at a minimum of 50%. This suggests that the desirable balance of local:central funding lies within the range of 20:80 and 50:50**
- **There are no <u>easy</u> "obvious solutions" which would, at a stroke, move the balance of funding to, say, 50:50.**

24. **There are no solutions in this paper which readily address the balance of funding issue. Given this, the ability of councils to meet local needs and to be accountable to their local electorate will without compensating changes remain limited.**

Elsewhere within this evidence the difficulties created by increasing ring-fencing and central direction have been clearly highlighted (see Part 4). A recognition of the problems created by the current balance of funding but the difficulties in addressing this could be given by the Scottish Executive significantly reducing the central control over the use of available resources. Such relaxation would be a demonstration of parity of esteem and partnership, with central government trusting local government to deliver on jointly agreed priorities.

PART 8 – REVENUE GRANT DISTRIBUTION

Section 1 – Critique of Current GAE System
Section 2 – GAE Reviews
Section 3 – Link Between GAE and AEF
Section 4 – Stability Arrangements
Section 5 – Council Tax Differentials
Section 6 – Grant Distribution – The Way Forward

INTRODUCTION

> *"There is dissatisfaction with the way we allocate and distribute resources to local government. And there is a feeling that between us we do not focus enough on what really matters: delivering excellent public services efficiently and effectively….We need to modernise the system by which we determine and distribute resources for local government…..That is why I believe that now is the time to take stock and take a long hard look at how we might reform the system."* (Jack McConnell, Minister for Finance, March 2000)
>
> *"… we need to look seriously at simplifying the current arrangements for distributing grants to individual councils. They are complicated, overly technical and almost certainly not consistent with the vision of open and transparent accounting arrangements. The current distribution arrangements worked fairly well up to reorganisation in 1996. They do not however reflect the diversity of local government put in place following reorganisation. We need to maintain a confidence in the distribution system, and a radical overhaul of the current arrangements is long overdue."* (Norman Murray, COSLA President, May 2000)

THE CLIENT GROUP APPROACH

1. The client group approach is intended to be a systematic means of allocating a pre-determined level of grant aided expenditure (GAE) for each service equitably among local authorities. It covers nearly all services provided by local authorities with the main exception of Housing for which there are separate arrangements. It also excludes loan and leasing charges which are treated separately within the grant distribution system. The client group approach does not determine the level of GAE in absolute terms nor its allocation between services. The total relative GAE for a local authority is the sum of the separate assessments for individual services. The total estimate of GAE for each local authority is used by the Scottish Executive for the distribution of AEF.

2. A Scottish Office circular dating from 1992 states that the client group approach is an objective method used to estimate, within a controlled total, the relative GAE of local authorities. It goes on to state that it is designed to take into account variations in the demand for services and the costs of providing them to a similar standard and with a similar degree of efficiency. Central to the approach is the identification of factors associated with inter-authority expenditure variation. Those demand factors and cost factors (which are outside the control of local authorities; offer plausible explanations; and can be shown to be associated with inter-authority expenditure variation) are utilised in the formula for calculating GAE.

3. The GAE system undertakes calculations at an individual service level and, in some cases, for different elements of a service. The reason given for this in the 1992 circular is that factors influencing expenditure on a service are more likely to be detected in a disaggregated approach and more sensitive GAE assessments achieved. Much of the debate surrounding distribution over recent years has centred on the necessity for this detail with the call for a limited number of indicators or assessments to be used to replace the approach.

4. Individual GAE assessments are calculated using primary indicators (the most significant determinant of expenditure on a service) and secondary indicators (factors which could plausibly affect either the demand for services or the unit cost of meeting that demand).

5. There is a high level of dissatisfaction with the present resource allocation system, this being reflected in evidence by a number of contributors to the Local Government Committee's Inquiry. However, there are also particular strengths associated with the present approach and many of its weaknesses can be addressed through a focussed work programme and through a holistic approach to reform local government finance.

6. Each year the Scottish Executive publishes the detail of GAE calculations in, what is known as, the "Green Book". The presentation of the Green Book is crucial to the understanding and therefore the credibility of the grant distribution system. Users find the GAE distribution methodology difficult to understand and explain. The Green Book contains too much detail for some users and not enough detail for others. Work is required to develop a "Plain English" guide to grant distribution arrangements. However, full details of the calculations will still be required by a select group of readers.

GAE ARRANGEMENTS 2001/2002

7. GAE distribution has developed over time and now incorporates a number of different approaches. The following is a summary of the current position as background for consideration of possible changes to GAE arrangements.

8. Police GAE is subject to an ongoing review and has been excluded for the purposes of this analysis. Fire GAE (3 assessments) has also been excluded. The distribution basis for all other GAE assessments can be categorised as follows:

Table 1: Categorisation of GAE Distribution Basis

	Number of Assessments	**GAE 2001/02 (£m)**
Primary Indicator Alone	30	1,882
Primary Indicator with Secondary Indicator(s)	16	2,074
Composite Primary Indicator	3	692
Scottish Executive Policy Initiatives	8	235
Other GAE Assessments	8	202
Expenditure-Based	13	156
Other	5	54
Specific Grants	4	40
	87	**5,335**

- 46 GAE assessments use standard Primary Indicators. 16 of these incorporate secondary indicator adjustments.
- There are 3 composite primary indicators for social work services.
- 8 separate assessments have been introduced to support Scottish Executive Policy initiatives (for childcare strategy, Sure Start Scotland, Excellence Fund – core and special, community care action plan, carers service and respite care, children's services development fund and youth crime). The distribution formulae for these assessments are not disclosed in the Green Book.

- 8 GAE assessments are distributed pro-rata to the GAE distribution formula for other assessments.
- 13 GAE assessments are distributed according to either actual or budgeted expenditure.
- The 5 GAE assessments which have been classified under "other" are: education deprivation, ethnic minorities, new towns transfer, flood prevention and the teachers remoteness and distant islands allowance.
- 4 assessments (Gaelic, School Security, Community Care: Mental Illness and Civil Protection) are allocated pro-rata to share of specific grant/former specific grant.

9. GAE distribution methodology is commonly referred to as consisting of primary indicators and, where found to be justified, allowance for one or more secondary indicators. Clearly distribution is far removed from this position with composite primary indicators, expenditure-based GAE, Scottish Executive policy allocations and other specialised formulae being applied.

STRENGTHS AND WEAKNESSES OF THE CURRENT APPROACH

10. There are a range of strengths and weaknesses associated with the current methodology for GAE distribution.

Table 2: Strengths and Weaknesses of GAE System

Strengths	**Weaknesses**
The underlying principles are strong. System is intended to be needs-based. Only plausible factors which are outwith local authority control should be recognised. Emphasis on evidence-based decision making. Data should be "fit for purpose" and GAE calculations are checked thoroughly for accuracy.	Inadequate resources. The system is used to distribute national totals for GAE and AEF which are determined by the Scottish Executive.
The system is rules-based. The 1992 Scottish Office circular sets out in detail the operation of the approach. Decisions on changes are taken in light of these rules.	Expenditure-Based GAEs. £156m of GAE based on expenditure of councils. Expenditure will reflect variations in policy, efficiency and accounting practice as well as variations in demand and cost factors. Expenditure is also subject to considerable year-on-year fluctuations creating difficulties in relation to the predictability and stability of grant. Because a reduction in expenditure means a reduction in grant there is a potential disincentive to Best Value.
Consultation. Councils can participate in the decision-making process through written submissions and participation in committees and working groups.	Judgement in Weighting of Indicators. Due to data limitations it is not always possible to objectively select/weight the indicators used in resource distribution. In some cases, e.g. the Social Work composite indicators, judgement (based on best available evidence) has been used.

Strengths	Weaknesses
Transparency. Documentation relating to decisions is available for scrutiny and the calculation of GAE distribution is published in the Green Book.	Policy GAEs. Increasing tendency for the Scottish Executive to bypass established arrangements for consultation with local government. Distribution arrangements for the Excellence Fund, the Childcare Strategy, the McCrone settlement and the Better Neighbourhoods Services Fund were not considered by the Distribution Committee.
Intelligible. According to independent experts on grant distribution, GAE is relatively easy to understand and update and particularly so when considered in comparison to other grant distribution systems used in the UK.	Limitations of Secondary Indicators. The Local Government Committee Inquiry heard evidence from three advisers on resource distribution. All were critical of the technique used to determine secondary indicator adjustments.
Independence. Many decisions taken in relation to GAE distribution are based on independent advice. Changes arising from reviews of Social Work GAE, Deprivation, Population Distribution have all been based upon independent research.	Understanding Linear Regression. The application of linear regression to determine the amount to be redistributed by secondary indicators causes particular difficulties for those trying to gain an understanding of grant distribution.
Sensitive to Change. As indicator data is updated regularly GAE allocation is sensitive over time to demographic and social change.	Out-of-Date Service Categories. No comprehensive overhaul of GAEs has taken place since their introduction.

11. **Although there are significant weaknesses with the current approach, many of these could be addressed within the principles of needs based arrangements but through a focussed work programme. A review targeted at reducing the scale and improving the presentation of formula arrangements would be more productive than the traditional programme of reviews.**

12. An alternative to the current approach would be the incremental or Barnett-style approach. However, this is not supported for the following reasons:

- This approach is not sufficiently sensitive to social and demographic change over time and would not therefore be sustainable. Children and the elderly are key groups in determining the need for and cost of local authority services. Significant change is projected for these groups and resource distribution arrangements must allow local authorities to manage this change.
- Technical consideration has not identified any objective way of deriving factors, indicators and weights to be used and it is highly probable that the only way of proceeding would be to build in a significant judgmental element which could be open to considerable dispute.
- It does not represent a simplified system which will ease explanation and therefore public understanding of local government finance.
- Additional resources for policy priorities would not be allocated in a sensitive manner and this could jeopardise delivery of agreed outcomes in many council areas. The existing arrangements offer an established and objective basis for distribution or for consultation on any new arrangements which may be required.

BASIS FOR A REVIEW

13. Issues for consideration are:

- The imbalance between the number of assessments and the resources they distribute.
- Whether a cross-cutting theme based approach would be more suitable than a service based approach.
- The scope for rationalisation of GAEs, with this leading to fewer and (tighter) primary indicators.
- The relevance of secondary indicators.
- The impact of Local Outcome Agreements on GAE arrangements.
- The rationalisation of Primary indicators and the deletion of secondary indicators.

14. Breaking this down into areas to investigate, there are four principal avenues to explore:

- Reducing the number of small value GAEs.
- Rationalising GAEs and reducing the number of Primary Indicators.
- Looking at a cross-cutting approach as opposed to a service based approach and the impact of Local Outcome Agreements in this context.
- Examining the relevance and potential deletion of Secondary Indicators.

These are discussed in turn below.

Reducing the Number of Small Value GAEs
The accounting concept of materiality can be brought into play here. An analysis of GAE shows that 25 assessments have a value under 0.1% of the total value of GAE for the current year. In total, they allocate around 1% of GAE. These GAEs could be treated as *de minimus* and rationalised.

Rationalising GAEs and reducing the number of Primary Indicators
There are 34 different primary indicators. 27 are unique to a single assessment and 7 are shared by 19 assessments. If the objective was simply to reduce the number of assessments then the 19 assessments which share a primary indicator with at least one other assessment could be merged into 7 assessments with no redistributional effect. In considering this further, thought would need to be given to the continuing relevance of plausibility as an influencing factor.

Looking at a cross-cutting approach as opposed to a service based approach
At the moment GAE distribution is service-based with assessments grouped into the service blocks identified in Table 3 (excluding Police and Fire).

Table 3: GAE Service Analysis

	No. of Assessments	Total GAE 2001/02 (£m)	GAE per Assessment (£m)
Education	20	2,870	143
Social Work	20	1,256	63
Roads & Transport	9	330	37
Leisure & Recreation	6	333	56
Cleansing & Env. Health	6	254	42
Other	26	292	11
	87	**5,335**	**61**

GAE has been criticised on the basis that it deals with departmental "silos" and therefore does not encourage joint working. There has also been some difficulty in the past identifying how much GAE has been directed at priority themes such as social justice/deprivation.

If GAE was to be restructured along theme-based lines, then themes would have to be agreed and defined and new distribution formulae may be required.

The cross-cutting theme based approach has developed in recent years as exemplified through Local Outcome Agreements and Government Spending Reviews. However, below this strategic level, both the Scottish Executive and local authorities are still administered in fairly traditional service structures. Also, local authority data is currently reported largely on traditional service lines.

A theme-based GAE structure would allow measurement of resource inputs by themes. However, as Local Outcome Agreements will focus on improved service targets and outcomes rather than resource inputs, the need for a theme-based GAE approach is perhaps less clear.

Further, more detailed consideration is needed of the issues surrounding theme based and service based approaches. As a minimum, however, the Scottish Executive should incorporate reconciliations between theme-based adjustments arising from Spending Reviews and movements in service-based GAE as part of wider improvements in presentation of Local Government Finance information. This would bring greater transparency to the Local Government Finance Settlement.

Examining the relevance and potential deletion of Secondary Indicators
Secondary indicators have been introduced where it has been agreed that additional factors could plausibly influence the demand for services or the unit cost of meeting that demand.

The redistributive effect of secondary indicators is less than 2% of the total amount of GAE. However, the impact on individual assessments can be large and secondary indicators can be particularly significant in the distribution of additional resources. Most secondary indicators can be grouped into one of three main categories: urban, rural and deprivation and there may be some scope for rationalisation or a revised treatment structured around these groups.

CONCLUSIONS

15. **This Section has set out the background to current GAE arrangements and has examined and assessed some options for revisions to those arrangements. On the back of this analysis a way forward in grant distribution arrangements is suggested in Section 6.**

INTRODUCTION

1. This Section considers the various reviews which have taken place since local government reorganisation (1996 – 2000) . **It is clear that a great deal of work has gone in to the GAE Review process with very few positive results** and this Section identifies the key reasons for this.

   Table 1 identifies the areas where reviews have been undertaken during the 5 year period.

Table 1 : GAE Reviews 1996 – 2000

Review	**1996**	**1997**	**1998**	**1999**	**2000**
Social Work : Elderly Assessment					
Expenditure Based Assessments					
Police GAE					
Adults in Education					
Day Schools : Inter-Authority Payments					
Fire GAE					
LGR Costs & Savings					
AEF Equalisation					
Loan & Leasing Charges					
Stability / Council Tax Safety Net					
Pre-School Education					
School Census Data					
Composite Indicators Appraisal					
Community & Residential Care for Children					
Transport Debt					
SINA					
Population Distribution					
Economies of Scale					
Deprivation					
Teachers for Deprivation					
Tourism GAE					
Airport Health GAE					
Income Support Data					
Roads					
Best Value Audit Burdens					
Pennington					
Civil Defence Grant					
FE Travel & Bursaries					
Street Cleaning					
Earmarked Funding					
Leisure & Recreation Parks					
School Transport					
3 year AEF Allocations					

DATA AVAILABILITY

2. The current GAE system is heavily reliant on the availability of quality data. **In examining all main reviews carried out since local government reorganisation, the consistent weakness that prevented acceptable outcomes being reached was either the lack of available data or poor quality data.**

3. For the first three years after local government re-organisation, expenditure information was not available for unitary authorities. However, once available, it was apparent that the quality and comparability between local authorities varied across services. There were a number of cases where no indicators were used, as data was not developed. In a number of reviews, even where data was improved, it was felt that some of the information was not as accurate as it could have been.

4. Better quality data may become available on a regular basis through the Scottish Neighbourhood Statistics Initiative and the release of the Scottish Household Survey at Local Authority level. This may help to alleviate some of the issues raised in various reviews. However, there still remains problems with expenditure data and the consistency in how expenditure is recorded. There will always be the opportunity for expenditure to be recorded differently at a local level due to different working practices. This issue needs to be considered as part of the process of developing a simplified distribution system.

PROCESS

5. The outcome of reviews were more successful where they did not have major data problems and where a group of technical experts took the issue forward.

6. On several of the bigger reviews, independent consultants were commissioned to undertake investigations and research. Overall, this was generally a satisfactory method to progress a review when the consultant had the relevant background and experience.

7. Other arrangements have included a political steering group with an officer advisory group eg. deprivation review. From a process point of view, this arrangement worked reasonably well and achieved outcomes quickly. However, there were criticisms that the review was not far reaching enough and only two out of six of the consultants' recommendations were implemented. This arrangement works well where issues are of a high political priority and a resolution is required quickly.

CONCLUSIONS

8. **Data quality and availability is the main problem with reviews. However, a transparent and inclusive approach to reviews between Scottish Executive and COSLA tends to address issues early in the review with a better chance of a successful or tangible outcome.**

9. **There is no one best process for undertaking reviews. This will vary depending on the scale and nature of each review.**

10. **The approach to future reviews for distribution needs to be considered as part of the simplification of the grant distribution system.**

INTRODUCTION

1. This Section explains the principles of the Aggregate External Finance (AEF) distribution and its relationship with Grant Aided Expenditure (GAE) allocations.

BASIC PRINCIPLES

2. The aim of the methodology used is to distribute a fixed sum of money fairly between Scottish local authorities. The key principle in the distribution of funding to local authorities is that a council tax payer living in a property of a particular value (for council tax purposes), should pay the same amount for the same level of service, wherever they live in Scotland. The two main steps in the distribution methodology are as follows:

- First, an assessment of the relative spending needs, given a similar level of service, of individual local authorities.
- Secondly, the distribution of funding to local authorities to provide ‘a similar level of service’ whilst also recognising each local authority’s ability to raise tax locally.

DETERMINING A SIMILAR LEVEL OF SERVICE

3. The ‘client group approach’ is used to calculate an assessment of what each local authority would spend to provide an average level of service at an average cost. The assessments, Grant Aided Expenditure (GAE), represent the distribution of a fixed sum for a service amongst all local authorities. For each local authority, each GAE assessment is added together to arrive at the total GAE for the local authority. These calculations are undertaken within a fixed total, the total GAE, which is determined by the Scottish Executive.

4. Added to GAE are a number of other cost assessments and adjustments [special islands needs allowance (SINA), council tax safety net, loan and leasing charge support, non-relevant expenditure (housing and council tax benefits) and the floor adjustment], to arrive at the total assessed cost the Scottish Executive recognises that it should support. This is called Total Estimated Expenditure (TEE).

DISTRIBUTING GRANT FUNDING TO LOCAL AUTHORITIES

5. The GAE and TEE distributions are the key factors in the distribution of funding to local authorities.

The Scottish Executive determines the overall funding available nationally, Aggregate External Finance (AEF). AEF is then allocated to individual local authorities, using TEE as the starting point, and after adjusting for the ability for each local authority to generate tax locally.

The difference between TEE (the need to spend) and AEF (the funding provided) represents the assessment by the Scottish Executive of the funding to be raised locally through the Council Tax. In practice, however, each local authority’s council tax will be determined by its own budget policy and funding decisions.

The difference between TEE and AEF is allocated to each local authority pro-rata to its council tax base (band D equivalents). This shares the national burden for local tax amongst authorities on the basis of each local authority's tax base. This sum is then deducted from each local authority's TEE to arrive at the total Scottish Executive funding (AEF) for the local authority.

SUMMARY

6. Through this methodology, a Council that receives an additional £1 in GAE, will also receive a further £1 in AEF, so long as the additions do not affect the floor adjustment. However, this is in principle only. It is only the case in practice where the Scottish Executive matches every £1 added to GAE by also adding £1 to the total AEF to be allocated. Section 5 demonstrates that this is not the case and over recent years the Scottish Executive has placed an increasing burden on council tax revenues as a result of a relative decline in AEF compared to GAE.

INTRODUCTION

1. With the recent development of three year budgeting within Scottish councils, there is an increasing need to provide relative stability in the distribution of Government grant to ensure that individual local authorities are not faced with unjustifiable year-on-year swings in funding levels. High degrees of turbulence in grant levels can undermine efforts to stabilise council tax increases, and can adversely impact on service planning. Whilst the issue of three year funding figures by the Scottish Executive provides certainty, it does not of itself address the issue of stability. Currently, stability is achieved within the three year settlement through a combination of the in-built statistical damping of secondary indicators to reduce the effect of annual data changes, and the application of a floor mechanism at AEF level to ensure that every council receives a minimum annual increase in grant.

2. To a large extent, the floor mechanism has proved both effective and popular. It is generally viewed as an equitable arrangement, ensuring an adequate increase in resources for councils which would otherwise be faced with below average funding, whilst not unduly penalising councils which are awarded above average increases in grant for valid reasons.

   However, given that a general review of distribution is being promoted, it would be useful to develop a draft protocol for the application of future stability arrangements.

3. This Section considers a range of issues relating to stability and, drawing on the analysis presented, sets out a protocol.

THE NEED FOR STABILITY ARRANGEMENTS

4. The overall objective of stability arrangements is to protect councils, and ultimately council tax payers, from changes in government funding which are likely to result in excessive swings in council tax levels or expenditure reductions. The current ‘floor’ stability arrangement is relatively simple and takes account of the vast majority of different changes in grant so achieves the overall objective.

5. However, in agreeing a stability protocol, it is useful to consider the different types of grant change which can occur and the arguments for including these in stability arrangements. In principle, the fundamental determinant of whether expenditure should be included in, or excluded from, any stability arrangement should be the relationship between assessed expenditure need and actual need to spend.

6. There are three major reasons for changes in grant level.

   - **Methodological Changes**
     Methodological changes are those changes in grant allocation to an individual council that occur directly as the result of changes in the needs assessment formula. Examples of this type of change include the introduction of composite GAE indicators in relation to Services for the Home-based Elderly, Residential Accommodation for the Elderly and Community and Residential Care for Children GAE assessments. This change was subject to damping, being introduced gradually over a four-year period. Similarly the damping scheme in

relation to the modification of population distribution and street cleaning assessments introduced in 2000/01 continues to be applied. Treatment of major methodological changes has, however, to some extent lacked consistency in recent years. For example the recent (2001/02) assimilation of the Residential Schools GAE assessment into the Community and Residential Care for Children GAE, which caused major turbulence in the assessments of individual local authorities, was not damped.

In addition to specific revisions, a major overhaul of the distribution arrangements, for example the proposed simplification of the current GAE system, would fall within this category of change.

It is likely that methodological changes do not in general give rise to changes in spending requirement, as increases in grant from this type of change do not accompany any change in actual need for services. In addition, of all the types of change within the grant system, methodological changes have the greatest capacity creating major instability. For these reasons methodological changes should, in principle, always be included in stability arrangements.

- **Base Data Changes**

  Base data changes relate to those changes to the grant allocation to an individual council which result from the updating of data within a pre-existing formula. This includes, for example, the annual changes to primary school pupil numbers reported in the school census which are used to update the Primary School Teaching Staff GAE assessment.

  GAE formulae are only determined following an intensive review process. They are chosen to reflect the requirements of objectivity and relative stability. Within these parameters the indicators express the best achievable proxy of spending need, and once established it seems only equitable that annual data changes are allowed to flow through without impediment.

  It has been argued that the feeding through of annual changes is unnecessary, as many of the costs associated with service provision are stepped in nature. For example, increasing pupil numbers do not necessarily involve increasing teaching costs on an annual basis. Similarly, it is argued that decreasing pupil numbers will not necessarily involve decreasing teaching costs each year. This argument is supportable in relation to marginal movements in base data. However, where base data movement shows a clear trend over a number of years it is likely that annual changes in grant will be fully mirrored by changes in actual spending need.

  In general, deferring base data changes over more than one year inevitably creates even more significant redistribution when the accumulated effect of several years' increases comes in to effect. It is more equitable to allow these changes to flow through incrementally. Under three year finance settlements councils which experience funding reductions through changes in base data are able to take appropriate action to reduce costs gradually over the three year period. It is therefore appropriate that base data changes are fully reflected in annual changes in grant. Indeed, in principle, there is a strong case for excluding base data changes from stability arrangements.

- **Resource Allocation Changes**

  The client group approach to needs assessment does not determine the level of resources in absolute terms or the division of resources between services. The allocation of resources between services is largely historical but is subject to review in order to reflect Ministerial policy priorities. Resource allocation changes encompass those changes which result from the redistribution of resources between services within the existing allocation formula.

The relationship between resource allocation changes and need to spend depends on the nature of the resource allocation. Increased funding via ring-fencing and central direction is likely to give rise to a specific need to spend. Additional grant funding in relation to the Excellence Fund, for example, which is 100% grant funded, requires that a council increases expenditure by an equivalent amount in order to obtain the full grant allocation. Where expenditure is not 100% grant funded, it nevertheless remains the case that authorities are obliged to incur relevant expenditure to access their full allocation of funds. On grounds of equity it is not appropriate, in principle, to include specific grant funding within any stability arrangement.

Similarly central direction involves individual local authorities entering into agreements with the Scottish Executive in order to fulfil specific policy objectives. Central direction is clearly based on specific financial inputs and councils which do not take up their full allocations of earmarked funding face jeopardising future year funding. A radical development of the earmarking concept will form the basis of Local Outcome Agreements (LOA). Unlike earmarking the emphasis in these agreements will be firmly refocused on outcomes, and the financial arrangements relating to the agreements have not yet been agreed.

Changes in joint board requisitions also fall within the resource allocation changes category. Both increases in police and fire funding, which result from overall national increases in funding these services and changes in requisitions, which result from movement of resources within board areas, result in real increases in spending need within local authorities. Where Boards agree these changes, councils have no option but to meet the revised requisitions.

It is clear that such changes result in actual spending requirements and therefore, in principle, all such changes should be excluded from stability arrangements.

STABILITY MECHANISMS

7. In addition to the requirement that any stability mechanism is equitable, with ongoing pressure to simplify the needs based allocation formula, any stability mechanism should similarly be as simple as possible.

8. In recent years several mechanisms have been applied in order to minimise the level of instability within the local government finance settlement and it is worthwhile giving consideration to the two most important. Both of these schemes are over-riding stability mechanisms that should, in theory, operate to assist in achieving relative stability at taxpayer level. The council tax safety net was applied for three years from 1998/99 and the ‘Floor’ arrangements applied in the current and following two financial years.

- **Council Tax Safety Net**
  The Council Tax Safety Net arrangement was originally effective, as there was a clear relationship between changes in spending capacity and changes in grant, with expenditure which was earmarked being disregarded for Safety Net

purposes. In 1999/00, following the removal of this relationship through the replacement of the capping regime with expenditure guideline arrangements, the Safety Net captured not only increases in funding which only had a council tax effect, but also funding movements which were directly linked to increased expenditure. For example, where fire officers were shifted between constituent councils within the same fire board area this movement was caught in the safety net. This was manifestly unfair, and some adjustments were implemented to remove inequalities in 2000/01.

The general principles upon which the Council Tax Safety Net was based were sound. It attempted to differentiate between funding movements on the basis of whether they affected council tax, and measured grant movement at taxpayer level. However, overall there was considerable dissatisfaction with the Safety Net system because it involved a complicated calculation (which included the carry forward of council tax adjustments from one year to the next) and assessed 'excess' changes in grant against a largely arbitrary threshold level.

- **AEF 'Floor' Arrangement**

The 'Floor' arrangement, introduced in 2001/02 and applied annually within the three-year settlement, is much less complex than the Safety Net. With the exception of Level Playing Field Support (LPFS) for PPP projects it takes account of all AEF movements. It provides a minimum increase in grant for all local authorities but avoids excessive penalties being applied to local authorities with high increases in AEF as no 'ceiling' is applied. Funding is provided to councils which would otherwise experience a grant increase less than 80% of the overall increase in distributable grant. This equates to 5.0% in 2001/02, 4.0% in 2002/03 and 3.4% in 2003/04. Effectively this additional support for the low increase authorities is deducted pro rata to the total AEF of all other authorities. The whole approach is relatively simple in that the basis of allocation is total AEF (excluding LPFS). Therefore the burden of providing support is allocated uniformly over the majority of authorities on the basis of overall government grant. In 2001/02 the scheme results in an abatement of grant equivalent to 0.32% of total AEF.

Despite its simplicity and its relatively 'painless' impact in each of the three years of the current settlement, there are two significant issues which merit consideration in relation to the floor approach.

Firstly, although the floor system works well in circumstances in which there is relatively little variation from the overall settlement movement, a potential problem exists in that it does not differentiate between changes in grant level which are related to need to spend and those which are more likely to have an effect purely on council tax levels. The all-encompassing nature of the arrangements means that in years of extreme turbulence (for example as the result of highly re-distributive methodological changes) it may not provide an equitable approach. In relation to methodological changes the scheme would compensate for substantial losses but would not target those councils which had gained most from the changes. This outcome would be highly destabilising in relation to council tax levels. If two hypothetical authorities (authorities A and B) had the same AEF levels and the same increase in AEF, they would experience the same 'floor' abatement under the current arrangement. However if the AEF increase awarded to authority A was mainly in relation to changes in base data or joint board GAE's, which have a real effect on spending need, whilst that in authority B was mainly due to methodological changes which have no effect on spending need, then applying the same floor abatement will have a destabilising effect on council tax levels.

Secondly, the floor arrangement is calculated based on movements in total AEF. It takes no account of the effect of its changes at council tax Band D equivalent level. Since a major objective of stability arrangements is to assist councils in ensuring stability at tax payer level the floor arrangement may not be suitable where AEF movements, and in particular methodological changes, are considerable.

In summary, the simplicity of the 'Floor' arrangement is attractive. However where significant re-distributive grant change (resulting, for example, from methodological changes) is experienced a more sophisticated mechanism may be necessary to ensure that authorities are treated equitably and that true stability is obtained.

- **Other Mechanisms**
  A comprehensive summary of other stability mechanisms is set out in **Appendix A** of this Section.

DRAFT PROTOCOL

9. Taking account of the foregoing, a draft protocol has been drawn up and is appended to this Section (**Appendix B**). The protocol effectively proposes the continuation of the simple 'floor' arrangement applied in the current settlement. However, this is with the proviso that in circumstances in which there is a substantial degree of methodological change, consideration should be given to a more complex arrangement.

CONCLUSIONS

10. **Having considered the theoretical basis of stability and reviewed current and past arrangements, this paper sets out a draft protocol for stability. The protocol proposes that stability arrangements should follow a simple methodology in circumstances where there is little turbulence - effectively a floor arrangement.**

11. **However, where there is a high level of methodological change the stability arrangements may have to be modified to take account of the direct effect on tax levels. To this extent the protocol reflects a balance between producing arrangements which are relatively simple while at the same time highlighting circumstances where more complex arrangements may be required to ensure that the methodology is equitable.**

Appendix A

STABILITY MECHANISMS

Current Mechanisms

Secondary Indicator Damping
Damping is applied to all continuing GAE secondary indicators on an annual basis. Essentially the current year secondary indicator coefficient is averaged with the coefficient used in the previous year. This increases stability by reducing the impact of any change in coefficient value.

Population Distribution & Street Cleaning GAE Damping
Following the revision to secondary indicators relating to population distribution and street cleaning a damping scheme was introduced in 2000/01. This scheme phases in the impact of the changes by allowing 33% of the changes to flow through in 2000/01, 66% in 2001/02 and 100% in 2002/03. It applies to six GAE assessments (school transport, refuse collection, refuse disposal, environmental health, consumer protection and street cleaning).

AEF "Floor" Arrangement
A floor adjustment is applied at AEF level to ensure that each council receives a grant increase of at least 80% of the overall percentage increase in distributable AEF. The arrangement was first applied in the current year. For the three years of the local government finance settlement this redistributes a total of £33.8 million. In 2001/02 five councils will benefit from the scheme, in 2002/03 six councils will benefit and in 2003/04 seven councils will benefit. The arrangement is self-financing, and contributions to it are made pro-rata to councils' AEF totals (excluding level playing field support).

Former Mechanisms

Mismatch Scheme
The Mismatch Transitional Scheme was initially proposed by COSLA and was subsequently accepted by Ministers. It was applied to the 1996/97 and 1997/98 settlements. The scheme was self-balancing within each of the former regional areas and attempted to address the disparity between GAE and notional budget at individual authority level. It was originally proposed that changes would be damped by two-thirds in 1996/97 and by one-third in 1997/98, a supplementary mismatch special grant scheme was also introduced to moderate the impact on authorities which would otherwise have experienced substantial year on year decreases in grant.

Council Tax Safety Net
The Council Tax Safety Net was applied to the finance settlement annually between 1998/99 and 2000/01. Applied at GAE level the initial application in 1998/99 was based on the crucial link between spending capacity (as determined by capping level) and grant. At that time, for the majority of councils, capping limits were set principally with reference to previous expenditure levels rather than GAE. Essentially this meant that it was possible to isolate those changes which had an effect only on council tax levels and to moderate these by reference to the impact at tax payer level (a plus or minus threshold per Band D equivalent unit). Items which were disregarded for capping purposes (such as transfers of responsibility and new burdens) were excluded from the Safety Net calculation, while movements in base data were included.

Expenditure guidelines, which replaced capping as the expenditure control, were first applied to the 1999/00 local government finance settlement. The methodology for the calculation of Indicative Guidelines did require the identification of disregards, and as the Safety Net methodology had not been revised the 1999/00 Safety Net captured all changes in government grant including specific grants, joint board requisitions. This outcome was unsatisfactory, as it did not adequately reflect authorities need to spend the new resources, but essentially assumed that all funding changes would have a potential impact on council tax levels.

For 2000/01, following consideration by a Review Group, it was agreed that 100% specific grants and changes in joint board requisitions would be excluded from the safety net calculations.

Social Work Damping

The introduction, in 1998/99, of composite indicators for use in the Services for the Home-based Elderly, Residential Accommodation for the Elderly and Community and Residential Care for Children GAE assessments, had the potential to give rise to considerable turbulence in GAE. A damping scheme was therefore agreed which controlled that rate of change allowed to flow through annually. The scheme restricted the redistribution caused by the introduction of the composite indicators by limiting the change to 25% of the full effect per Band D equivalent property in the first year, 50% in the second year (1999/00), 75% in the third year (2000/01) and the full effect in the final year (2001/02).

Local Government Reorganisation Damping

Following local government reorganisation a Reorganisation GAE was established which, based on Scottish Office calculations, distributed a net allocation £40 million, comprising £30 million on-going savings and £70 million short-term costs in 1996/97. By 1997/98 the net savings were included in GAE at £20 million. Following the 1997 general election the Secretary of State determined that this net savings amount should be removed from the settlement, however to avoid a destabilising redistribution a four year damping scheme, applying the same arrangements as those used for the social work damping scheme was applied.

Appendix B

DRAFT PROTOCOL ON STABILITY ARRANGEMENTS

COMMITMENT TO STABILITY

A high degree of turbulence in grant levels undermines efforts to stabilise council tax increases and adversely impacts on service planning. Therefore local government is committed to the principle of relative stability in the distribution of Government grant so that individual authorities are not faced with unjustifiable year on year swings in funding.

PURPOSE OF PROTOCOL

Within the context of support for the concept of stability, this protocol outlines the views of local government on when and how stability arrangements should be applied.

WHEN STABILITY ARRANGEMENTS SHOULD BE APPLIED

Stability arrangements should be applied to allocations of grant in respect of individual financial years to ensure that no council is unfairly disadvantaged by the grant settlement which it receives.

HOW STABILITY ARRANGEMENTS SHOULD BE APPLIED

- **General**
  A stability mechanism should be simple, transparent and widely understood but should also provide for the equitable treatment of all authorities.

- **Level of Stabilisation**
  Stability measures should be focused on changes at government grant level (AEF) as it is the overall grant settlement which is of importance to individual councils rather than the changes relating to individual needs assessments.

- **Ongoing Stability – Floor Arrangement**
  Within the ongoing grant system, where instability is usually limited, local government supports a ‘floor’ threshold. This is a relatively simple mechanism whereby a minimum increase in AEF is accorded to all authorities, effectively by top-slicing the allocations to other authorities.

  Although this mechanism has no specific reference to the effect of changes on individual council taxpayers, it does guarantee a minimum percentage grant increase to all authorities and is transparent and easily understood. In addition, the arrangement has the advantage of awarding assistance where necessary without unduly penalising councils with higher levels of grant increase required to meet additional spending needs.

  In addition to exclusion of level playing field support from the floor arrangement, the principle of excluding other ring-fenced expenditure from the calculation, depending on the materiality of the sums involved, could be considered.

  With regard to the minimum level of increase within the floor arrangements it should be recognised that there are different factors leading to instability. The process of setting a floor should thus involve due consideration as to whether instability has arisen because of changes in base data which impact on the need to spend or through changes in methodology which do not.

- **Grant Turbulence – More Complex Arrangement**
  Within the current system, where there is inherent stability of primary indicators and the in-built damping of secondary indicators, significant turbulence in grant levels is likely to be due to methodological change. The current Inquiry into local government finance may result in such change if there is a substantial or wholesale revision of the needs assessment system in advance of the next three-year local government finance settlement.

  In such a scenario there would be a need to separate the different type of changes and consider a stability arrangement which separately identifies and moderates funding.

INTRODUCTION

1. This Section examines the issue of council tax differentials and attempts to analyse the key factors which impact on council tax levels to establish any underlying explanation for these differentials. Councils rely on the Scottish Executive for nearly 80% of their funding needs and these have been subject to spending and/or council tax controls. Grant distribution is determined by the Scottish Executive using the client group approach which is a systematic means of allocating a predetermined level of expenditure amongst local authorities. The Scottish Executive therefore has a key influence on not just spending but also the council tax levels across Scotland.

2. **In 2001/02 the council tax levels range from £747 to £1,120 at Band D level, a differential of £373 or 50%**. Local government is about the needs of the local community and this should be reflected in the taxes paid by local taxpayers. This Section explores the key influences on council tax levels and whether a differential of 50% can be explained by Council actions.

FACTORS INFLUENCING THE SETTING OF COUNCIL TAX LEVELS

3. There are a number of factors to be considered when reviewing the levels of council tax set by Councils. These factors include:-

   - Grant distribution mechanism.
   - The consequences of local government reorganisation.
   - Council spending levels.
   - The Scottish Executive's assumptions on Council resources.
   - The Scottish Executive's calculation of spending assessments.
   - Influence of balances and income generating capacity.
   - Local policy decisions and grant influences.

Grant Distribution Mechanism

The current grant distribution mechanism allocates Aggregate External Finance (AEF) on the premise that this distribution will compensate each Council for their own specific demographic influences across the various client group assessments. An analysis of the levels of AEF and council tax, at Band D equivalent level for each Council, however, indicates there is no linear relationship between Councils' AEF allocations and their council tax levels.

This lack of a linear relationship confirms that many factors influence council tax levels. Although it is proper that choice at a local level should be reflected in differing council tax levels, the present levels are also influenced to some extent by historic spending decisions of demitting councils prior to local government reorganisation and because of central control mechanisms. It is important that these matters are fully taken into account in addressing this issue.

A declining population will mean a local authority will receive a reducing level of grant in relative terms. This is because grant distribution is heavily dependant on population, and local authorities with a declining population may need to increase Council Tax to maintain existing levels of services.

Local Government Reorganisation

At local government reorganisation it was recognised that there was a significant "mismatch" for a number of local authorities where their inherited budget commitments were substantially in excess of Grant Aided Expenditure (GAE). Short term transitional funding arrangements were introduced to assist those Councils to manage down their spending levels. It was also recognised that a number of councils inherited inadequate spending bases in relation to the costs of services required.

The relationship between a council's spend and its GAE can be interpreted as a consequence of the spending decisions of each Council, however a significant influence in this is the restrictions placed on individual council's spending levels over the years through central capping and spending guideline arrangements. Through these measures, over a period of years the Scottish Executive effectively dictated individual councils' spending decisions.

Council Spending Levels

An analysis of council tax movements between 1996/97 and 2001/02 confirms an average increase across Scotland of 31% was needed to fund spending increases of 22% **- clear confirmation of a shift in tax burden through a relative reduction in grant support**. Council budgets will, on average, comprise approximately 55% payroll costs and 19% loan charges and these spending shares will significantly influence any Council's ability to manage cost reductions or efficiency savings. In the period following reorganisation all Councils were subject to significant downward spending pressures as a result of Government spending priorities and tight spending controls. **Spending levels operated by Councils today are a direct consequence of this central control and the council tax differentials have also been influenced by the same central control.**

The Scottish Executive's Assumptions on Council Resources

For grant distribution purposes, within the overall level of resources made available GAE is calculated to reflect the relative needs of individual councils on the basis of the client group approach. Each authority's GSE (effectively GAE plus loan and leasing charges) is used to apportion AEF on the basis of the GSE adjusted for Band D numbers. **This distribution assumes that council tax levels across Scotland will be at a standard level and for 2001/02 this proxy level of council tax was £697. All 32 Scottish authorities have set a council tax level higher than £697** with the lowest being £747 (7% higher) and the highest £1,120 (61% higher).

On average the council tax levels across Scotland are 33% higher than the proxy council tax. This could indicate that the Scottish Executive's assumptions on council tax levels are unrealistically low when compared to the level of spending needed by each local authority to provide services and meet the local population's needs.

The Scottish Executive's Calculation of Spending Assessments

An analysis of GAE, AEF and council tax movements (as adjusted for transfers out for urban programme and the Strathclyde Passenger Transport Authority) from 1996/97 through to 2003/04 has been carried out. This illustrates that the Scottish average increase for GAE from 1996/97 to 2001/02 has been 16.9% and from 1996/97 to 2003/04 is forecast to be 26.8%.

The Scottish average increase for AEF from 1996/97 to 2001/02 has been 9.8% - an average annual increase of 1.9% and below the prevailing annual rate of inflation - and from 1996/97 to 2003/04 is forecast to be 18.4%.

It is evident that the headline increases in GAE do not flow through to increases in AEF, this putting pressure on Councils when determining council tax levels. This gap and the actions of individual Councils will, in part, explain the council tax differentials which arise. The gap between GAE increases and AEF increases across Councils will narrow through to 2003/04 and this may reflect the stability arrangements which have been put in place.

The Scottish average increases for council tax from 1996/97 to 2001/02 has been 31.2% and from 1996/97 to 2003/04 is forecast to be 43.6%.

Council Tax increases have been and are projected to be higher than the relative GAE increases. This clearly reflects the Scottish Executive's policy to provide increases in AEF at a lower rate than GAE - effectively transferring a burden to the council taxpayer which becomes exaggerated by the gearing influence within the present funding arrangements.

Influence of Balances and Income Generating Capacity

At a national level, council tax collection has improved from 94.84% in 1996/97 to 95.49% in 2000/01 reflecting Council efforts to improve collection levels. Recent initiatives across councils including the advancement of the Council Tax instalment date and the response to the paper "It Pays to Pay" may assist in improving council tax yields. Also, COSLA is currently developing guidance on a modular basis which may be referred to by councils when considering best practice arrangements for council tax collection.

Councils have been able to limit the increase in council tax to 31.2% since local government reorganisation compared to the increase of 41.4% assumed in the Executive's proxy calculation.

Councils will have some influence over their spending levels but will be guided in their decisions by national priorities and statutory obligations. Two other factors will influence council tax levels - any deficit/surplus balances and collection rates.

Differentials could not, however, be addressed through the use of balances, improvements in yields, or through the expected level of council tax increases inherent in three year budgets recognising forecasted levels of AEF as:-

- Local authorities are unable to utilise balances to sustain lower council taxes in the medium to longer term;
- The achievable improvement in yields could produce only a marginal reduction in the differentials;
- Forecasted increases in council tax levels again produce only a marginal reduction in the differentials.

Local Policy Decisions and Grant Influences

Each Council's budgeted expenditure is determined as part of its process of evaluating the needs of the local community and the local authority's aims and goals in service delivery. As the Scottish Executive provides a level of funding commensurate with their assessment of a local authority's relative spending needs (through the GAE assessment) any additional spending required as part of a local authority's determination of its actual spending requirement must therefore be met from the council tax base.

CONCLUSIONS

4. **This Section has provided a commentary on the factors which influence council tax levels. A number of key messages can be taken from this:**

- **Council tax increases since 1996/97 have averaged 31.2% compared with average spending increases of 22.2% - a clear indication of a reduction in the proportion of grant support.**

- **A cumulative increase in GAE since 1996/97 of 16.9% contrasts with an increase in AEF of 9.8% and has led to an average increase in council taxes since 1996/97 of 31.2%. In comparison, the Scottish Executive's proxy council tax assumption in the AEF calculations has increased by 41.4%.**

- **Council tax levels are affected by any surplus or deficit balances applied by individual Councils but these can only have a short term impact and have little bearing on council tax differentials.**

- **Council tax differentials cannot be fully explained by any single factor, however, given that AEF accounts for nearly 80% of Councils income it seems reasonable to conclude that grant distribution could have some degree of influence on council tax differentials.**

5. **Given these conclusions, it is recommended that further independent research is undertaken as a matter of priority into the factors which influence council tax levels and expenditure levels in relation to GAE, causing the significant differential between the highest and lowest council tax levels. On the basis of the conclusions in this Section and founded on that research, the Scottish Executive should provide additional resources which would assist those councils most adversely affected by influences largely outwith their control to reduce their council tax levels.**

INTRODUCTION

1. COSLA considered possible changes to the revenue grant distribution system within the context of the following overall objective:

   "*developing and promoting a simplified, fair and transparent formula for distributing on a predictable and stable basis, three year revenue grants*".

2. Fundamentally, the overall resources available to local government are insufficient to maintain core services and fund the scale of new initiatives being taken forward. The current system makes individual councils too dependent on grant levels and this contributes largely to the strains on and dissatisfaction with the current system. **In developing a simplified formula it needs to be recognised that a grant distribution system cannot solve the problems of inadequate resource levels and an inadequate tax base.**

3. A revised formula needs to be built on arrangements which provide three year stability and should be founded on the following principles:

   - a simple formula should provide fair and reasonable results to all local authorities. It is recognised that there may be a trade-off between fairness and simplicity;
   - any new formula should be simpler and easier to understand than the current GAE system;
   - it should be capable of being applied to govern the entire distribution of general grant;
   - simplicity is at least as much dependent on simplicity of concepts and accessibility of process as the actual construction of a formula;
   - explicability of a formula is extremely important. There should be clear and understandable methods of choosing indicators and deriving weights within a formula. People will feel more comfortable if they understand the reasons why grant varies from one local authority to another and from year to year;
   - even though the formula should be simple, it should be subject to a process of rigorous construction. It should, therefore, take into account the various factors which may impact on councils' spending need;
   - formulae should be constructed and applied in such a way that the resultant grant distribution system is predictable and stable;
   - up to date and robust data should be used in constructing formulae and in underlying analyses;
   - indicators and variables should be capable of being justified on a rational and objective basis;
   - any judgement used in the construction of the formula should be open and transparent.

4. The existing formula is the product of joint development and refinement of the system by central and local government since the late 1970s. It is important that the development of a simplified formula is similarly taken forward on a joint basis.

THE WAY FORWARD

5. It is widely recognised that the scale of the current formula has become excessive and needs to be rationalised. It has also tended to become unduly technical and readily open

to challenge. This has in many respects resulted in inertia within the system and difficulties in developing and refining the formula.

6. In recognising this, however, COSLA is of the view that there are a number of strengths within the current system, which should be retained and a review should be directed towards addressing the weaknesses. With this in mind, a simplified formula should continue to be constructed on a needs basis; a review should avoid "throwing the baby out with the bath water". It also needs to be recognised that there are difficulties in balancing fairness versus simplicity. In undertaking a review, a suitable programme of work needs to be put in place to openly, inclusively and thoroughly investigate all the various issues in the development of a simple formula for grant distribution. In doing so, a clear, firm and abiding decision needs to be made from the outset on the principle of achieving this simplification, otherwise there will inevitably be a great deal of dissent from whatever decisions are finally made.

7. Section 2 demonstrated the difficulties in obtaining robust and consistent data across councils, in particular following local government reorganisation and taking into account the variable basis in which councils deliver cross-cutting services. In many respects this lack of robust data could be regarded as the principle reason why there has been a degree of inertia within the system since reorganisation. The result is that **since reorganisation significant reviews have been undertaken but the end product does not justify the level of input**. Before undertaking future reviews, therefore, arrangements need to be put in place whereby a feasibility study on the availability of sound data is undertaken before a review is progressed. Further, a review of grant distribution arrangements would benefit from a more focussed work programme and this could include measures to improve data availability for the future.

8. A number of improvements and changes can be made to current arrangements.

- Recognising the significance of grant distribution, but also emphasing its intended purpose (ie to arrive at one figure which may represent the relative needs of individual councils and be used as the basis for distributing grant), simplifications could be made to the current "Green Book" presentation. This could assist in a greater understanding and acceptance of the system.

- On the face of it, AEF is distributed by relying on the use of formulae. In theory, it could be argued that a needs based system should make no provision for the exercise of Ministerial discretion in setting the grant level for an individual council. Such an arrangement would be seen to have a significant degree of transparency. In reality, however, Ministerial judgement influences final distribution arrangements to a significant extent. Examples of this are the weighting of assessments within the formula, the inclusion of targeted specific grant resources, special grants through mismatch etc arrangements, stability arrangements through floors, the methodology for the years 2 and 3 grant calculations, etc. In particular since the establishment of the Scottish Parliament, **it is inevitable that political judgement will be a continuing feature of grant distribution arrangements**. Such a process, however, needs to be more open and transparent and the introduction of the Planning Framework proposals outlined in Part 3-Section 1 are the means of opening up such political consideration and debate.

- Both within central and local government, there is a temptation to regard GAEs as "spending targets" for individual service areas. This is inconsistent with the intended purpose of GAEs and conflicts with moves to develop outcome based arrangements. In order to emphasise their prime purpose, COSLA suggests that the term GAE should be replaced by Distribution Factor (DF).

- In reviewing the formula, it needs to be recognised that no system can yield completely reliable estimates of relative spending need. A review should not, therefore, be looking for the Holy Grail. Having said that, however, it is important to keep the focus on the end product derived from a formula, ie individual councils' block grant figures. This is the prime purpose underlying the detail of distribution calculations.

- Subject to sensivity analysis to assess the impact of changes, a review should investigate the possibility of:-

  - **abandoning secondary indicators**; these are a very technical aspect of current arrangements.
  - **abandoning expenditure based assessments**; these simply reflect individual councils' spending levels and do not filter out policy choice or encourage efficiencies;
  - **rationalising small GAEs** with a *de minimus* level being set.

- It needs to be recognised that the current system cannot adequately address the specific needs of individual councils. COSLA would, therefore, promote **the introduction of special allowances or safety valves** beyond the main distribution arrangements to accommodate this. It would be important, however, that such special allowances were kept to a small and manageable level; they could for instance perhaps cover urban, rural and deprivation factors. The introduction of such arrangements would result in a transparent recognition of the specific needs of individual councils and of the Scottish Executive's commitment to tackling issues such as social inclusion.

- Whilst much of the focus of the suggested review has been on the GAE system, it will be important that a review also considers the subsequent calculations which through AEF equalisation arrangements calculate individual councils' grant figures. For instance, without creating perverse disincentives, a review may wish to consider the varying council tax collection capacities of councils.

- It is essential that a review of grant distribution arrangements builds on the stability and certainty offered by three year settlement announcements for individual councils. The entire arrangements, therefore, need to be **underpinned by robust stability arrangements** with a protocol on their application being put in place. As the main purpose of the review, however, would be directed to introducing simplified arrangements, it will be important that similarly stability arrangements which are put in place are not unduly technical or cumbersome.

<u>CONCLUSIONS</u>

9. **In conclusion, COSLA would promote an early joint review of grant distribution arrangements aimed at rationalising and simplifying the current system. This review should recognise the inevitability of political judgements within the system and build these transparently into revised arrangements. The review should build upon the strengths and address the weaknesses of the current system. Revised arrangements should be underpinned by robust stability arrangements.**

PART 9 – LOCAL TAXATION

Section 1 – Critique of Domestic Taxes
Section 2 – Refinements to Council Tax Arrangements
Section 3 – Water and Sewerage Relief
Section 4 – Public Expenditure Definitions
Section 5 – Return of Non-Domestic Rates to Local Control
Section 6 – Business Improvement Districts
Section 7 – Relationship between Local Authorities and the Business Sector

INTRODUCTION

1. To assist in considering appropriate local domestic tax systems, COSLA has prepared a factual 'critique' of identifiable domestic taxes within Scotland. The critique covers a range of taxes including those taxes currently being administered and those which are not. The critique also covers the feasibility of these taxes as being alternatives to current taxes and those which could be supplementary.

2. In previous evidence to the Inquiry, COSLA emphasised that the local taxation base level is inappropriately low and that serious consideration needs to be given to expanding this base to improve accountability arrangements.

3. **For a realistic democratic choice at local level, electors should be able to choose between different 'packages' of taxation and spending. The current financial regime limits the range of options available to the electorate, which is undesirable if public interest in local affairs, and involvement in local democracy, is to be maintained.**

4. Council Tax alone could not, taken across the country as a whole, raise significant additional income for local authorities, though there is perhaps scope for some increase in the amount raised by this means.

5. If the level of local authority spending to be raised by locally-determined taxation is to increase to a more appropriate level, local authorities will need access to a wider range of local taxes.

6. **This critique provides a broad commentary on a range of possible local taxation systems. There have been a number of major examinations of local taxation in recent years, including the Layfield Committee, and at the time the community charge and council tax arrangements were developed and introduced. These emphasise that any further review of local taxation should not be taken lightly and must be taken forward on a fully researched and considered basis.**

BASIC PRINCIPLES

7. Within any system of local taxation, there has to be a number of fundamental basic principles which underpin the system. The basic principles are shown in Table 1.

Table 1: Basic Principles

• Ability to Pay	• Difficult to Evade and Avoid
• Easily Understood	• Impartiality
• Administratively Efficient	• Accountability
• 'Benefit' Principle	

Ability to Pay
A local taxation system must be related to a person's ability to pay. This principle ensures that there is public support for the tax. In defining 'ability to pay', consideration must be given to the liable person's assets and not just their sources of income. This is apparent within the council tax system in which 50% of the tax is based on property. A local taxation system also needs to incorporate an effective rebate or relief system which recognises and assists those on low incomes. The council tax benefit system is an

example of such a necessary arrangement. The absence of effective rebate or relief arrangements in respect of water and sewerage charges emphasises the difficulties created by not effectively recognising ability to pay. This is of major concern and needs to be addressed as a matter of urgency. Further details are given in Section 3.

Easily Understood
Tax bills must have clear and definitive explanations as to what they represent and any exceptions within them, fully explained. Tax bills must be understood by taxpayers in order to have credibility. Examples of this include the requirement for local authorities to provide full explanations of how the council tax has been calculated and some detail on how the tax revenue will be spent.

Administratively Efficient
Any system of local taxation should be administratively efficient. The system should enable straightforward collection at a relatively low cost. Examples of this are the council tax and business rates systems which are administratively efficient and relatively cheap to collect.

Difficult to Evade and Avoid
Local taxation systems should be developed and set up to ensure that it is difficult for tax payers to evade and avoid. Property based taxes, such as council tax (which is 50% property based) and business rates are examples of this in which the liable person can be identified relatively easily.

Impartiality
Local taxation systems should be impartial between one person and another. Taxpayers want a system which is fair and equitable and not subject to discretion. In terms of council tax, all other things being equal, a taxpayer who lives in a Band D property in a local authority area will pay the same as someone else living in a Band D property within the same boundaries of that local authority area.

Accountability
Local authorities must be accountable for local taxes. The Layfield Report on Local Government Finance argued that for *'local authorities… to be accountable they should be responsible to their electorates for both the expenditure they incur and the revenues they raise to finance it'*. If local government is to respond to local needs and to play an effective part in Scotland's Government, it needs more responsibility for its finance. The combination of spending controls and Government grants mean that only 22% of council expenditure is now funded from local tax. Against any comparable country, Scottish local government is dependent on central funding; in France, Germany and the United States of America the percentage raised through local tax is around 40%.

The local revenue base is simply too small. COSLA is firmly of the view that local taxation should raise at least 50% of local government income if there is to be real accountability between a council and its electorate and an effective relationship with central government.

'Benefit' Principle
The 'benefit' principle should apply to a local taxation system in that those who benefit from locally provided services should make a contribution towards their cost and those who contribute towards the cost of locally provided services should benefit in some way from them.

COUNCIL TAX

8. The introduction of the Council Tax in 1993 followed a period of uncertainty regarding local government domestic taxation. In 1989 domestic rates were abolished and replaced by the Community Charge, which itself was abolished in 1993 with the introduction of the Council Tax. Council Tax and Community Charges represent, in many aspects, entirely different concepts of taxation. Council Tax is primarily a property tax (although with a personal element as outlined in paragraph 10), whilst Community Charge was an entirely personal tax.

When introducing Council Tax, elements were incorporated to reflect the main criticisms which had been made of the predecessor domestic property tax, domestic rates.

9. **Capital Valuation**

For the purposes of the Council Tax, properties are placed in one of 8 valuation bands which are specified by statute. Each band contains a range of capital values and it is therefore necessary to estimate the selling price of each domestic property on a statutorily defined date subject to certain assumptions, eg the property must be assumed to be in a reasonable state of repair.

Valuations for domestic rates were based upon the hypothetical rent which could be achieved if the house were to be offered for let. This created difficulties as there were only a limited number of domestic lettings available for analysis. It was therefore necessary to create schemes of valuation for application to all properties, from a limited body of appropriate rental evidence. This made the basis of valuation difficult to understand particularly for the uninitiated ratepayer.

The conversion to the use of capital values has a number of very significant advantages. There is an extensive body of sales evidence available which enables accurate valuation of all types of properties to be undertaken. Furthermore, local tax payers are for the most part able to make an informed judgement on the value of their property and also have a right of appeal if they are of the view that the valuation is not correct. In addition, unlike the rating system, the valuation is based on bands of value rather than exact value.

10. **Ability to Pay**

A persistent criticism of domestic rates was that liability was not related to the ability to pay. The particular example which was often cited referred to persons living on fixed or restricted incomes in old family homes where liability exceeded the ability to pay. Recognising this issue, the system of Council Tax includes a "sole residence provision" which stipulates that a 25% discount is applicable in situations where only one adult resides in a chargeable dwelling. There are further provisions relating to "disregarded persons". A statutory list of categories of persons, eg students or the severely mentally impaired has been compiled, and if any person is included within any of those categories they are disregarded for the purposes of calculating discounts. Discounts are therefore available to some taxpayers depending on the composition and characteristics of the household.

11. **Deterrent to the improvement of property**

Domestic rates were considered to act as a deterrent to the improvement of property. It was considered to be invidious that immediately a person expended money on improving their property they were often liable for additional rates.

In terms of Council Tax, if a property is improved to the extent which would justify a band change then the increased liability does not become effective until the property is sold.

12. **Accountability**

All adult householders with few exceptions are directly taxable. In addition there are a significant number of non-householders such as partners of householders. In these circumstances both parties will be jointly responsible for the payment of the tax and all parties should be made aware of the extent of their liability.

A single bill is issued per household which reflects both the banded valuation and the effect of the discount arrangements. Those who pay directly will be aware of the extent of liability and as mentioned above all parties who are jointly responsible for the tax should be made aware of their responsibility. However, it is less clear to indirect payers such as partners.

13. **Tax Yield**

The yield from Council Tax is more stable and predictable than a tax based on income. It is difficult to escape payment of taxes based on property as there is little scope for avoidance. The general tax base is very stable with the number of chargeable dwellings varying only very modestly from year-to-year to reflect new houses and deleted properties.

14. **Fairness**

For the majority of households, property values, particularly derived from capital values, are a reasonable reflection of ability to pay. There is however some evidence to suggest that those with the lowest incomes are liable to pay a higher amount of tax in relation to their income, although this is offset to some extent by a rebate arrangement.

As stated above, in paras 8 and 10 Council Tax is a combination of personal and property taxation. The discount scheme is particularly advantageous to single residents and whilst the discount is applicable irrespective of income, it will be particularly beneficial to those persons of limited means who live alone.

There is currently no statutory requirement to undertake Council Tax Revaluation. The current banded values are based on the values of houses as at 1 April 1991. This creates considerable difficulties for valuers attempting to allocate bands to newly built properties. If no revaluations were to take place then taxpayers will perceive that the liability for tax is not related to the current value of their property. However, from the point of view of tax stability, revaluations are problematic. Even if it is accepted that the purpose of revaluation is redistribution rather than the creation of additional income, there is a possibility that an individual’s liability may alter significantly following a revaluation. Furthermore, at revaluation, the relative movement in values is unlikely to be uniform throughout the country but will exhibit wide variations from one area to another.

15. **Technical Feasibility**

The system is already in place and fully operational.

Property taxes are, in general, less costly to administer than personal taxes. In the absence of revaluations, the maintenance of the Council Tax Valuation List involves only very modest levels of expenditure. There is, however, an ongoing need to administer the benefits and rebates system.

The yield from Council Tax is much less variable between years than an Income Tax or

Sales Tax. Council Tax complements the national tax systems and provides a broad tax base.

LAND VALUE TAX

16. The theory of land value taxation can be traced back to Adam Smith who reasoned that land rents were 'peculiarly' suitable for taxation. He argued that taxes on land rents: -

- are neutral in their resource allocation effects;
- are equitable in that it is fair to tax away surpluses which are more due to extraneous circumstances than to individual efforts; and
- that people who benefit from government actions and services should pay for them.

17. The principle underlying land value taxation is that it is levied on economic land rents which landlords derive from their ownership of land. It is argued that taxation of rents from land, which is in inelastic supply, will not cause any change in supply and demand and cannot be shifted from the ownership of land.

18. The case for land value taxation was promoted by Henry George, a 19th century American who argued that land values were exclusively due to general forces whether of a natural or social character. Landlords had no moral right to land values and so there was no case for their being allowed to retain existing rents or inflated rents in the future as economies expanded.

19. The moral and ethical argument underlying the case for taxation of land as a source of wealth therefore, is that the value of land is created by the community at large rather than by the particular owner at any point in time. The amount paid for land reflects socially created demand and is not a payment to bring land into existence. Proponents of land value taxation argue that if the community can recoup by way of land taxes some of the value it has created, this would be a more equitable way of raising government revenues.

20. Whilst Henry George argued for a single tax on land and the abolition of other taxes, (which in his time were predominantly levied on other property), more recent proposals for taxation of land by way of a land value tax tend to be in the context of an alternative revenue source supplementing other existing property taxes.

21. Despite its attractions as a revenue raising source, taxing unearned rents on land threatens powerful land-owning interest groups which could prove a formidable impediment to any proposed implementation.

22. Land value tax is envisaged as a local tax levied on the current market value of unimproved land. The basis of the tax may be either rental value or capital value. Under a system of land value taxation, land would be valued in accordance with its optimum use within existing planning and other relevant law. Buildings and other improvements would be disregarded but 'merged' improvements (levelled site, transport infrastructure, water, sewerage, utilities, etc) would be included in value. In this way, land value taxation would tend to act as an incentive towards optimum development of land.

23. Because of the 'optimum use within existing planning and other relevant law assumption', it is clear that the success of a system of land value would depend on complementary and efficient interaction with planning and other relevant legislation.

24. In theory, all land within the valuation area would be subject to land value taxation (including agricultural land and public parks which are exempt from valuation under current non-domestic rating legislation). Identification of each parcel of land in separate ownership would present an immediate practical issue since an easily accessible and complete register of ownerships does not exist. The Land Register for Scotland over time will provide a definitive register of ownerships but current registrations only cover about 30% of all ownerships. Under existing legislation, land is only registered in the Land Register when it is sold. Some estates held in public ownership (e.g. Crown Estate, local authority owned property) may never be sold and therefore have never been registered in the Land Register.

25. **Accountability**

Land value tax would be a local property tax and would fall on all owners of land in a local authority area. The tax base would accordingly be more narrowly based than that of council tax and non-domestic rating taken together.

The tax cannot be 'passed on' to tenants because ultimately market forces would prevent a landlord from charging more than the economic rent for the land. If a landowner attempted to increase the rent beyond the economic rent to recoup the tax, he risks putting the tenant out of business and losing his rental stream completely. Meanwhile the landowner would still be liable for the tax.

Some form of 'Land Value Tax Roll' would require to be created which would list the subject to be taxed, the liable person (the owner) and the taxable value of the land.

Bills would be issued to landowners based on the entries shown on such a Land Value Tax Roll. The tax would be perceptible but only to those to whom a bill was issued.

Land value tax would be based on the unimproved value of land. Modelling of yields based on the estimated total value of land and the rate per pound of value would require to be undertaken because it would be a new tax. A number of studies have been carried out which have looked at the way in which land value taxation operates in a number of countries, states and towns throughout the world and might offer some useful guidance.

All land by definition falls within one local authority area or another. The value of land is determined by its location. Since the attractiveness (and therefore value) of a location is at least partly determined by local infrastructure and facilities provided or maintained by the local authority, there is arguably a direct link with local authority expenditure.

26. **Fairness**

The principle underlying land value taxation is that it is a tax on unearned income brought into existence not by anything which the owner as such has done but by the activities of the community generally. If introduced land value tax would represent a new burden on those liable and issues in relation to ability to pay would be inevitable.

If land value tax were to be introduced as a supplementary tax it could be considered as a means of offsetting, to some extent, the burden imposed by council tax and rates at present levied on dwelling houses, non-domestic subjects and improvements to land.

One clear advantage of a tax on land is that land is permanent and its value is relatively stable. Capital values by contrast are more volatile being subject to short-term supply and demand factors. Buildings can be rendered unusable for property tax avoidance purposes but land cannot.

It is envisaged that regular revaluations would form an integral feature of land value tax to reflect changes in land values which take place over time and between localities. Current criticisms of Council Tax focus on the urgent need for a revaluation. If revaluations are not undertaken, over time taxable values move out of line with current market values. This adversely affects public perceptions of the fairness of the tax.

27. **Technical Feasibility**

Clearly there would be significant initial costs in setting up land value tax. These would be incurred in relation to staffing, training, I.T., setting up of databases, etc. By allocating the valuation task to existing networks of local authority based valuers and the appeals machinery to existing tribunals, the overhead of setting up completely new organisations could be avoided.

Once a Land Value Tax Roll has been established it could be relatively cheap and easy to administer. Because improvements are excluded the assessment process would be simpler. There are fewer factors to be considered in arriving at a land value by comparison with valuation of buildings. Land Value Tax assessors would not be concerned with new construction and alterations and additions to existing properties, which in turn would mean fewer inspections. There would be more scope for the utilisation of mass appraisal techniques perhaps using geographical information systems, since a land value tax base is less complex and more uniform in comparison to Council Tax and non-domestic rating bases which take account of improvements.

There would however be real difficulties in arriving at land values in the first place. There is limited evidence of open market transactions in unimproved sites and whilst it is possible to derive land values from sales of improved sites there would be difficulties in defending valuations derived in this way before an appeals tribunal. The extrapolation over a wide area of values based on a limited number of sales or rents would be to divorce the tax from the market.

Once fixed for land value tax purposes and published in a Land Value Tax Roll, the valuation base, subject to appeal adjustments, should be fixed until there is a revaluation. In principle therefore, Land Value Tax yields should be stable and predictable.

28. **Interaction with National Tax Priorities**

As a means of encouraging enterprise and development Land Value Tax has a number of potential advantages:-

- It would tend to encourage earlier development of sites. It would make it relatively more expensive to hold onto idle land in anticipation of larger future returns. Land value taxation puts pressure on owners to ensure optimal development of land; whilst this will not reduce land tax it will reduce the burden in relative terms.

- Land value taxation would tend to promote and encourage building development by taxing land at its value for highest and best use thus penalising owners of undeveloped land.

- The revenue from taxes on land could be used to reduce or supplement Council Tax and Non-Domestic Rates, both of which to some extent tend to act as a deterrent to new construction and improvements to existing buildings.

LOCAL INCOME TAX

29. In each of the reviews of local taxation systems carried out in the last 25 years, consideration has been given to introducing a local income tax as either a full or partial alternative to local property based domestic taxes.

30. A local income tax could take a number of forms and these were examined by the Layfield Committee (1976) and in the Green Paper "Alternatives to Domestic Rates" (1981). The favoured form was a local income tax fully integrated with the national income tax system and it is this form that this critique comments on. A local income tax of this kind would be charged on the same tax base as the national income tax. It would thus be levied on income from earnings and pensions, investments income and profits of unincorporated businesses, but not on company profits.

A local income tax could be either an alternative to the existing domestic taxation system or a supplementary source of revenue to local authorities.

31. **Accountability**

In order to meet the accountability criteria, the tax base should be wide enough so that the burden is spread amongst as many of the electorate as possible. Only between one-half and two-thirds of the electorate pay income tax and whilst this is a little better than the existing arrangements, it falls short of the ideal.

A local income tax integrated with the national tax system would not be particularly perceptible. National and local tax rates would likely have to be combined in composite tax tables if employers' responsibilities for operating PAYE were to remain manageable. Whilst local income tax deductions would be apparent in annual tax assessments, the whole objective of PAYE (which applies to over 80% of taxpayers) is to align ongoing deductions with ultimate liability; where this is broadly achieved, the taxpayer is unlikely to be interested in the details of the make up of that liability.

Central government is responsible for administering the collection of income tax. The inclusion of a local income tax in this process would effectively break the link between local authority spending decisions and the levels of local income tax. A requirement on local authorities to issue details of spending plans and explanations of local income tax levels would be unlikely to bridge this gap.

32. **Fairness**

Liability for a local income tax would be directly related to income which is widely regarded as an appropriate measure of ability to pay. Accordingly, one of the strengths of local income tax would be its perceived fairness amongst the electorate. It could, however, be argued that the scope for avoiding or evading local income tax is considerably greater than for a property tax.

Those on low or fixed incomes would be protected through the systems of allowances and exemptions and there would be no need for a separate "benefit" system. However, unless there was a radical review of the way in which Housing Benefit is calculated and administered, this would not result in any significant advantages or cost savings.

Local income tax on investment income would require special consideration. As some of this is currently taxed at source, national deposit takers would find it difficult to apply up to 32 rates of local income tax across their investors and at the same time, ensure consistency of residence address with PAYE deductions. One possible solution might be a nationally determined rate of local income tax on such income.

The position of unincorporated businesses would also need consideration as the proprietors of these could suffer local income tax on their profits whereas incorporated businesses would have no such liability.

Each local authority would determine its own local income tax rate. Local authorities with high wage economies would be able to set a lower tax rate than those with low wage economies to finance the same level of spending.

33. **Technical Feasibility**

There is little doubt that the collection of local income tax along with the national income tax would be technically possible. There would of course be initial set up costs, but these, together with the ongoing administrative costs, would be counterbalanced by significant reductions in the Valuation Office Agency and local authority Assessors and collection staff and associated overheads.

There would also be additional costs falling on employers in terms of administering the revised PAYE scheme and establishing residence address for staff so that the correct rate of local income tax would be applied. There would be particular difficulties for national businesses employing staff resident both north and south of the border.

For national income tax purposes, a taxpayer's place of residence within Great Britain is of limited significance; in general, the tax system is not organised on the basis of where the taxpayer lives. In particular, for PAYE, the tax affairs of all employees of the same employer are handled together, usually by one tax office. A local income tax would thus entail a new requirement of establishing the place of residence of every taxpayer resident in Scotland only before the start of each tax year, so that the appropriate rate of local income tax could be charged, and the tax paid over to the right local authority. Information to determine place of residence for this purpose could be included in the income tax return forms, but at present these are received by only approximately one-third of taxpayers each year. Some other means would therefore have to be used for the others. In most cases there would be little difficulty in establishing the area of residence, but special rules would be needed for those who have more than one home, or who move frequently. Given the number of people who move each year, this would mean that in any particular tax year a large number of people would not be paying tax to, or at the rate levied by, the local authority in whose area they then lived.

Introduction of local income tax would have considerable cash flow implications for local authorities. At present, council tax is payable monthly, with the majority of local authorities requesting payment in advance for April to January. The vast majority of employees are paid in arrears, with PAYE being remitted to the Inland Revenue on the 19th of the **following** month. Additional delays would arise where tax liability was only determined following a tax return being made.

Any local income tax would give rise to problems of predictability of yield. However the yield from local income tax would be buoyant with few variations in the rate of local income tax charged necessary.

The introduction of local income tax would increase the burden of direct taxation and this would
run counter to successive Governments' policies of shifting the burden of taxation from personal income to personal expenditure.

One of the main objections to the introduction of local income tax as an alternative to domestic rates which was set out in “Paying for Local Government” (1986), was that income tax is not an appropriate tax for local authorities. There is a broad distinction to be drawn between the roles of Central Government and local authorities.

For local income tax to operate as part of the PAYE system, the system of coding and tax tables would have to be elaborated to enable employers to deduct local income tax at the appropriate rate for each employee. An additional element would have to be added to each code such as a local authority tax rate indicator, and additional tax tables would be needed to cover the various combinations of local and national tax rates. These changes would considerably complicate the operation of PAYE for employers as well as for the Inland Revenue. Codes would be more complex, and liable to more frequent changes and tax tables would be more elaborate, with different tables often necessary for different employees. If these additional complications to the operation of PAYE, including the burden on employees, were to be kept within bounds, some limit would have to be placed on the number of tax rates which local authorities could use. This would mean that the rate of tax would have to be set in fairly broad steps, which would have implications for the lumpiness of the yield.

SCOTTISH SERVICE TAX

34. The Scottish Socialist Party has put forward proposals for an alternative system of local taxation – a Scottish Service Tax. The proposals argue that there is a need for higher public investment in health and local authority services and that the current system of local government finance is unable to deliver service improvements in such a way that is effective, efficient and equitable. It is also argued that the current system of local taxation, the council tax, is a regressive tax and should be replaced with a more progressive form of taxation linked to an individual's ability to pay. The personal service tax proposed has been designed so that all individuals with incomes below £10,000 are exempt. The tax would be established at a Scottish level and collected using the existing PAYE system, with revenues distributed across local authority areas according to need. The proposals, however, give no details of the distribution mechanism which would be used to redistribute the revenue amongst councils.

The proposals would be seen as an alternative to the council tax system.

35. **Accountability**

As the tax would be collected at a national level, there would be no direct link with a local authority and in many respects the proposals could be regarded as a centralisation of taxation rather than promoting and assisting to take forward local democracy and accountability. It is, therefore, suggested that a Scottish Service Tax in line with the proposals could not genuinely be regarded as a local taxation system.

36. **Fairness**

The proposals argue that the Tax will recognise ability to pay and is more progressive than the Council Tax. The Tax, however, being linked to the PAYE system would be based solely on an individual's earned income. It would be substantially influenced by Scotland's economy and would be less predictable than income receivable under council tax arrangements. What might be regarded as the more regressive aspect of the council tax arrangements can be controlled by an effective council tax benefit system, albeit that refinements and a simplification of current arrangements is required. It is not clear how the Scottish Service Tax proposals would relate to the wider benefits system, in particular given that policy on this matter is reserved to the UK Government.

37. **Technical Feasibility**

A Scottish Service Tax would have to address the following issues: -

- It would add to the present burden of income tax collection and assessment both for the Inland Revenue and for industry and commerce;
- The costs of its operation;
- A change in circumstances in which income tax is used as a tool of central economic management;
- The requirement of special measures to make it perceptible within the individual taxpayer's total local and national income tax;
- The setting up period required;
- It is dependent upon a number of simplifications being made within the national tax system;
- The taxpayer's place of residence. The current tax system is not organised on the basis of where the taxpayer lives. Similar to local income tax, a new requirement of establishing the place of residence of every taxpayer in Scotland would be required.

LOCAL SALES TAX

38. As with local income tax, in each of the reviews of local taxation systems carried out in the last 25 years, consideration has been given to introducing a local sales tax as either a full or partial alternative to local property based domestic taxes. Each of these reviews has rejected local sales tax as such an alternative for a number of reasons which continue to remain valid.

39. There are essentially two models of local sales tax for consideration.

- a single stage tax administered and collected in conjunction with the VAT system by HM Customs and Excise on behalf of local authorities which would be applied to all goods and services currently subject to VAT with local authorities being given freedom to set the rate of tax.

- single stage tax with an entirely separate system of collection administered by authorities. Again local authorities would have freedom to set the rate of tax and determine which goods and services should be taxable

40. **Accountability**
In order to meet the accountability criteria, the tax base should be wide enough so that the burden is spread amongst as many of the electorate as possible. One of the main advantages of local sales tax is that it would widen the incidence of tax to include all domestic consumers of local authority services.

41. **Scope**
This needs to be considered in the context of whether the sales tax is a full or partial replacement for either or both domestic and non-domestic taxes. If it is a replacement for only local domestic taxes, the imposition of a sales tax on the purchases of goods and services by "households" only presents significant practical problems in terms of identifying which consumers are liable to the tax and which retailers should impose the tax.

If authorities were given the freedom to determine which goods and services were subject to the tax, national chains of retailers and suppliers would encounter considerable difficulties in their pricing and charging systems.

42. **Cross-border Shopping**
Large population centres support a wider range of shopping facilities than smaller ones. This is exacerbated by "out of town" retail parks and shopping villages. In the context of a local sales tax this would result in considerable distortion between where the tax is collected and where the consumption of local services took place. Attempting to levy the tax according to the consumer's residence would be unworkable. Cross-border shopping into the north of England from the border authorities would add further anomaly.

43. A local sales tax would be highly perceptible so long as retailers were required to show the tax as a separate item on bills and receipts. However the issues discussed in paragraph 42 virtually destroy any link between the local sales tax and local democratic accountability. Consumers would simply look to make their purchases where the level of sales tax was lowest. There would be virtually no link between the tax paid directly to the local authority and the services provided to consumers by that local authority.

44. A local sales tax would be capable of yielding sufficient revenue to replace the existing domestic local taxation system. However, predicting that yield would be difficult due to the unpredictability of eg. neighbouring (competing) authorities' tax levels, fluctuating tourist populations due to e.g. the weather, incidents such as the recent Foot and Mouth Disease outbreak etc.

45. Generally speaking, the tax yield would increase at the same level as increases in the price of goods and services on which the tax was levied. Where, however, local authority expenditure and costs increased or reduced at a higher or lower level than these goods and services, adjustments to the tax rate would be required.

46. Local authorities' ability to change the level of tax would be inhibited by the impact on retailers and suppliers and their need to change pricing/receipting/accounting systems frequently as well as the interaction with the VAT system if the option of integration with HM Customs and Excise was in operation. This in turn would result in the yield being "lumpy".

47. **Fairness**

The incidence of the tax would be considerably widened from those currently liable to pay local taxes (generally owners and tenants of property) to all consumers of goods and services . To this extent, a sales tax would go some way towards meeting the beneficial and redistributive principles that underpin the fairness concept.

However, those on low and fixed incomes currently protected by the benefit systems, would undoubtedly lose out if a sales tax was introduced unless some other form of protection and assistance was introduced in parallel.

The effect of cross-border shopping and tourism as discussed above would likely result in wide variations in tax levels across the country. Unfairness may be perceived where local authorities are given freedom to determine which goods and services are to be subject to the tax.

48. **Technical Feasibility**

There is little doubt that technically, either sales tax option could be operated. However, a major problem with a local sales tax would be that of defining the transactions to which it applied. Since it would be a replacement for domestic, but not for non-domestic rates, it should in theory be limited in its application to goods and services purchased by households. In this sense, a sales tax is often thought of as a tax on retail sales. However, such an approach would run into two immediate difficulties. First, the concept of a retail sale is essentially related to goods; special rules would still be required for services. Secondly, there would be no readily identifiable group of "retailers" or those making retail sales. Equity would suggest that under the option of integration with HM Customs and Excise, all those supplies to domestic households of taxable goods and services which already bear VAT would also be subject to sales tax. At the same time, it would be difficult to exclude all business purchases, especially at the retail level.

The introduction of a local sales tax in Scotland only would result in residents in Scotland purchasing taxable goods and services from England whenever possible and practical or by mail/telephone/internet order from English based companies that would substantially reduce the tax base for local authorities in Scotland.

The cost of implementing and operating a local sales tax would depend on the extent to which it could be tailored to fit in with the existing VAT system and the freedom given to local authorities to determine which goods and services would be subject to the tax.

The option of integration with HM Customs and Excise would be cheaper to introduce and administer than the separate system of collection and probably cheaper than the cost of collecting existing local taxes. However, businesses would face substantial additional costs under either option and these would bear disproportionately on small businesses who would make up the bulk of traders operating a sales tax system.

Changes in the tax rate by local authorities would have to be limited having considered the impact on traders. Steps of the order of 1% might be the minimum acceptable, but the actual position could depend on the way a local sales tax rate was combined with the VAT rate. Steps of whole percentage points, however, would cause a problem for local authorities because of the extreme lumpiness of the yield. Taking for illustrative purposes an average tax rate of 7%, a 1% change in the rate would change the yield by about 10% - 15%.

For both local and central government, a local sales tax would bring financial control problems. Because of the unpredictability of the yield, local authority budgeting would become more difficult; whilst the lumpiness of the yield would mean that even relatively small changes in the rate would produce considerable variations in income. The high combined effective tax rate of VAT and the local sales tax would have implications for Government's overall fiscal policy and its freedom for manoeuvre, while the interaction of the two taxes would almost certainly impose some restrictions on local authorities.

The question of a local sales tax rate and the VAT rate would need careful examination. At present, European Community rules require that VAT should be levied on a base including all other taxes, duties, levies and charges. Hence, VAT would have to be charged on a tax base which already included local sales tax. To achieve a composite rate in whole percentage points would require rates of local sales tax to be set to several decimal places. This could pose difficulties for retailers and be difficult for the general public to understand. It is possible that, if a local sales tax were introduced, the Government would have to consider seeking a derogation from the European Community rules to enable sales tax and VAT to be charged in parallel on a common base.

If the option of integration with Customs and Excise was adopted, the increase in the price of goods and services would, at least initially, impact on demand which in turn would affect both local sales tax and VAT yields. Similarly, changes in future sales tax or VAT levels and structure would impact on the other tax. Whilst these impacts could be mitigated to some extent, if there were constraints on the freedom of local authorities to set tax levels and structures, this would have implications for the independence of local government and its accountability to local electors.

TOURIST TAX

49. Tourist Tax is envisaged as a mechanism to augment local authority revenue and not as a replacement for local taxation. It may be more attractive to the bigger cities or areas popular with tourists. The longer term implications, however, have to be recognised particularly the following: -

- The yield from Tourist Tax will be volatile and may be influenced by external factors e.g. Foot and Mouth.
- Tourism is in a highly competitive market and additional taxes may prove detrimental and lead to job losses.
- The views of the tourist have to be market tested as for this particular tax the consumer requires to be delivered to the product. Tourism is non obligatory in respect of destination and there is freedom of choice. Consequently high charges may be deemed unattractive.
- Value for money has to be demonstrated through transparency of how the increased taxation is to be utilised. Negative perceptions may be apparent when the tourist settles the bill and taints an otherwise enjoyable visit and discourages the individual to return.

The potential of tourist tax has already been considered by one local authority. The concept did not receive widespread support and what may have been seen as a worthwhile project, required to be examined in more detail to involve all sectors affected by the matter.

50. **Accountability**

In general tourist tax would fall on all visitors to the area and may be levied through different mechanisms e.g. accommodation, tourist attractions. The tax would be difficult to avoid and may only be noticed on the settlement of the bill. The consumer may regard the tax as an unreasonable burden and it is important that the purpose of the levy is well publicised and appropriate language used to sell the intent.

Local authorities would likely need to be held accountable on how the additional resources generated from the tax are spent and justify where it is not recycled into the provision of facilities for tourists. General support towards all council services may not appeal to the tourist.

The unpredictability of yield and the imbalance of tourist attractions over local authorities would have to be addressed in exhibiting value for money spent for the resource collected.

51. **Fairness**

In assessing fairness, as the tax is a general levy it is not related to ability to pay. Differential charges could be introduced according to the quality of the service on offer. For example, different rates could be adopted for different standards of accommodation – hotel, B&B, camp site. There is no appropriate benefits system that could be applied to tourist tax and essentially the tax is regressive with the levy being less of a burden on higher earners. The consumer has the freedom of choice and has some discretion in whether they consider the payment of the tax represents value for money from the facilities available. High charges may discourage return visits irrespective of whether noticeable improvements in tourist attractions are apparent.

52. **Technical Feasibility**

It should be technically possible to develop, implement and maintain a system for tourist tax once all the procedures for assessment, billing and collection have been determined. The existing system of income tax and the experience gained in setting up the procedures for Council Tax would greatly assist in this matter. Problems would be posed if the tax was not introduced uniformly throughout Scotland and if cross boundary collections and redistributions were necessary.

Maintaining the data base and marketing the tax would be an ongoing liability but would not be an insurmountable problem.

DOMESTIC RATING

53. Domestic rating was abolished in Scotland in 1989 in favour of Community Charges. Domestic rating revaluations had been carried out in 1973, 1978 and 1985 in Scotland whereas in England and Wales in 1989, no domestic rating revaluation had taken place since 1973. The government of the day had become increasingly unsympathetic to the system of domestic rating and following the 1985 revaluation in Scotland and the political furore which it generated, measures were brought forward to abolish domestic rating completely. The system of Community Charges was introduced in 1989 in Scotland and in 1990 in England and Wales. So severe was the public reaction to the introduction of Community Charges that the system across the UK lasted only until 1993 when it was replaced by Council Tax.

54. **Summary of Domestic Rating**
Domestic rating was first introduced in 1854 and survived largely in its original form until 1956 when reforming legislation introduced the concept of valuation based on tone of the roll and regular revaluations.

Domestic rating was a tax on dwelling houses. The tax was levied on a hypothetical rental value which was calculated for each domestic property having regard to its location, character, size and any pertinents.

One of the criticisms of domestic rating was that the assessed (rental) value was not linked in the mind of the taxpayer to actual market rental evidence. When the tax was introduced in 1854, most domestic properties were leased. Empirical rental data was accordingly readily available and used in arriving at the assessed value for individual properties. In the latter half of the 20th century, the advent of the Rent Acts had the effect of diminishing the supply of privately owned housing for lease and that, together with the gradual move towards owner occupation had rendered the perceived link between actual value and assessed value ever more tenuous. Another common criticism of domestic rating was that it was a tax on improvements to properties. If the taxpayer improved their property the effects of these improvements were taken account of in a higher assessed value.

By contrast the property element of Council Tax is based on an assessment of capital value. The evidence base of capital values is much stronger and the perceived link between the Council Tax band and market value is thus much more readily understood. The system of wide value bands under Council Tax has also reduced the scope for dispute about factors which have a relatively minor effect on value. To overcome the 'tax on improvements' criticism, improvements to properties under Council Tax are only taken account of at the time a property is sold.

55. **Accountability**
Domestic rating was levied on all dwelling houses irrespective of the number or status of the occupiers. All other things being equal and disregarding any entitlement to reliefs, the same domestic rates bill would have been issued to a person living on their own as to a household with two or more adults. This situation has to some extent been addressed under Council Tax in that an adult living on their own will pay only 75% of the full charge.

Domestic rating bills were levied on the householder. This led to the criticism that the tax was perceptible only to the person paying the bill. Partners and other adults living in a house may have been less clear about the rating liability.

As a tax based on property, the scope for avoidance of domestic rates was relatively low. The tax base for domestic rates historically was relatively stable with the number of chargeable dwellings varying from year to year mainly to reflect new houses and dwellings which had been deleted. Collection rates were generally very high and yields predictable.

Since domestic rates were levied on all dwelling houses within a particular local authority area there was a clear and perceptible link between the services provided and the local authority providing these services.

56. **Fairness**

A common criticism of domestic rates was that the dwelling house in which people lived did not reflect their ability to pay the tax. The counter was that the value of a person's home broadly reflected an ability to pay with the system of rebates taking account of individual cases of hardship.

It may also have been considered that a degree of regressiveness in a local property tax was acceptable when taken against the positive features of stability of yield, difficulty of avoidance, and clear link to the local area.

57. **Technical Feasibility**

It is thought unlikely that a return to domestic rates in their form prior to abolition would be acceptable. A property tax based on capital values such as Council Tax has been shown to work and to have caused low political turbulence since its inception in 1993.

POLL TAX

Poll Tax is, perhaps, the oldest form of taxation and operates on the principle that a charge is levied on every adult. There is, of course, recent experience of poll tax with the operation of the community charge system in Scotland for the 4 years from 1989 – 1993.

59. **Accountability**

The strongest case for a poll tax is that it satisfies the accountability requirement in that a per capita tax achieves high perceptibility amongst the electorate. One drawback, however, is that it can be perceived as a means of paying for the right to vote. There was clear evidence that, during the community charge era, the number of people registering to vote fell dramatically.

60. **Fairness**

By their nature, poll taxes are particularly regressive as they do not take account of ability to pay. Any form of taxation can be supplemented by a benefit scheme for low income households, but the provision of 100% benefit removes the principle objective of achieving high perceptibility. This was tackled during the community charge with the provision that every adult would pay a minimum 20% of the full charge. This presented clear difficulties for the poorest in society, those on income support where there was no uprating to take account of this liability and, similarly, for students who had no means to pay the charge.

The strength of the perceptibility issue was highlighted when community charge was introduced as it become a major topical issue in the UK. However, this was not demonstrated in the way intended ie by people showing their views on local government via the ballot box, rather, by large demonstrations against the principle of the tax. As in previous centuries, this form of taxation is clearly disliked in general by the majority of the public and the issue of acceptability to tax payers remains.

61. **Technical Feasibility**

The key to the successful operation of a poll tax system is the maintenance of an up to date register of all those liable to pay. This presents the greatest problems in the efficient administration of this tax system. It is extremely expensive to maintain an up to date register which records peoples movements.

The operation of the community charge showed that, whilst systems could be put in place to administer the tax, it was hugely expensive, was subject to evasion, did not receive general acceptance with an end result of poor collection performance.

SUMMARY

62. The critique provides a broad and factual commentary on seven local taxation systems. This may be used as a basis for evaluating COSLA's call for consideration to be given to putting in place a basket of new taxes. The commentary has been provided based on the analysis against the basic principles as outlined in Table 1. A summary of each taxation system's assessment against these principles is shown in Table 2.

Table 2 : Critique of Domestic Taxes

	Land Value Tax	**Council Tax**	**Local Income Tax**	**Local Sales Tax**	**Tourist Tax**	**Poll Tax**	**Scottish Service Tax**
Ability to Pay	√	√	√	**X**	**X**	**X**	√
Easily Understood	√	√	**X**	**X**	**X**	√	**X**
Admin efficient	√	√	√	**?**	**X**	**X**	√
Difficult to evade /avoid	√	√	**X**	√	**X**	**X**	**X**
Impartiality	√	√	√	√	**X**	√	√
Accountability	**?**	**?**	**?**	**?**	**?**	**?**	**?**
Benefit Principle	**X**	**?**	**?**	**X**	**X**	√	**X**

63. In general, it was possible to provide a definite positive or negative assessment for each tax against each principle. However, where this was not possible and there was perhaps some ambiguity, a question mark has been placed against this in the table. Areas of ambiguity can be explained as follows :

- It is not possible, at this stage, to assess whether local sales tax would be administratively efficient. Whilst it could be argued, for example, that the option of integration with VAT could be relatively simple to collect, there would inevitably be complications in terms of onward distribution to local authorities.
- It was not possible to provide a definite assessment against 'accountability' for any of the taxes which were considered. Individually, none of these taxes meet the principle of accountability in terms of the revenue they raise (or could raise) compared to the expenditure they fund. This is, however, perhaps more of a consequence of the current imbalance in funding arrangements whereby only 22% of council expenditure is funded from local tax. Accountability could perhaps be addressed by broadening the local tax base.
- The benefit principle advocates that those who benefit from locally provided services should make a contribution towards their cost. It could be argued that not all individuals in a local authority area will be liable for income tax and therefore will not make a contribution towards the cost of

the services they are receiving. Given that council tax is primarily a property tax, it could be argued that not all individuals are contributing towards the cost of the services they are receiving.

64. The critique demonstrates that council tax meets the majority of the principles and whilst there are two question marks against the principles of accountability and the benefit principle, there are no negative responses. This demonstrates that it is valid and effective and should continue to be regarded as the main local taxation system for local government.

However, the council tax system runs the risk of losing its credibility if it seen to be out of date and unfair. Refinements are, therefore, needed to the system to reflect these issues and these are outlined in Section 2.

INTRODUCTION

1. Section 1, Critique of Domestic Taxes, demonstrated that the council tax system is regarded as an effective taxation system and in some part relates to a person's ability to pay. However, it is essential that tax systems need to be kept up to date and be seen to be fair in order not to lose their credibility.

   A number of refinements are needed to the council tax system to improve its effectiveness and create a more balanced system of taxation.

REVALUATION OF BANDINGS

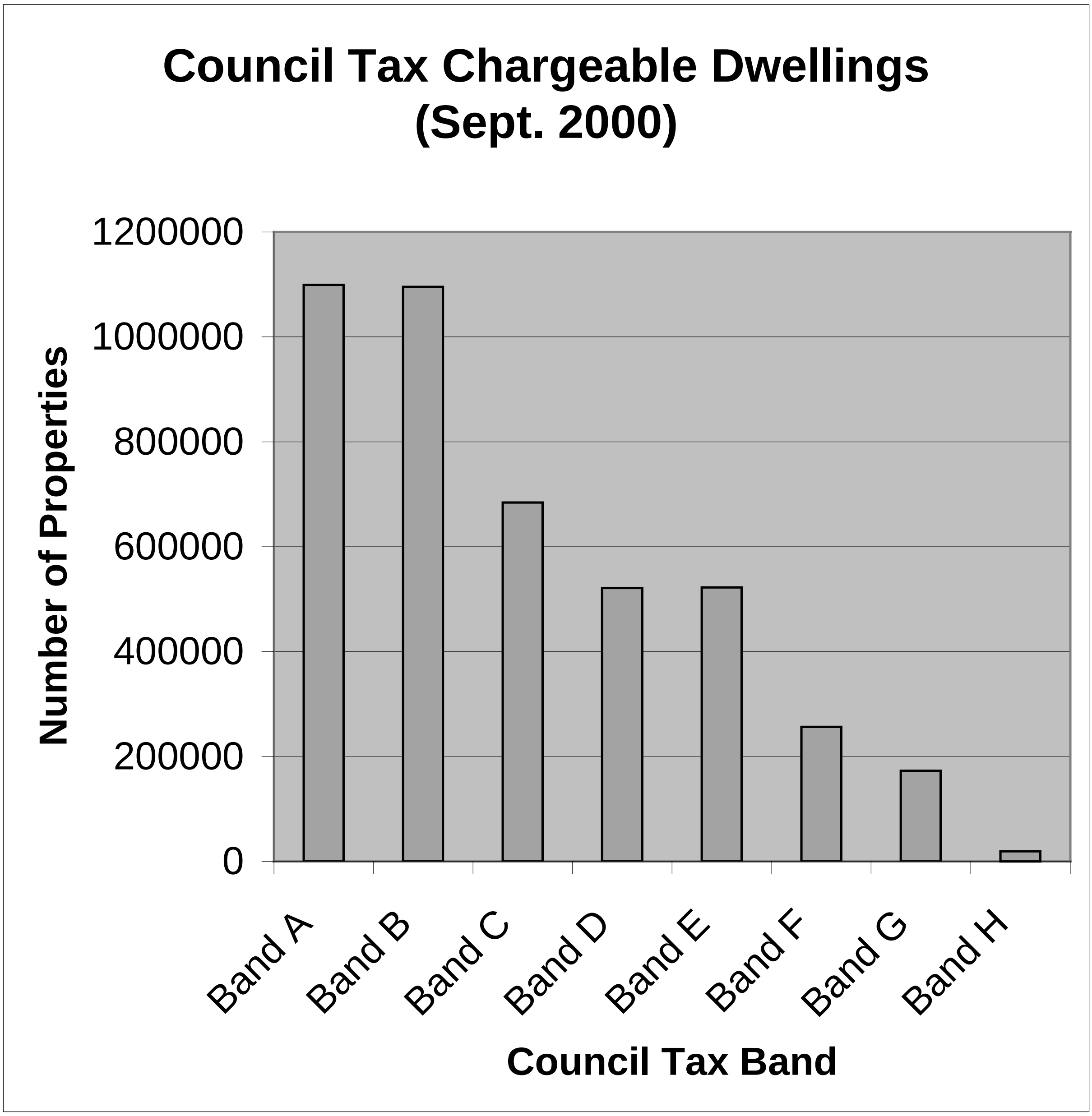
2. Within the Council tax system, there are 8 valuation bands which are specified by statute. Table 1 shows the bands which cover the capital values of the properties.

Table 1: Council Tax Valuation Bands

Band	£		
A	Under		27,000
B	27,000	-	35,000
C	35,000	-	45,000
D	45,000	-	58,000
E	58,000	-	80,000
F	80,000	-	106,000
G	106,000	-	212,000
H	Over		212,000

3. When council tax arrangements were being developed it was widely expected that Band D would represent the "average" across Scotland. Relativities between bands were, therefore, based around Band D. However, the reality is that 65.9% of properties are within Bands A – C and 22.2% in Bands E – H. Table 2 shows a summary of the properties per band based on properties listed at September 2000.

Table 2: Council Tax Dwellings (September 2000)



4. **It is clear from the table that a significant and disproportionate amount of properties are in Bands A and B. Just over half the properties in Scotland (50.2%) are in these Bands and this highlights the inequities in the current banding system.**

Whilst it is acknowledged that an independent review of the bandings is taking place under the instruction of the Local Government Committee, **subject to this review, in principle, COSLA believes that the Bands should be increased from 8 to, say 10 or 12.** An expansion of the Bands should be concentrated at the lower banding levels in an attempt to create equity within the council tax system.

However, any increase in the bandings should have due consideration to the housing benefit system and no individuals in receipt of benefit should lose out due to changes which are made.

5. It is accepted that there will be a number of practical implications of such an increase but COSLA believes that it is for the long-term benefit of the council tax system to introduce these changes.

   Although the system is generally accepted by taxpayers and well understood, further changes and refinement to the bandings should be perceived as introducing greater equity into the system.

REVALUATION CYCLE

6. The values which are used at present for council tax purposes are those from 1 April 1991. The values are 10 years out of date at present and will be even more out of date if, and when a revaluation cycle is introduced. Given the increase in property prices during the past decade, it is evident that a revaluation is long overdue.

7. In July 2001 the UK Government announced that there should be a ten-yearly fixed statutory cycle of council tax revaluations in England. Work on the first revaluation will start in 2005, with council tax bills, based on updated property values, being issued in 2007. Consideration is also being given to undertaking a council tax revaluation in Wales to take effect in April 2004. Revaluation would not lead to any increase or decrease in the overall revenue raised from council tax. Local government in Scotland needs to be put in an equal position.

8. **COSLA endorses this intended revaluation and recommends that a fixed cycle of revaluation is introduced after an initial revaluation is undertaken in Scotland**. This is necessary to bring council tax valuations up to date and keep them up to date.

   Once properties have been revalued, the banding values within the Bands will need to be adjusted as a matter of course.

9. Whilst it is accepted that this will be an extensive administrative exercise, it is necessary for the credibility of the council tax system and to ensure that council taxpayers will still accept the system as fair and reasonable.

COUNCIL TAX ON SECOND HOMES

10. From 1 April 1998, local authorities in Wales were given the discretion to charge up to the full council tax on second homes. Whilst this was introduced through secondary legislation in Wales, it is understood that such a change in Scotland would require primary legislation.

11. The introduction of this discretionary power in Wales has given local authorities the ability to maximise council tax revenue by being able to charge owners in the following types of properties from the first day the property becomes a second home:

    Class A – second, furnished homes with a restriction on occupancy by law w prohibits their use for a period of at least 28 consecutive days in any 12 month period, and

    Class B – second, furnished homes with no restriction on occupancy.

COSLA is strongly of the view that a permissive power to charge full council tax on second homes should be introduced in Scotland.

Such a power will enable local authorities to maximise council tax revenue and create a more equitable council tax system. It is recognised that this may impact on grant distribution calculations and further consideration of this aspect would be required. Such further consideration should not, however, undermine the principle of refining and improving the council tax system.

CONCLUSIONS

12. **A significant and disproportionate amount of properties are in Bands A and B highlighting the inequities in the current banding system. Subject to a review, the current bands should be increased from 8 to, say 10 or 12 with this being concentrated at the lower bandings.**

13. **A ten yearly-fixed statutory cycle of council tax revaluations was announced for properties in England. COSLA endorses this and recommends that a fixed cycle of revaluation is introduced after an initial revaluation is undertaken.**

14. **At present, no legislation exists to enable local authorities to charge the full council tax on second homes. COSLA believes that a permissive power should be introduced to enable local authorities to charge full council tax on second homes.**

INTRODUCTION

1. In April 2001, the Scottish Executive implemented a transitional water relief scheme to 'protect lower income households from the impact of increases in water and sewerage charges'.

   COSLA strongly criticised the proposals indicating that they did not target those in genuine need of assistance.

COSLA'S POSITION

2. The following information is an extract of the main comments which were made in the response to the consultation:

   "COSLA called for a water benefit/relief system to benefit all Scotland and not to be targeted to any particular area. COSLA called for a water benefit/relief system which was aligned to current benefits systems.

   Financial Issues

   The proposal is to impose a limit on the level of water and sewerage charges which council tax benefit recipients will pay. The level which has been indicated for the 2001/02 financial year is between £180 and £200.

   There are 1.4 million chargeable dwellings in Council Tax Bands A – C. Under the proposal within this consultation, 1.3 million of those properties would not qualify for any form of rebate.

   Given that the main objective is to protect lower income households, this will not be achieved with this proposal. 66% of all chargeable dwellings in Scotland are in Bands A – C. Under the proposal, only 9% of those would benefit from this proposal. This is not a benefit/relief system which benefits those in low income households and in most need of the support.

   Although the above statistics are based on 2000/01 charges, the effectiveness of the proposal will not change significantly with increased charges. Indeed the water authorities have indicated that charges could well increase by 15 - 20%. If they increased by 20%, there would still be no benefit for those living in Band A properties in the East of Scotland and the West of Scotland Water Authority areas. Given that only those in Band A properties in the North of Scotland Water Authority area would benefit, 76% of the total number of properties in Band A would be excluded from any benefit.

   An additional issue of concern under the new proposal is the issue of single people in receipt of council tax benefit. The proposal does not indicate that a pro-rata amount will be applied based on a reduction, as is currently applied in line with the current council tax benefit arrangements. The effectiveness levels here are in the high banded properties and the earliest a benefit would be gained would be for a single person in receipt of council tax benefit living in a Band D property. In realistic terms, the majority of single people in receipt of council tax benefit reside in lower banded properties and the proposal does not assist them.

A sum of £24 million over three years has been identified in the proposal to finance this initiative. However, there is no further information as to what this £24 million will cover. You will note from the issues relating to practicalities that there are a number of issues which will require to be funded. COSLA seeks clarification of the proposals for the £24 million and how this will be phased over the next three years.

The proposal has been presented as a transitional arrangement which will be phased out by the end of financial year 2003/04. The proposal does not indicate what arrangements will be in place from 1 April 2004. The consultation states 'The Executive believes, therefore, that there is a need for transitional arrangements to help such groups accommodate these increases'. A transitional arrangement is not a benefit/relief scheme as called upon by COSLA. Any proposal should be long-term and have a degree of permanency. The implications for software changes, alone, cannot be considered economic on a short-term basis.

Conclusions

COSLA does not regard the proposal within the consultation paper to be an effective proposal in targeting those in lower income households. COSLA calls upon the Scottish Executive to consider further the implementation of a ***FULL*** *benefit / relief system for water and sewerage charges.*

COSLA does not agree with the implementation of a transitional scheme and would seek a long term solution.

COSLA seeks confirmation that all funding issues arising from any proposal will be funded in full by the Scottish Executive.

COSLA seeks clarification on the administration of this scheme and further information in relation to timescales for implementation.''

WAY FORWARD

3. The scheme which has been implemented does not reflect the very real problems facing those in lower income households. The original policy intention of the scheme was to *'fund a transitional scheme to protect lower income households from the impact of increases in water and sewerage charges.'* The scheme has not met this objective. It is targeted towards those Scottish households with lower incomes living in high banded properties and in the area served by North of Scotland Water where the increase in charges has been the greatest. The scheme does not claim to offer general protection for all low-income households. COSLA has continued to press the Scottish Executive to implement a full rebate scheme for water and sewerage charges. A rebate scheme for water and sewerage charges which is fully aligned to the council tax benefit system.

4. Beyond this, COSLA has requested a meeting with the Minister for Environment and Rural Development to discuss the issue of a full water rebate scheme and to engage in discussions on the future of billing and collecting water and sewerage charges and the harmonisation of domestic charges as part of the move to a single Water Authority.

INTRODUCTION

1. This Section :

- explains Scottish Executive and Central Government's interest in public expenditure;

- examines where local government expenditure falling on the general fund currently fits in; and

- summarises the arguments about local authority self financed expenditure (LASFE) that have been advanced from different viewpoints.

SELF-FINANCED SPENDING

2. The devolved administration and local authorities have responsibility for spending financed from local government and to varying degrees for spending financed from other sources of revenue, for example: non-domestic rates and, in Scotland, the Scottish variable rate of income tax. The current spending funded by these revenues is an issue for the devolved administrations and their local authorities. It is however open to the Government to take into account levels of self-financed expenditure in each of the devolved countries when determining the Assigned Budget where:

- the levels of self-financed spending have grown significantly more rapidly than the equivalent spending in England over a period; and

- this growth threatens targets set for public finance's part of the management of the economy.

3. Treasury funding rules for the Scottish Parliament set out specific requirements as follows:

- Council tax benefit adjustments; if as a result of decisions taken by the Scottish Parliament or local authorities, the cost of council tax benefit subsidy paid to local authorities changes at a disproportionate rate (both higher or lower), relative to changes in England, then an appropriate balancing adjustment will be made to the Scottish Executive's departmental expenditure limit.

- Non domestic rate poundage: a power to adjust this in Scotland is devolved and the Scottish Executive will have to set the level of spending in line with expected receipts.

CENTRAL GOVERNMENT'S INTEREST IN LEVELS OF PUBLIC EXPENDITURE

4. The Government views, as important, its responsibility to maintain sound public finances as levels of public expenditure and taxation have an impact on economic activity. In light of that, the Government plans and tracks the forward path of public expenditure having regard to its objectives for taxation and borrowing. The Government considers it important to be confident that it can anticipate with a considerable degree of accuracy the actual levels of public expenditure in order to deliver its economic objectives. The Government also considers it important to be concerned about levels of public sector borrowing since levels of borrowing have an impact on the wider economy distinct from those of expenditure and taxation in that build-up of debt affects interest rates through the money markets.

INTERNATIONAL CONVENTIONS

5. The United Nations and other international agencies have adopted a System of National Accounts; consistent with this is the European System of Accounts 1995 which the UK is now required to follow by European Community Law. This system identifies the basis on which transactions should be classified as public or private expenditure. The system does not prescribe which activities should be conducted within the general government sector, nor which are appropriate to central and local government, nor the elements of expenditure which Government should plan, track and deliver. Its adoption simply means that nations' statistical systems should consistently classify expenditures undertaken by general government as public rather than private expenditure.

6. Activities within the public sector vary from country to country and may change from time to time within individual countries. Similarly the division of responsibilities between central and local government varies from country to country and will change over time. A particular economic activity may be wholly within the private sector in one country, split between the private sector and central government in another, between the private sector and local government in another, between all three in a fourth and, possibly, entirely within the public sector in a fifth (housing is one example).

7. International conventions and European legislation determine in which circumstances an activity should be counted within the general government sector but they do not give any strong guidance on which particular elements of that sector should be the subject of detailed Government planning, tracking and delivery. Individual Governments will take judgements on which aggregates are right for their particular economic (and social) circumstances. Nor do the conventions say what are the appropriate forms and levels of targets for Governments to set although Maastricht criteria are set for the government deficit, where effectively General Government Expenditure (GGE) is the related measure of expenditure, and the levels of general government debt.

8. UK national accounts broadly conform with the international conventions and European requirements in constructing measures of General Government Expenditure (GGE). The previous Government used GGE(X) as its key target indicator of levels of public expenditure. GGE(X) is all GGE net of interest and dividend receipts and excludes privatisation proceeds and spending funded from the National Lottery.

9. The previous Government's detailed planning focused on an aggregate known as the control total which was narrower than GGE(X) by:

- excluding cyclical social security and central government debt interest on its own account, whose inclusion could lead to automatic but unwarranted reductions or increases in non-cyclical spend at different points of the economic cycle;

- including overseas and market borrowing of public corporations, because it affects the Public Sector Borrowing Requirement (PSBR);

- excluding minor accounting adjustments.

10. The UK Government has put in place rules for spending and borrowing, viz: the golden rule that '*over the economic cycle, the Government will borrow only to invest and not to fund current spending; and public debt as a proportion of national income will be held over the economic cycle at a stable and prudent level'.*

LOCAL GOVERNMENT SPENDING

11. Local government spending is, by international convention, part of General Government Expenditure. Some of local government's spending is also directly represented in central government expenditure or in public sector borrowing because of the way in which it is financed:

- revenue expenditure financed by revenue support grant;

- revenue expenditure financed by special grants;

- revenue expenditure financed by specific grants;

- capital expenditure financed by borrowing;

- capital expenditure financed by grants.

12. Local government spending financed from the national non-domestic rate is in a similar category because the amounts collected and distributed are determined by statutory procedures. Central government would make up any shortfall if the amount distributed were to exceed the amount collected.

13. As for central government, the measure of local government expenditure included in GGE is expenditure net of sales, fees and charges. This applies equally to core services and to trading services. Trading services are expected to break even. The net expenditure definition means that any deficits on trading services met from the general fund are automatically counted within GGE, but conversely surpluses retained within trading services accounts are not counted as negative expenditure.

LOCAL AUTHORITY SELF FINANCED EXPENDITURE (LASFE)

14. Differences of view exist about whether or not the remainder of local authorities' expenditure falling within GGE should be considered as equivalent to central government spending. This includes:

- revenue expenditure financed by council tax;
- revenue expenditure financed from revenue balances;
- revenue expenditure financed from surpluses of trading services including any surplus from the Housing Revenue Account.

15. These items are all part of Local Authority Self Financed Expenditure (LASFE). Expenditure financed by council tax is by far the biggest element, making up on a GB basis around three quarters of the total of LASFE (and around a quarter of net revenue expenditure), followed by capital expenditure financed from capital receipts which make up most of the remainder.

GOVERNMENT'S CASE FOR ITS INTEREST IN TOTAL LOCAL AUTHORITY SPENDING

16. The Government's case for constraining total spending including council tax funded spending is that from its point of view, economically this expenditure is indistinguishable from the Government's own expenditure. Its view is that the economic impact would be the same if central government rather than local authorities delivered the services. Furthermore, it is not possible to differentiate economically between the outputs funded by council tax, by Government grants or the NDR. The Government is of the view that the level of council tax has a direct and indirect impact on its own levels of spending, in that it uses up some of the taxable capacity within the economy.

VIEW OF ECONOMISTS

17. This Section has so far largely set out the Government's position on its perceived need to control LASFE with this being founded substantially on economic arguments. These arguments are, however, not universally supported by economists.

"The Environment, Transport and Regional Affairs Committee (ETRAC) of the House of Commons, in its 1999 review of local government finance, …concluded that the economic case for tight central control over LASFE cannot be sustained….In their written evidence DETR did not advance the macro-economic case for tight control over LASFE; they emphasised the cautious relaxation of controls. They actually prefaced their evidence with the following statement: 'Stronger local financial accountability is vital to modernised local government' (ETRAC 1998, p84).

"Despite this apparent acceptance that the economic case for tight central control of LASFE is weak to non-existent, the Government's published response to the 1999 House of Commons report was unequivocal:

'The Government hopes to use the reserve capping powers rarely. In an ideal world, they would not need to be used at all, because all local authorities would exercise restraint in setting council tax increases. But the Government does not believe that it would yet be defensible to rely exclusively on voters' ability to exert influence on council taxes via the ballot box because it is not clear that local voters fully understand where responsibility lies for increases in council taxes and because of low turnout in local elections.

'The Government has an interest in the level of council tax and a responsibility to local taxpayers. It will not shirk this responsibility and will retain the powers to step in and protect local taxpayers from excessive increases if necessary.' (DETR 1999.paras. 67 and 68)

"In effect, the Government has now acknowledged the poverty of the economic case upon which reliance has hitherto been placed but has said that much the same policies will continue, for political instead of economic reasons.

"The recognition by the Government that the nature and degree of central control over LASFE is a political rather than an economic matter is to be welcomed. However, this means that there are now two major tasks facing local authorities and their representative bodies. The first is to work for all-party agreement that the defunct economic arguments should not be resurrected in future, so that the debate remains focussed on the political arena, which is the appropriate one. Second, they will no doubt wish to challenge the political assertions which have been made by DETR. In so doing, the issue of key importance should be the role and function of local government in the contemporary governance of the United Kingdom and its constituent countries."

(Michael Chisholm,1999)

CONCLUSIONS

18. **Definitions of public expenditure in place are significantly at the discretion of the Government of the day. Economic commentators have demonstrated that council tax increases have a minimal impact on macro-economic policy and that LASFE controls are largely in place for political rather than economic reasons. This is reinforced by the fact that over the years, Governments have changed control arrangements. LASFE was previously outwith the public expenditure control total but was brought back in after the end of the community charge because the Treasury regarded it as unsatisfactory that such a large element of public expenditure was not controlled. It needs to be recognised, however, that other countries do not include local government tax revenues within their economic targets.**

19. **A number of reforms in local government finance arrangements were introduced from this financial year, including the abolition of spending guidelines and the piloting of local outcome agreements. The main thrust of such developments, coupled with those in organisational reforms within councils, is to stimulate local democracy and improve accountability arrangements. The Government's continued control of LASFE is inconsistent with these wider reforms and needs to be addressed to ensure a consistent approach from the Government.**

20. **It is clear from this Section that this is a complex issue but one which needs to be addressed at a political level with an open debate of the underlying issues.**

"The outcome of that debate will translate into economic measures, but these should be the consequences of the policies, not the putative reasons for them." **(Michael Chisholm, 1999)**

INTRODUCTION

1. In looking at the balance between central and local funding, the Hunt Committee stated that at least 50% of local government expenditure should be funded from local taxation and suggested that non-domestic rates might be returned to local control. Based on the current year's figures, such a move would increase the share of council expenditure in Scotland funded locally to around 43%.

2. **Rates are determined centrally by the Scottish Executive. They are collected by councils, paid into a central pool then distributed among councils at a standard amount per resident**.

3. The power to set the non-domestic rate poundage is devolved to the Scottish Parliament. However, if self-financed expenditure generated by the Parliament grows significantly more rapidly than in England, the UK Government can take the excess into account when considering the level of grant to the Scottish Parliament.

   The Scottish Executive has set the poundage for 2000/01 and 2001/02. In each year the poundage has been set at a level where the revenue raised from non-domestic rates in Scotland will increase in line with movements in the Retail Price Index. The same practice has been followed in England. Business premises were revalued for rates purposes at 1 April 2000. Rateable values in England increased by 18.8% although values in Scotland increased by 8.7%. When poundages have been set, the policy objective has been to raise the same revenue in real terms. Therefore, the lower increase in rateable values in Scotland has produced a higher rate poundage compared with England. The rate poundage for Scotland in 2001/02 is 47.0p compared to 43.0p in England.

THE CASE FOR RETURN TO LOCAL CONTROL

4. **The return of business rates to local authorities would help to restore the link between local businesses and the local council and its services.** With the introduction of the uniform business rate this link was substantially weakened. There is now no relationship between rates levels and council expenditure - either at a local or national level. Councils are merely acting as collectors of a central government tax. The full cost of any additional service expenditure is met by council tax payers. Businesses benefit from many local services such as education, transportation, police and fire. It would appear reasonable, therefore, that there should be a clear and understandable connection between the costs of these services and the business community's contribution to their funding.

5. One of the main justifications offered for the removal of the local business rate in 1989 was the argument that local authorities were not properly accountable, given that businesses do not have a vote and, therefore, cannot influence councils' spending decisions through the democratic process. Such an argument could, however, equally apply to all taxes levied on business by government.

4. **Nevertheless, if business rates were to be returned to local control, it is now generally acknowledged that arrangements would have to be put in place to ensure that the interests of local businesses were taken fully into account.** A meaningful consultation process between the council and the local business community would require

to be developed. In many areas there already exists a significant degree of partnership working, with businesses becoming more closely involved in developments of particular interest to themselves, for example, CCTV installations or area regeneration initiatives. Community planning arrangements provide another opportunity for businesses to contribute directly to the council's planning process. It is necessary to build on these

initiatives and to construct appropriate forums for involving the business community in the key areas of council activity and decision-making which are critical to their interests. Section 7 outlines more fully the proposed development of consultation arrangements.

The restoration of business rates to local authorities would appear to be consistent with the Government's emphasis on partnership between the public and the private sectors. Retention of business rates locally could provide an added incentive to local authorities to provide for business development within their area. At present, this incentive does not exist since the benefit of any additional yield from business expansion and growth is lost within the general pooling arrangements.

THE BUSINESS PERSPECTIVE

7. From the business point of view, two of the major benefits anticipated from the introduction of the uniform business rate were elimination of the apparent wide variation in rates bills between different areas for similar properties, and the unpredictable and erratic variation in rates bills from year to year. The inter-area variations still exist to some extent because of the variations in rateable values and the longer term stability of rates bills for individual properties could still be significantly affected by the impact of revaluations on individual rateable values. Indeed, it was arguably the effects of revaluations and the cross boundary variations, more than the actual rates levels set by the local authorities, which constituted the most significant difficulty with the former arrangements.

8. The fact remains, however, that the business community has expressed concern that restoring control of rates to local government could result in increased variations between local areas in the amount of rates levied. This concern is often heightened by reference to the possibility that local authorities, given a free hand, would be inclined to increase the proportion of expenditure funded by non-domestic rates in preference to perhaps politically unpopular increases in council tax. Again, it is worth noting that this latter issue is not unique to local government. Crawford et al's study for the Department of the Environment considered the effect of local business rate variations on employment trends in England, between 1974 and 1981. They concluded that neither the level of rates nor changes in rates costs were consistently related to employment change in three out of four leading economic sectors. They pointed to numerous local authorities where employment expanded despite significant growth in rate costs, and others where business taxes had been held down with no discernible jobs advantage. Hale and Travers (1994) argue that if all other locational factors were equal, rates would be an important influence. Indeed, when surveys of business opinion are conducted, rate costs appear as a salient factor in decisions of where to locate. However, when asked to rank factors in order of importance, rate costs come well down the list. Regardless of these findings, the concerns raised by the business sector need to be recognised and addressed if a case for return of rates to local control is to be considered.

9. Claims have also been made by small businesses that the burden of business rates falls most heavily on their sector. Rates take no account of ability to pay and generally

represent a much higher proportion of turnover and profits in smaller businesses. Earlier this year, the Scottish Executive consulted on proposals to introduce arrangements which would give rate relief to small businesses. Attached as an **Appendix** is COSLA's response to that consultation exercise.

FUNDING OF COUNCIL EXPENDITURE

10. **At present, total Scottish local authority expenditure is broadly funded 57% by government grant, 21% by non-domestic rates and 22% by council tax, although those percentages vary quite considerably at individual local authority level.** In considering whether to return control of business rates to local government, a decision would be required at the outset as to whether or not these proportions represent an appropriate distribution of the local tax burden between businesses and council tax payers.

11. **The balance of local government funding has, however, changed over the years with business ratepayers benefiting relative to council tax payers. The rates yield has been linked to inflation while Government settlements have assumed council tax increases of 5% per annum. Council Tax revenue increased by 39% in the five years to 2001/02. NDR income increased by 18% over the same period.**

OPTIONS FOR REFORM

12. Consideration would need to be given to the arrangements for varying the rates in subsequent years and to the extent to which the business community's desire for predictability in rates bills can be satisfied. There are perhaps two general possibilities in this regard:

- limit year-on-year changes in rate poundages to a given percentage, such as an appropriate inflation index;
- ensure that increases in rate poundages are no higher than those in council taxes.

The former approach is, in fact, equivalent to the arrangement which operates currently at national level. This would satisfy the business community's desire for predictability but over time could result in a variation in the shares of funding contributed from businesses and the council tax payers. The latter approach would maintain the funding shares between the two groups of taxpayers but would affect the predictability of the tax levels. This difficulty could be addressed, however, by the development of three year budgets and by the business community's closer involvement in the planning process.

13. **Widening the local tax base to include business rates could halve the gearing effect, with the result that percentage increases in rate and council tax levels under this arrangement would be 50% of those which would otherwise apply on the current basis of funding.**

14. If a full return of business rates to local control was not to be acceptable to the Government, and having regard to the Executive's previous statements in this respect, then consideration should be given to introducing arrangements which provide more

marginal local flexibility and discretion with regard to the setting of business rates. For instance, two options which may be worthy of further consideration are:

- The Scottish Executive setting a notional standard business rate poundage for all Scotland and councils having discretion to set the poundage which will apply in their local area subject to that being within predetermined upper and lower limits. Under such an arrangement AEF equalisation could apply as currently but may be based on Scottish Executive notional poundage figures and not actual NDRI receivable by councils. If a council set its poundage at a level higher than the notional poundage then the discretionary element could be retained in perpetuity for use as considered appropriate locally.

- Where a council's rating base increases as a result of economic growth in its area, a predetermined proportion of the increased NDRI could be fed into AEF calculations but the balance retained by the individual council for local use.

15. A separate but related issue which needs further consideration is the development and introduction of Business Improvement Districts. This is set out more fully in Section 6.

CONCLUSIONS

16. From 1996/97 to 2000/01, local authority revenue expenditure was strictly controlled through capping and spending guideline arrangements. AEF did not keep pace with increases in expenditure permitted by the control arrangements and **council tax revenue increased by 31% to fund a 12% increase in expenditure.** During the same period there was also a significant increase in hypothecation of council expenditure by central government.

17. A number of developments have been taken forward in the current year to assist in addressing this. The potential for Local Outcome Agreements which would provide flexibility at a local level to take forward local and national priorities is being examined. Spending guidelines have been abolished in return for councils' commitment to publish indicative three year council tax figures, and for the first time in several years, the settlement includes partial provision for the cost of pay awards.

18. Despite these improvements, considerable problems remain:

- The "gearing" issue persists with several councils declaring council tax increases in 2001/02 which were in excess of the 5% figure assumed in the settlement;

- Settlements do not provide adequate recognition for expenditure pressures including pay, taxation increases and general inflation;

- Additional resources are required to take forward community planning, address under-investment in infrastructure and to modernise services;

- The 5% council tax increases assumed in settlements, hypothecation and the significant extent of central direction of resources for national policy priorities leave little scope for delivery of local priorities;

- The arrangements which make Council Tax payers pay part of the cost of Council Tax Benefit are an unnecessary central control.

19. Reform of non-domestic rate arrangements could alleviate some of the above pressures but only if local authorities were free to raise additional resources through the business rates:

- Councils, subject to appropriate safeguards, could adjust the balance of funding between council tax and business rates to address, to some extent, the gearing and equity issues created by national settlement assumptions;
- Additional rate income could be used to provide the impetus for modernisation of council services or improvement of infrastructure;
- Additional rate income could increase the scope for delivery of local policy objectives;
- Additional financial autonomy for local authorities could reduce some of the pressure on grant distribution arrangements.

20. **Councils invest heavily in development of local business. The business contribution to local authority services has fallen relative to council tax over recent years and the sums of money associated with a degree of flexibility would be immaterial to the vast majority of businesses. There is no evidence to support the view that returning control to local authorities would distort competition. However, any proposal to return control of business rates to local authorities would have to be built round improved consultation arrangements which address the concerns of the business community.**

APPENDIX

RATE RELIEF FOR SMALL BUSINESSES

1. General

1.1 COSLA welcomes the opportunity to comment on the Consultation Paper: 'Rate Relief for Small Businesses'. It is acknowledged that small businesses make a significant contribution to the Scottish economy and the Scottish Executive's commitment to assisting small businesses is supported.

1.2 By way of initial comment, COSLA would like to state that whilst support is needed and should be targeted to small businesses, the provision of rate relief, <u>as proposed</u>, is perhaps not the most appropriate way to do this. The proposals, as they stand, may not target the small businesses which is clearly the policy intention of the Scottish Executive.

1.3 If, however, the Scottish Executive is of the view that these proposals are the most effective way to provide assistance for small businesses, then COSLA would make specific comments on the proposals as follows.

2. Part 1 - General Rate Relief Scheme For Small Businesses

2.1 It is agreed that relief should be targeted towards small businesses and not larger businesses occupying small properties. However, in targeting relief towards small businesses, there needs to be a clear definition of what a small business is.

2.2 The upper threshold of £10,000 rateable value should be increased to £12,000 in line with the existing rural rates relief scheme. Given that rates is a property based scheme, any proposals for further relief should be based on rateable values. This is administratively more straight forward for local authorities and explicable to rate payers. The rates system is well established and understood by rate payers and should not be complicated unnecessarily.

2.3 If, in defining what a small business is, criteria are to be used, then this has to be set nationally and should be mandatory. It must be easily understood and simple for local authorities to administer. Criteria such as turnover would need further consideration, particularly in dealing with new businesses. Rate relief could be granted to businesses at the start of a financial year based on, perhaps, a projected turnover which may transcend into a higher actual turnover. Indeed, this may apply to established businesses as well. Therefore relief may be overpaid and consideration must be given to recovering any overpaid relief. Perhaps consideration could be given to a turnover threshold based on whether a business is registered for VAT.

2.4 The criteria of number of employees is not considered appropriate as this may be a disincentive to businesses to increase the number of employees.

2.5 The proposed scheme will involve a system of applications based assessment. Businesses will have to submit applications for rate relief to local authorities who will need to assess applications and verify these. The additional resources required for this process have not been highlighted in the consultation. Most local authorities operate small rating sections and do not have spare capacity to take a scheme like this on board.

2.6 The types of property to be excluded from the scheme must be agreed nationally and should be discussed in full with all relevant interests including the Scottish Assessors' Association. Advertising Hoarding and Telecommunications masts, as noted in the Consultation, are not all owned by large businesses, particularly in rural areas. Non-profit making organisations should be excluded from these proposals.

2.7 The proposal to fund this scheme on a self-financing basis requires further consideration. The proposal to increase the poundage by 1.3p would mean large businesses facing a 2.8% increase before any normal inflationary increase is applied. This may have an adverse affect on businesses investing in specific areas as the rates will be too high for them to sustain their business.

2.8 A number of rates relief schemes are already in place as part of the rating system and whilst the Consultation Paper acknowledges their existence, further work is required in this area to ensure that the relationship between them is robust, administratable and explicable to rate payers.

2.9 The Consultation Paper indicates an implementation date of 1 April 2002. The proposals will involve software changes to systems and there needs to be an appropriate lead-in time for addressing such changes. There will also be implications for staff training. There also needs to be an acknowledgement of the costs involved in implementing the proposals.

3. Part 2 - Rate Relief for New Farm Diversification Enterprises

3.1 The policy of encouraging farm diversification is welcomed by COSLA. A number of local authorities have actively encouraged farm diversification within their areas. As a result of the recent foot and mouth crisis, the move into farm diversification is likely to be significantly higher than 'normal'. This proposal is significantly relevant in line with the Scottish Executive's Farm Business Development Scheme which is ready to be rolled out to all rural areas.

3.2 The proposal to establish the scheme for a fixed 5 year period seems excessive to meet the policy intentions. A period of 3 years with a phased relief scheme would be sufficient to capture new businesses and give them the opportunity to get established. A phased approach would also ensure that a final cessation date does not create any bigger issues, and assist local authorities in administering the scheme.

3.3 We accept that stud farms, which benefit from the existing reduction in their rateable value, should also be eligible for the discretionary element of the relief proposals.

3.4 COSLA advocates that relief should be available for all new enterprises on a farm and not restricted to one per farm.

3.5 A point for further consideration is where former agriculture buildings have been let on a commercial basis to a business which is unconnected with the farm. A mechanism would need to be put in place to ensure that such businesses did not benefit unduly from rate relief.

4. Part 3 - Extension To The Provisions For Rural Rates Relief

4.1 In general, the proposals to extend the provisions for rural rates relief are welcomed. A number of local authorities already operate discretionary rural rates relief schemes and

COSLA fully supports the policy intention of the Scottish Executive to extend the mandatory relief further.

4.2 There are general concerns surrounding the terminology which has been used in the Consultation Paper. There is some vagueness surrounding these and before any proposals are taken forward, definitions must be clarified.

4.3 Whilst COSLA supports the extension of relief, the categories for inclusion require further consideration. A number of Local authorities, who already grant discretionary relief, do not grant this to businesses involved with the sale of alcohol. The proposal to include singly owned pubs may not, therefore, sit well with the policy decisions already taken by local authorities.

4.4 Whilst COSLA supports the principle of providing relief to businesses which are providing a focus for the community, it is clear that there has to be defined criteria for assessing this and this should be mandatory.

4.5 The extension to the scheme is intended to sustain rural communities. A community may have more than one food shop and it may therefore not be one of the key elements in sustaining the community. COSLA supports the principle of supporting small stores, but there needs to be defined criteria which fits into the overall policy intention of the extension of rural rates relief.

4.6 Rural residents are dependent on cars for travel and garages are vital in providing services for them. We support rate relief for garages.

4.7 COSLA supports the exemption of ATMs. This will encourage banks and buildings societies to retain facilities, particularly in rural areas.

4.8 The terms of the scheme should be consistent with the existing rural rates relief scheme.

5. **Part 4 - Extending The Agricultural Exemption from Non-Domestic Rates to Farm Buildings Used for Machinery Ring, Contract and Share Farming Enterprises**

5.1 COSLA supports, in principle, the proposals contained within the Consultation.

5.2 However, there are issues which will require further consideration in terms of their practical implementation. An example is that of 'Machinery Rings' where most buildings housing machinery utilised by Machinery Rings already enjoy agricultural exemption when they are housed on the owner's farm. However, it is possible that machinery is being housed on an Agricultural Contractor's premises instead and no exemption would be applied. The Machinery Ring will also be involved in non-agricultural activity and an element of this must be allowed for as it is essential for the survival of the business.

6. **Conclusions**

6.1 COSLA welcomes the policy intention to support small businesses and the principles contained with the Consultation.

6.2 COSLA does not support the specific proposals within the Consultation and does not believe that these are the most appropriate or effective way to target assistance to small businesses.

6.3 If the proposals within the Consultation are to be taken forward, COSLA would request further discussions with the Scottish Executive on the practicalities of implementing the scheme.

INTRODUCTION

1. A Business Improvement District (BID) is a public/private partnership through which a special assessment is used to finance improvements or services within a designated area.

2. BIDs first emerged in the USA several decades ago and there are thousands in existence across the USA covering services such as street-cleaning, security and capital and retail developments. The USA has been hugely successful in establishing and developing BIDs where local businesses help pay for projects that improve their local area. BIDs provide an opportunity to link the public and private sector in a way which can enhance service provision for local residents, improve the environment and enhance the image of the area.

3. A BID represents an opportunity, created by statute, for local businesses to form an assessment district to develop funds entirely for the purpose of improvements and promotion of the respective local business district.

   BIDs are non-profit making organisations. However, the incentive for the private sector is that a radically improved environment for business can lead to a rise in profits and an increase in the value of their assets.

4. BIDs are initiated by local businesses petitioning the local authority to establish a BID on their behalf. The business or group of businesses submit an application to the local authority together with a business plan. The business plan contains such information as:-

   - the specified area of the BID
   - the improvements proposed
   - the estimated costs of the improvements
   - the estimated charge that will be applied to businesses in that area
   - duration of the scheme.

5. Services which are provided under the auspice of a BID need to be provided in addition to and not as a substitute to those provided by local authorities. Local authorities have contractual agreements set up with the BIDs and they can either administer the various projects on the BIDs behalf or return the fees to the BIDs by way of an annual contractual agreement.

PROPOSALS IN ENGLAND AND WALES

6. In April 2001, the Prime Minister announced '*a new scheme of Business Improvement Districts that will help councils and local businesses work together to improve their local area'*. The Green Paper, 'Modernising Local Government Finance', consulted on proposals for a supplementary business rate and whether it could be used to fund Town Improvement Schemes. Both businesses and councils welcomed the idea of working more closely together to improve their communities, but had concerns about the details of the proposed supplementary rate. A series of discussions then developed between them to ensure all parties were fully agreed on the principles.

7. Under the scheme, many of the details of the BID will be left to local agreement including:-

- the area to be covered
- the amount to be raised
- what it will be spent on
- the local council/business partnership for implementing it.

8. Councils or businesses can initiate proposals for a BID scheme and they will be funded by an additional business rate agreed together by local businesses and councils. Ratepayers in a BID area would know in advance how much the rate would be and how it would be used. They would vote in a referendum on the proposed scheme. If the majority voted in favour of the scheme, all ratepayers in the area would pay, but if a majority voted against the scheme, no additional rate would be raised.

   Details will be taken forward and developed in the Local Government Finance White Paper.

SCOTTISH POSITION

9. There are no powers within statute at present to create BIDs in Scotland. Primary legislation is required to introduce a 'permissive power' to enable local authorities to take these forward. There is an opportunity for this to be introduced within the Local Government Bill.

10. The potential implications of introducing BIDs needs to be fully explored and discussed with the business sector. The timescale for doing this would also need to be incorporated into the Bill process. COSLA would wish to explore the proposal in advance of this and enter into early discussions with the business sector at the earliest opportunity.

11. Much of the detail of BIDs and the practical issues will not be developed until later, but some of the principles of a BID operation need consideration at an early stage:-

- will ratepayers within a BID area contribute voluntarily or will it be a compulsory charge if there is a majority vote?
- will a charge be linked to the rating system?
- how will businesses be involved in the implementation and management of BIDs?

   Whilst further discussion will be required on the above issues, it is worth noting that the majority of BIDs operate on a 'compulsory charge' basis and are linked to the business rate system.

   A more open question is the one of implementation and management.

CONCLUSIONS

12. **BIDs are highly successful in the USA and have been so for a number of years. Legislation will be introduced in England and Wales for the implementation of a scheme for BIDs largely on the back of the success within the USA.**

13. **Initial explanatory discussions are needed with the business sector to assess the feasibility of BIDs.**

14. **Legislation is required for BIDs and the opportunity exists within the Local Government Bill for Scotland. COSLA advocates the introduction of a permissive power within legislation to enable local authorities to engage in BIDS.**

INTRODUCTION

1. A number of the proposals presented in the evidence clearly have implications for the business sector and it is COSLA's intention to explore these issues in a preliminary meeting with business sector representatives. However, it would be inappropriate for COSLA not to develop these issues at an early stage and consider the areas which need to be addressed.

2. In considering the relationship which exists between local authorities and the business sector, COSLA looked at recent work which was undertaken in September 2000 and used this as a useful starting point to assess the issues and the most appropriate way of addressing these.

BACKGROUND

3. A study which was commissioned by the Department of the Environment, Transport and the Regions (DETR) from York Consulting in September 2000. The study resulted in the publication of a Guide for Local Authorities on Engaging the Business Community entitled "Doing the Business". It was based on two nationally representative surveys of local authorities as well as in-depth case studies on eleven principal local authorities in England.

4. Although the Guide was developed in the context of English local authorities, the principles for engagement and the issues to be avoided are of direct relevance to Scottish local government.

   The DETR report reflects a number of the issues which local authorities must address. Engagement is examined from three directions;

   - Partnership Working: formal and informal arrangements between Councils and the business community in connection with the delivery of services and the promotion of networking.
   - Consultation: initiatives to solicit the views of the Business Community
   - Information Dissemination: initiatives to provide general information to the Business Community.

   The methodology which lies behind the development of the proposals within the Guide appears to be comprehensive and robust, involving;

   - A postal survey of all principal local authorities in England.
   - A telephone survey of a sample of 1,000 businesses in England selected at random within quotas for size, activity and type of Council.
   - Case studies of 11 principal local authorities in England and visits to five other authorities as part of the survey design process.

- A literature review of the involvement of businesses in other countries on local government budgetary issues.

5. On the basis of the foregoing this would appear to be an authoritative piece of work which has been undertaken in England and there is no reason to believe that if such work was replicated in Scotland that the outcome would be any different from that established by the DETR study.

OUTCOME OF DETR STUDY

6. The Study resulted in the publication of a Guide which established a set of principles for engagement and highlighted some of the key issues to be avoided which apply to most, if not all, authorities. These principles and issues serve as a checklist against which authorities can assess their current position of their engagement with their business communities and identify areas for improvement and development.

PRINCIPLES OF ENGAGEMENT

The Guide identifies 29 Principles in relation to 6 aspects of engagement as follows;

7. **Engagement Strategy**

- **Develop a strategy for increasing engagement with the business community.** Such a strategy would outline and evaluate current links, highlight current problems and how they can be addressed, establish objectives and priorities and set out an action plan embracing the whole council.

- **Develop clear objectives and priorities for engagement and communicate these to the business community.** Businesses do not necessarily have a large amount of time to devote to links with the local councils. As a result, authorities need to be clear what their objectives and priorities are for these links, what the results will be and how they will be delivered, what role they will play and what they expect the business community to do.

- **Develop a shared agenda and vision for engagement with the business community.** As with any partnership, unless the partners have a shared understanding of what they are and also what they are trying to achieve together, and how they see the partnership developing over time, it is unlikely to provide the basis for either effective or long term working.

- **Define the scope and nature of the engagement that both the Council and the business community want.** The nature and scope of engagement will vary. In part this reflects the fact that a business has a greater interest, for example in transport issues, than it does in the level of personal services.

- **Learn from the experience of other authorities.** It is important for authorities to share experiences of engagement so that lessons do not have to be learnt over and over again and best practice can be replicated between local authorities.

8. **Approach to Engagement**

- **Establish a business – friendly "culture" at all levels and in all service areas of the council.** The business community is not going to engage with the council if its daily experience of the authority is an organisation that is indifferent or hostile to its needs and interests. What is necessary is for a business–friendly "culture" to be present in all service areas and departments to ensure the business community receives one consistent message from the council.

- **Develop mutual trust, understanding and respect between the council and the business community.** In many ways mutual trust, understanding and respect are the products of effective engagement. A good starting point would be for both local authorities and businesses to recognise that there is currently a general perception of a lack of mutual understanding. This would at least establish building trust and understanding as a key priority of the developing engagement.

- **Approach links with the business community with commitment and enthusiasm.** Businesses may not view the local council as an organisation with which they would want to, or should, have close links. Therefore, engagement with the business community will require commitment and enthusiasm. If businesses perceive a lack of commitment or enthusiasm from local authority officers they will conclude that there is nothing for them to be committed to or enthusiastic about.

- **Be action-oriented and demonstrate to the business community what results have been generated by engagement.** The last thing that the business community will want to be involved in is a "talking shop" that does not achieve outcomes. As a result, authorities need to ensure that their approach to the business community emphasises taking action and delivering results. Equally, local authorities should always seek to demonstrate to the business community what results have been generated by their involvement. This will establish the credibility of the authority as a deliverer of results and hence underpin the commitment of businesses to working with the council.

9. **Structure of Engagement**

- **Keep arrangements with the business community simple.** Case studies demonstrate that engagement works best when structures and arrangements are kept as simple as possible. Whilst local authorities should not create complex partnerships, consultation structures and arrangements, they need to respond to the organisations and structures that the business community establishes.

- **Build on existing successful links with business representative organisations and individual businesses.** Authorities may have existing links with business representative organisations and individual businesses. Where these are judged to be successful or have the potential to be so, they should form the base for developing a wider engagement with the business community.

- **Explore opportunities for increasing the representation of business representative organisations.** In areas where membership of a representative organisation is low, engaging with these businesses may not address the general issue of engaging with the business community. In a number of case studies, local authorities sought to address this issue, in part, by attempting to boost the membership of the business representative organisations, either by assisting existing bodies with initiatives to increase membership or by facilitating the establishment of new bodies.

- **Develop links with individual businesses.** It is important that local authorities develop links with individual businesses as these links provide an important mechanism by which councils and their officers can understand the needs and priorities of the business communities.

- **Try to engage with both large and small business.** It is important that local authorities engage with as diverse and representative a cross-section of their business community as possible. Arrangements should be tailored so that small businesses and others that find it more difficult to participate, can be involved.

10. **Organisation of Engagement**

- **Integrate links with business, including those related to the regulatory role of the Council.** One of the principle benefits of developing a strategy for engagement with the business community is that it provides a basis for a corporate approach. There is a tendency for local authorities to regard economic development as their business–friendly arm and for other service areas, particularly the regulatory areas, to adopt a somewhat different stance. There is no reason why all parts of the local authority should not adopt the same business–friendly "culture" and be part of the engagement process.

- **Publish clear service standards and set performance targets for services provided for the business community.** Effective engagement is unlikely to be developed if businesses do not perceive that they are receiving high quality services from their local council. Local authorities should publish clear service standards and set performance targets for the services they provide to the business community. They need to be communicated to businesses, along with the feedback on performance against the standards and targets as part of an overall approach of transparency in the dealings between the partners.

- **Establish a single point of contact for businesses.** Businesses do not necessarily have a clear understanding of the structures of councils and rather than taking the view that businesses need to understand these structures, local authorities should insulate, as far as possible, their stakeholders and customers from the details of their internal structures. A one stop single point of contact will facilitate the engagement process.

- **Co-ordinate links with the business community between agencies and where relevant, other Community Planning Partner organisations.** In addition to local authorities, other agencies are involved in providing services and developing initiatives in local areas. Many of these agencies will be looking to involve or consult with the business community and there is a danger of engagement and consultation overload if the process is not co-ordinated.

11. **Operation of Engagement**

- **Remember that the business community is not homogeneous. Respond to the specific needs of individual sectors and areas and ethnic businesses.** There is no such thing as the business community, rather these are a large number of individual businesses with a range of different interests, some of which have come together in a variety of representative organisations. Authorities need to recognise this diversity and respond to the specific needs of individual sectors and geographical areas and other groupings such as ethnic businesses.

- **Ensure that links between the council and business community take place at the appropriate level.** Effective engagement between local authorities and their business communities cannot be based solely on having the appropriate structures and arrangements in place for partnership working and consultation. It also needs to be underpinned by a personal rapport between the Chief Executive and the rest of the Senior Management Team of the council and key figures in the business community.

- **Establish a personal rapport with key figures in the business community.** Effective engagement between local authorities and their business communities cannot be based solely on having the appropriate structures and arrangements in place for partnership working and consultation. It also needs to be underpinned by a personal rapport between the Chief Executive and the rest of the Senior Management Team of the council and key figures in the business community.

- **Develop personal contacts between council officers and businesses at all levels.** In addition to establishing a personal rapport between the key personnel in the business community, the results of the surveys undertaken by the study emphasised the importance of personal contacts at all levels between council officers and businesses.

- **Take initiatives to increase officer understanding of business needs and priorities.** A lack of mutual understanding between councils and businesses can hinder engagement but can be overcome through initiatives aimed at increasing officers' understanding of business needs and priorities.

- **Create different entry points for businesses wanting different levels of engagement.** The surveys undertaken by the study showed that partners agreed that a shortage of time is one of the main difficulties faced in getting involved in both partnerships and consultation. Different businesses will be able to participate to varying degrees in links with their local councils and it is important that local authorities consider how they can best provide different entry points for businesses wanting different levels of engagement.

12. **Communication**

- **Use existing working relationships with the business community as much as possible when consulting or disseminating information.** The dissemination of information will be more effective in the context of ongoing partnerships and as such councils should utilise these existing working relationships as much as possible when consulting or disseminating information. They should also look to extend ongoing working relationships in order to provide a more effective base for consultation.

- **Establish a regular dialogue with the business community and avoid one-off consultations.** Consultation and dissemination of information work best when they are part of a regular dialogue and communication between local authorities and the business community.

- **Ensure that information for the business community is clear, concise, accurate and well presented.** All councils should objectively evaluate the material that they sent to businesses in the light of the four criteria of clarity, conciseness, accuracy and quality of presentation.

- **Tailor the methods of communication with businesses to their particular needs.** Local authorities should use a wide variety of methods to communicate with their business communities. Thought needs to be given to how best to communicate with different parts of the business community. Looking to the future, interactive web sites will become a significantly more important method of communicating and authorities need to ensure that they grasp the opportunities presented by Information and Communication Technology.

- **Always provide feedback to businesses on the results of any consultation.** Local authorities should always aim to provide feedback on consultation outcomes. Without this feedback loop it is difficult to see how effective engagement with the business community can be achieved.

- **Identify the specific interests of businesses and tailor the approach to them accordingly.** In general, businesses will only engage with their local authorities if they perceive that there is some direct or indirect, short term or long term benefit for them. If authorities are to engage with a wide range of businesses they will need to become more adept at identifying these potential interests and more effective at marketing themselves to the business community.

ISSUES TO AVOID IN ENGAGEMENT

13. The issues to avoid in engagement are :

- Do not assume that the business community is homogeneous.

- Do not assume that the business community is just the representative organisations.

- Do not assume that businesses fully understand local authority roles, responsibilities and structures.

- Do not underestimate the time that it takes to change business perceptions of the council.

- Do not allow Economic Development to be the only business–friendly part of the council.

- Do not develop more links with the business community than it is possible to manage.

- Do not promise what it is not possible to deliver.

- Do not waste the time of businesses.

- Do not approach businesses for funding outside of an established relationship.
- Do not consult businesses unless they have a specific interest in the issue.
- Do not consult when everything is already decided.

CONCLUSIONS

14. **In conclusion, the research undertaken to date indicates that businesses generally have a low awareness of local government that does not provide a solid foundation for engagement with their local Councils. Similarly the recognition of the importance of businesses as key stakeholders of local government is often patchy outside the economic development function with a limited understanding of commercial practices and priorities. This lack of understanding presents difficulties in relation to effective engagement with the business community.**

    This suggests that considerable work requires to be done by both local authorities and the business community if the mutual understanding that will underpin effective engagement is to be developed. Better communication is perceived by the business community as the key to improving links with local authorities. It is important for authorities therefore to recognise the need for better dialogue and communication and improved personal links with their business communities. Part of the process of developing this mutual understanding and successful engagement must involve authorities in developing a business-friendly "culture" at all levels and in all service areas.

15. **Research also shows that there is no such thing as "the" business community which contributes to why engagement is not an easy process for authorities. A future priority for Councils is to build on whatever arrangements currently exist to include a more representative cross-section of their business communities and a broader range of their activities.**

16. **Both consultation and dissemination of information are more successful if they take place in the context of an ongoing relationship between authorities and businesses. This and the provision of more regular and effective feedback will help to increase the perceived usefulness of consultation and information flows for business.**

17. **Local authorities need to be flexible on the use of different consultation methods, both in relation to the preferences and circumstances of different businesses and the issues involved.**

18. **The key to successful dissemination of information to the business community is clear, concise, accurate and well presented information on issues that are relevant to the businesses targeted, sent to businesses at the appropriate time and forming part of an ongoing dialogue supported with feedback and wherever possible by personal contacts.**

PART 10 – CAPITAL

Section 1 – Abolition of Section 94 Consents – Non-Housing
Section 2 – Abolition of Section 94 Consents – Housing
Section 3 – Housing Receipts Set Aside Arrangements
Section 4 – Capital Matched Funding
Section 5 – Capital Reporting and Monitoring Arrangements
Section 6 – Regulatory Framework on Investments

INTRODUCTION

1. This Section sets out the case for abolishing existing Section 94 controls. It primarily refers to the case for non-housing services and Section 2 refers to the case for the abolition of existing Section 94 consents for housing. The principles outlined within this Section, however, apply equally across non-housing and housing services.

2. In England, the DETR and the Local Government Association have published a joint paper setting out proposals for the abolition of "credit approvals" in favour of a new prudential system to be delivered by statutory controls, professional regulation and self-regulation. The genesis of that paper was a DETR consultation document issued in 1998 which set out the case for modernising local government capital finance arrangements. The Government's view expressed in that consultation paper was that the aims of a finance system should be to:-

   - maximise the value of local authority capital investment;
   - strike the right balance between local and central priorities;
   - encourage a corporate approach;
   - tackle needs and resource inequalities between authorities;
   - be stable;
   - be simple, open and accountable;
   - encourage prudent financial behaviour; and
   - be economical to deliver.

   As part of that consultation exercise it was also recognised that the system should encourage forward planning, be flexible and provide the means of delivering the resources needed within a reasonable timetable.

3. These aims are perhaps broadly consistent with what might be desirable from a Scottish system and, therefore, in taking this forward it may be appropriate to consider how the arrangements in Scotland match and are seen to deliver against these aims. In many respects the current system in Scotland falls short of achieving a number of the aims. The key failings are:-

   - an inability to deliver the resources necessary to maintain assets in a suitable condition;
   - resource and systems difficulties which restrict councils in taking forward the modernisation agenda;
   - centralised controls resulting in a loss of local flexibility to take forward best value arrangements;
   - challenge funding arrangements which distort priorities and divert available staffing resources;
   - a double count for public expenditure purposes;
   - complexity and lack of stability;
   - pressures on the delivery of national priorities.

   These failings must be addressed in taking forward the agenda of modernising local government finance.

TACKLING UNDER INVESTMENT IN LOCAL SERVICES

4. Whilst for non-housing services, the abolition of the requirement to apply 50% of capital receipts to redeem debt outstanding, from August 1998, has provided greater investment capacity to councils (although its continuation for housing is of major concern and is addressed more fully in Section 3), it needs to be recognised that 10 years ago comparable net consent levels for Scottish councils were some £700m at current prices. **Whilst the Spending Review 2000 resulted in an increase in capital resources, these still do not match previous consent levels.**

5. When the Government came to power it expressed a commitment to stimulate capital investment. In particular, it put in place two fiscal rules:

   - *the golden rule*: over the economic cycle, the Government will only borrow to invest and not to fund current spending;
   - *the sustainable investment rule*: over the economic cycle, net public sector debt as a proportion of Gross Domestic Product will be held at a stable and prudent level, which is defined by the Treasury as being less than 40 per cent.

   These rules reflect the Government's view that *"a key component to the new approach to fiscal policy is to distinguish between current and capital spending."*

6. In many respects, lessons can be learned from the under investment in the water and sewerage service which is now being addressed, albeit that this is resulting in significant increases in charges. The public has strongly criticised such increases. The level of safeguard is stronger within local government given that councils are democratically elected bodies accountable to their local electorate. **It is essential, however, that adequate and sustainable revenue funding is made available by central government to enable the necessary investment to be taken forward. Local government needs to be put in a position whereby it may also tackle years of under investment by addressing the crumbling infrastructure in schools, roads and other community facilities, take forward the modernisation agenda and invest in "spend to save" initiatives.**

7. COSLA's submission to the Spending Review 2000 exercise identified an **investment need of at least £2.8bn**. Attached as an **Appendix** is an extract copy of COSLA's submission in this respect. This scale of investment need clearly flags up the need to address the overall system of capital controls which are in place. In many respects that appendix does not fully emphasise the scale of investment needed with there being significant pressures in making school buildings fit for the 21st Century, major investment needed in waste management to meet EC Directives and the need for investment in private sector housing. The appendix does, however, emphasise that the scale of investment need is extremely significant. **That scale of investment cannot be delivered under current arrangements.**

RESTRICTIONS ON TAKING FORWARD THE MODERNISING AGENDA

8. Faced with these investment needs, we need to look innovatively at how the modernisation agenda can be taken forward. Spend to save measures need to be examined whereby initial capital investment may result in longer term revenue savings.

In particular, serious consideration needs to be given to ICT investment and work on 21st Century Government may assist in this respect. In considering this, however, it needs to be borne in mind that to keep up to date with ever changing developments, ICT investment needs to be refreshed on a three to four year basis.

9. Investment needs for the modernising agenda include:-

- Buildings to make them energy efficient, to reduce ongoing repairs and to make them fit for purpose;
- Investment in ICT to revolutionise the way authorities do business;
- Document imaging and other measures to improve the efficiency of work practices;
- Alternative forms of transport to make a reduction in car usage and therefore congestion and pollution if possible;
- Alternative methods of disposing of waste that meet environmental and other criteria;
- Staff and member training to introduce new ways of working that are more efficient and effective in the use of time and other resources.

10. **Councils are prepared and are already looking at innovative ways of taking forward investment within current resource constraints**. For instance, Public Private Partnerships have been closely examined and councils are looking at ways of joining up services with other public sector agencies to ensure the most effective use of public resources. Major PFI projects are currently being taken forward largely on the back of the guarantee of level playing field support.

With restrictions in local government resources overall, consideration needs to be given to the most flexible use of resources and taking forward capital investment decisions on a best value basis. A relaxation of PFI/PPP arrangements and rules would assist in this. Also, active consideration needs to be given to addressing the main inhibitors in the joining up of public sector resources. Differing accounting, accountability and responsibility arrangements within the public sector act as limiting factors to developments in this area. Such factors inhibit councils' delivery, for instance, on regeneration initiatives. Further necessary considerations need to clarify the various responsibilities of public sector agencies.

11. In May 2001 COSLA responded to the Scottish Parliament Finance Committee's Inquiry into PFI/PPP arrangements, concluding:-

"COSLA has continually advocated for an increase in capital investment to address the under-resourcing in previous years.

Whilst PFI/PPP is a means of taking forward capital investment, it is one of many options and should not be seen as the only way forward to address the investment need.

There are a number of factors to be considered in adopting PFI/PPP :

- *Best Value*
- *Value for Money*
- *Risk Management*
- *The Position of Employees*

This list of not exhaustive and these are just some of the bigger issues to be considered when considering a PFI/PPP project.

Local authorities have embraced PFI/PPP and a number of projects have been taken forward. However, the main problem of years of under-investment in capital cannot be addressed by this alone. Flexible arrangements need to be put in place to allow councils, having had regard to their resource constraints, to take forward investment on a best value basis having considered all of the options available."

DOUBLE COUNT FOR PUBLIC EXPENDITURE PURPOSES

12. Section 94 consents effectively score twice for public expenditure purposes – firstly as consent and, again, through annual loan charges. This is not the most economic use of available resources and there are benefits for both the Scottish Executive and local government in considering the abolition of Section 94 consent arrangements. Given commitments to stimulating capital investment, a relaxation of control arrangements would assist councils in taking forward more flexible investment decisions, in particular where these involve partnership projects and "spend to save" initiatives. **The abolition of Section 94 consents for non-housing services alone could immediately release around £450 million within the Assigned Budget.**

In promoting this consideration it is recognised that, under current Treasury controls, capital spend would continue to require to be scored somewhere within the Assigned Budget. Discussions on this are, however, currently ongoing in a UK context and these need to be progressed as a matter of urgency.

13. There is an opportunity to address this accounting anomaly as part of the Government's introduction of new arrangements through Resource Accounting and Budgeting. If consents were supported by central government grant then the case for this scoring against public expenditure can perhaps be recognised. However, whereas in England it is more common for capital grants being available to support, for example transport projects, the use of grant payments in Scotland is very limited. Section 94 consents are effectively a "paper transaction" and the real central support for councils' capital investment comes through the recognition of annual loan charges in AEF calculations. **The double count for Government accounting purposes, in terms of best value and the most efficient use of the public pound, needs to be addressed as a matter of urgency.**

Given the benefits for both central and local government in freeing up available resources and assisting to take forward much needed priority investment, the Scottish Executive should, with COSLA, jointly approach the Treasury promoting a relaxation and review of public expenditure rules.

14. With the greater use of PPP arrangements, **there is an increasing blur between capital and revenue expenditure**. A relaxation of controls would recognise this situation and put in place arrangements which would better enable councils to take advantage of opportunities which may be presented by Public Private Partnerships. Current developments and the introduction of Resource Accounting and Budgeting within central government may provide the opportunity at this time to radically review current government accounting arrangements.

15. If capital consents were abolished then further consideration would need to be given to the system of revenue support and, perhaps, safeguards which should be put in place. **Revenue support for capital investment should be allocated in a way which allows headroom for capital investment in a prudent manner, encourages strategic local choice and enables capital and revenue options to be considered on an even footing**. **There must, however, be a firm commitment from central government to provide**

funding on a sustainable basis sufficient to allow councils to address investment needs. The funding arrangements will also need to recognise the diversity of individual councils and provide flexibility to deliver services to suit their own local circumstances.

Although Section 94 is termed as consent to incur capital expenditure it is, when capital receipts and contributions from revenue are stripped away, effectively borrowing consent. Given that the Government would require to see a greater degree of safeguard and that both local authorities and the profession would probably support a prudential approach, the emphasis might then switch from consent to borrow to "ability to repay" or "ability to fund".

PRUDENTIAL SAFEGUARDS

16. It is important to put the development of a system of self-regulated prudential safeguards in context. There are a number of developments which are relevant in this respect. The following does not purport to be exhaustive:-

- The introduction of a power of community initiative for Councils.
- The Best Value/Modernisation agendas.
- The drive towards Performance and Accountability.
- The McIntosh and related reviews geared to, *inter-alia*, energising local community and electorate interest in their Councils.
- The Treasury's macro-economic control levers.
- Government's encouragement of PFI/PPP.
- How best can Government's objectives and priorities be aligned with those of local government? As an illustration, the former may target housing as a priority area and seek to promote a solution e.g. stock transfer, which may be appropriate for certain Councils but not for others.
- The evolving accounting framework i.e. introduction of resource accounting in central government and the convergence of the public sector towards private sector GAAP. One particular example relates to operating leases where proposals are to align their treatment with that of finance leases, which would result in their inclusion on the balance sheet.

17. The most effective control is the one that is already in place with respect to revenue. **The key fact is that all investment regardless of how it is financed, will "flow through" to revenue**. The one caveat that needs to be recognised and controlled is deferred arrangements. Under current arrangements, the Government thus controls spending by limiting a rise in council tax. The Government's control of councils' main source of income, AEF, is a significant safeguard in this respect.

The above control on revenue spend, allied to a requirement to fix a balanced budget readily provides an overall control framework. An added element would be enhanced local electorate interest that large council tax rises would generate.

18. Work is underway on a UK basis to develop a framework of safeguards designed for internal use by Councils to help ensure appropriate and prudent decision-making on investment at a local council level. This work is being taken forward by CIPFA with relevant professional, central and local government interests involved in the process. **The intention, therefore, is to produce a professionally endorsed framework of safeguards which may be applied at a local level**. This will re-inforce internal safeguards currently in place, such as the CIPFA Guidance on Treasury Management and should be flexible enough to allow individual councils to address local circumstances. The role of external audit also provides a significant further safeguard.

COMPLEXITY AND LACK OF STABILITY

19. Over the years, many changes have been made to the Section 94 consent arrangements and **the system which is currently in place is, in essence, preventative rather than enabling**. **It is rules based and is over-complicated.** The system also does not, through year-end flexibility, carry forward etc. arrangements adequately recognise the longer term nature of capital investment.

Whilst the announcement of three year consent figures for the Spending Review period was generally welcomed, this still does not recognise the longer term nature of capital investment and the need to strategically plan over a much longer time horizon. Further consideration of refinements to existing consent arrangements may well result in the need to consider detailed and more complicated rules and regulations. This, therefore, points to the need to more fundamentally consider the abolition of the overall consent arrangements. Professional self-regulation could allay any Government concerns regarding individual councils' capital investment decisions and their accounting treatment.

DELIVERY ON NATIONAL PRIORITIES

20. The introduction of a single non-housing capital consent greatly assisted more flexible and best value decisions on investment at a local level. Increasingly, however, there are perhaps suggestions that this principle is being overtaken by the use of top-slicing or hold back arrangements by the Scottish Executive to take forward, for instance, public transport, waste management, air quality, care and repair, flood prevention, etc priorities. For instance, **by the end of the current Spending Review period in 2003/04, only 62% of capital resources will be available through the single non-housing consent. The balancing 38% represents resources targeted by the Scottish Executive to particular areas**. This undermines efforts which have been made through, for instance, the introduction of the single consent to put in place a more appropriate balance between central direction and local flexibility. It also significantly diverts available staffing resources within councils whereby staff spend a disproportionate amount of their time on the bureaucracies of challenge funding type arrangements. **There needs to be more discretion, trust and local flexibility on the use of resources. Consideration of capital priorities needs to be taken forward on a basis similar to revenue developments through the introduction of local outcome agreement arrangements.**

21. In taking this forward it is important that a balanced position is considered at a national level between an identification of national priorities and how these compare with priorities at a local level. Arrangements should be put in place for Policy Statements to be provided by individual councils with these, in many respects, acting as a possible opening of dialogue between the Scottish Executive and individual councils on local

policy choices. Further, robust monitoring arrangements to monitor capital expenditure by individual councils and to ensure that this takes into account the extent of all capital investment and also the impact of external funding, ie lottery, European grants, etc. on spending patterns need to be put in place. Such funding sources set against current inadequate resource levels and control arrangements can have a major impact on investment decisions of individual councils. The freeing up of controls may assist in addressing this potential difficulty.

CONCLUSIONS

22. **This Section has outlined a number of the practical difficulties associated with councils' investment decisions resulting from both inadequate resource levels and overly centralist controls. It sets out the case for abolishing existing consent arrangements to enable best value from the use of available public sector resources and promotes a credible basis for addressing the chronic investment need within local government. It also puts in context the form of safeguards which should be put in place to support the proposal and provide the necessary reassurances on public finances**.

23. **Existing controls should be abolished and replaced by a system of professionally endorsed prudential safeguards designed for use at a local level. These should recognise the diversity of individual councils.**

24. **These measures must be supported by a firm commitment from central government to provide funding on a sustainable basis sufficient to allow councils to address investment needs.**

Appendix

NEW CAPITAL EXPENDITURE PRESSURES

Property Repairs
In May 2000, COSLA and ADES prepared a joint response to the Education, Culture and Sports Committee's Inquiry into School Infrastructure. This report identified that **£1.3 billion** would be required to tackle the backlog of repairs and maintenance in Scotland's schools. The majority of investment in recent years has been to ensure health and safety compliance and not major investment to maintain and improve school buildings. This under-investment has led to a poor state of buildings which will soon not be fit for the purpose.

ICT Investment in Schools
As part of the COSLA / ADES submission to the Education, Culture and Sports Committee's Inquiry into School Infrastructure, a number of issues were raised with regard to ICT investment. The changing face of education indicates that investment in ICT is required in all schools to ensure they meet the challenge of a modernised education service.

Flood Prevention
Bad weather has resulted in a number of floods across Scotland in recent years. The consequences of this both physically and financially have been significant. In order to prevent further damage, investment is required to ensure that where there is still a possibility that this may happen, flood prevention schemes are put in place. These schemes require substantial investment as they may cover a large surface area requiring significant building works and sophisticated control mechanisms.

As an example, Perth & Kinross Council have embarked on a course of investment in flood prevention measures at a cost of £23m. Extending such schemes across Scotland will have significant financial consequences, perhaps of the order of **£60m.**

Social Work Information Systems
The need for improved information systems within social work services in all local authorities is long overdue. The need to integrate all systems and develop the provision of access to information will improve service provision as a whole. This requires substantial ICT investment. This investment will assist in ensuring a modernised service which will be in a position to deliver the priorities identified in the Programme for Government and facilitate a best value service. Estimates indicate this will cost **£20m** per annum on a rolling programme basis.

Public Safety Radio Communications System (PSRCS)
Police Forces in Scotland require to consider the installation of new radio systems for future years as existing analogue technology does not meet current needs and will become obsolete due to the move to digital technology by major suppliers. The functionality of existing analogue systems is limited and needs greater facilities to meet the demands of modern policing. Although there are on-going revenue costs associated with this, the initial investment is of a capital nature and is in the order of **£20m.**

Roads Maintenance
Due to significant under-investment in road maintenance over the last few decades, a major investment need has built up. This has been costed at around **£1bn.** On bridge maintenance, an estimated backlog of works of **£166m** exists to allow councils to comply with new European regulations on bridge assessment and strengthening. An estimated maintenance backlog of **£45m** exists for lighting maintenance.

Waste Management – Landfill Directive

The new European Directive on the Landfill of Waste will require local authorities to move away from its reliance on disposal of waste to landfill. Limiting landfill of Biodegradable Municipal Waste as per Article 5 of the Directive will result in an increase in costs for all local authorities. Local Authorities will need to invest in programmes to deal with this Article and initial capital investment will be required to invest in new projects.

A report commissioned by the Scottish Executive aimed at identifying additional costs imposed by the Landfill Directive identified that by 2020, councils will face a cost of **£200m** more than currently invested, **£101m** of this sum directly due to the European Landfill Directive.

Contaminated Land Regulations

The implementation of the Contaminated Land Regulations will result in capital costs both to fund the initial costs of implementing the regime and the on-going costs of contaminated land work. It is estimated that this will require an initial investment of **£10m.**

Modernising Agenda

The modernising agenda for Local Government needs to be taken forward. Spend to save measures need to be examined whereby initial capital investment may result in longer term revenue savings. In particular, serious consideration needs to be given to ICT investment and the work of the Digital Scotland Task force. However, it must be borne in mind that to keep up to date with ever changing developments, ICT investment needs to be refreshed on a three to four year basis. Examples of investment needs includes :

- buildings to make them energy efficient to reduce on-going repairs and make them fit for the purpose
- investment in ICT to revolutionise the way local authorities do business
- document imaging and other measures to improve the efficiency of work practices

The following table summarises capital investment needs.

Table A : Capital Expenditure

PRESSURE	COST (£m)
PROPERTY REPAIRS	1,300
ICT INVESTMENT IN SCHOOLS	?
FLOOD PREVENTION	60
SOCIAL WORK INFORMATION SYSTEMS	20
PUBLIC SAFETY RADIO COMMUNICATIONS SYSTEM	20
ROADS MAINTENANCE	1,211
WASTE MANAGEMENT	200
CONTANMINATED LAND REGULATIONS	10
MODERNISING AGENDA	?
TOTAL	2,821

INTRODUCTION

1. This Section sets out the case for abolishing Section 94 controls for Council Housing Stock accounted for within the Housing Revenue Account (HRA). This case is prepared on a similar basis to that for Non-Housing Services. Accordingly, the principles accord with those outlined in Section 1 for Non-Housing Services.

2. Within the UK the case for abolition of existing central government controls and their replacement with a system of "prudential ratios" could be applied within a system of statutory controls, professional regulation and self-regulation. In England this has been developed to the stage of a joint paper published by the DETR and the Local Government Association. This paper was further developed in the DETR Green Paper on the future of Local Government Finance published in September 2000. It recognises that the following issues will require to be further developed if the borrowing consent regime is replaced with prudential ratios:

    - Ongoing revenue support from government for some Councils;
    - Housing and the modernising agenda.

    To that can reasonably be added the following:

    - Permitting the proceeds from housing sales to be used to invest in housing stock;
    - The differing need for investment in housing given demographic and social change;
    - Housing stock condition.

3. In parallel with the paper on Non-Housing Services, the HRA Section 94 controls fall short of achieving a number of aims:

    - an inability to deliver the resources necessary to maintain existing assets in a suitable condition fit for purpose in a modern environment;
    - restrictions on resources and systems which prevent Councils taking forward the modernising agenda;
    - it fails to enable investment in new stock to reflect changing demography and household structures;
    - failure to recognise local housing need;
    - it fails to recognise the affordability or otherwise of housing investment to existing or potential housing tenants;
    - forces Councils and tenants to consider stock transfer to ensure further investment and in this context ignores the need for an effective agenda for joined up services and Housing's key role in this regard;
    - Simplicity and stability.

4. The issue of Capital Finance for Housing is further complicated by the current requirement to apply some 75% of cash received through Council House Sales to be applied in redeeming outstanding debt. This is challenged in Section 3.

CONTEXT

5. Before developing the detailed financial arguments, it is considered important to place this Section within a wider context. It is recognised that this Section deals with an issue

not wholly within the remit of the Local Government Committee. Nevertheless, the central role of housing warrants a summary of the current status of the local authority housing service. Furthermore, the inclusion of this Section ensures the comprehensiveness of the review into Local Government Finance.

6. Council housing stock faces new pressures beyond those of normal tenancy management. In some areas the effects of rent arrears, anti-social tenants, drug dealing, use of houses for mail drops for illegal activities and benefit fraud for fictitious persons or tenancies etc. all contribute to marginalising good tenants - many of whom are elderly. Addressing these issues will require cash resources. **In effect, addressing these issues represents an investment, if not in a tangible asset, in addressing a culture which threatens to undermine the social fabric of Council Housing neighbourhoods.** Whilst such investment is not in bricks and mortar it will undoubtedly improve the capital value of the housing stock.

Furthermore, cash investment is required to address the issues of vandalism, general repairs and demolition of unwanted properties. COSLA supports the principle of home ownership for Council tenants. Tenants who buy their houses often help to address the foregoing issues. They have a tangible interest in doing so.

TACKLING UNDER INVESTMENT

7. Council housing stock in Scotland:

- requires extensive renovation to overcome structural and other forms of natural dilapidation which occurs over time;
- requires renovation to equip the stock for modern usage;
- requires renovation to convert stock from its existing usage to one where it more appropriately meets the needs of the increasing number of elderly or single people;
- requires new investment to provide social housing to a wide variety of particularly disadvantaged groups;
- requires investment in insulation and new and energy efficient heating systems under Agenda 21;
- requires investment in some of the less tangible social problems in some Council Housing neighbourhoods.

8. Abolition of the Non-Housing Services requirement to apply 50% of capital receipts in debt redemption has provided greater investment capacity to Councils. Undoubtedly, many of the issues of under investment in housing in Scotland could readily be addressed if the proceeds of Council House Sales were to be used to renovate existing housing stock.

Housing Capital Receipts for Scotland amounted to £820million in 1998-1999. Only £205 million could be used to support housing investment. Permitting local authorities to deploy all their receipts in housing investment could make significant moves in reducing the backlog in investment.

This would not, on a national scale, represent an imprudent use of resources as no additional borrowing would be required, rather the redemption of debt would slow down.

Furthermore, this investment would accord with the Chancellor's rules for borrowing aimed at stimulating capital investment.

RESTRICTIONS TO TAKING FORWARD THE MODERNISING AGENDA

9. **Good housing is seen as essential to good health, social justice and welfare. The Government is seeking to address the issues of social inclusion and the general improvement of public services by reinforcing links between services.** Good housing has a high influence on health and displays a strong correlation with academic achievement. It is also central to a range of social issues such as the successful re-introduction of offenders into society and the success or otherwise of young children in care integrating into society. Furthermore, a substantial majority of Council house tenants are now elderly, receiving a range of curative and palliative care. **The move to create a financial incentive to transfer housing stock away from local authorities by maintaining unnecessarily tight Section 94 controls on local authorities undermines the modernisation agenda** by:

    - stifling Councils' capacity to make housing stock energy efficient;
    - preventing housing stock from being renovated to meet the needs of modern society;
    - reducing Councils' capacity to provide housing within the framework of care in the community;
    - reducing Councils' capacity to directly invest in their own housing stock to improve health and even educational attainment through home-work initiatives.

    Housing transfer, in itself, will do nothing to assist the trend to an holistic approach to community planning and service delivery.

10. Some local authority housing investment has involved differing types of public private partnership investment. Window replacement and central heating schemes have been arranged through operating leases. Often this approach to investment has been adopted as a means of mitigating the constraining effects of Section 94 consents. It may be the case that in a number of years, the revenue consequences of such approaches may present financial difficulties for the Councils involved. On the other hand, it may prove to be a success. Notwithstanding**, the abolition of Section 94 consent restrictions would enable Councils to select the most suitable method for financing capital works within a prudential framework.** The increase in flexibility would, under a best value regime, lead to a greater demonstrable case of appropriate means of investment.

PRUDENTIAL SAFEGUARDS

11. The development of a system of self-regulated prudential safeguards needs to be placed within a wider context. Many of the developments apply to all local government but some are unique to housing:

    - the introduction of community planning and leadership;
    - the Best Value/Modernisation agenda;
    - the recognition of increased tenant participation and empowerment;

- the development of resource accounting in central government and the Chancellor's rules on borrowing;
- the creation of new and innovative approaches to finance and service provision through the growth of PPP;
- the Partnership Framework Agreement between COSLA and the Scottish Executive to address issues of mutual concern.

12. Ultimately, all borrowing has to be paid for and all capital investment flows through to revenue charges which have to be met in the main by Council house tenants. **The average debt per Council house in Scotland is only £6,530 whilst one Council has an average debt level of £3,010 per house.** The implementation of prudential ratios would introduce a more appropriate and balanced consideration of investment funded through CFCR and that funded over the life of the asset.

13. **A consistent approach between the HRA and the General Fund is essential as both would be borrowing through the statutory loans' pool used by all Councils as the mechanism for the management of external debt.**

14. At present, the level of housing investment is determined by the level of consent rather than whether there is a sound business case. The abolition of Section 94 consents could result in investment in new types of housing with private sector developers. Ideal examples of this type of initiative might be niche housing for the elderly or the young. The important issue for existing tenants is that new housing investment would be built on a sound business case. Similarly, renovation of existing housing stock would be dependent on the trade-off between the quality of housing and the level of rent. Once again, the regulatory system of prudential ratios offers a better method of investment decision than the current approach of centrally determined consent levels.

    Whilst each proposal would be considered on its merits, a framework of prudential ratios would offer a safeguard. **The benefits of prudential ratios is that they permit local needs and priorities to be balanced with long-term local interests whilst offering appropriate safeguards to Government, Councils, tenants and other stakeholders.**

COMPLEXITY AND LACK OF STABILITY

15. The advantage of a system of prudential ratios is that it would enable local authorities and the Scottish Executive to focus on outcomes rather than inputs. Any system that attempts to impose control centrally tends to create ways of by-passing the controls as Councils seek to fulfil local objectives and priorities. New rules are introduced to close loopholes and hence the system becomes progressively more complex placing an additional burden on the regulator. **Hence, a move to a system of self-regulation would facilitate the development of partnership relationships between the Scottish Executive and local authorities in taking forward the modernisation agenda for public services.**

16. Systems of self-regulation are by definition trusting and designed to encourage good practice. The abolition of Section 94 consents and their replacement with prudential ratios should produce more business like decision-making cultures through improved accountability and business practices. Investment decisions both at project level and aggregate level will be based on the business or service cases.

17. **The relative instability of housing investment is exacerbated by the system of annualised controls and the profound influence that Council House sales can have on investment.** Indeed, Right to Buy often destabilises Housing service Plans. Moving to a system of prudential ratios would do much to facilitate a stable capital investment programme at local authority level whilst allaying any Government concerns on individual councils' capital investment decisions.

DELIVERY OF NATIONAL PRIORITIES

18. Moving to a system of prudential ratios and the abolition of Section 94 consent controls should enable housing investment to be adequately financed and deliver on objectives. Furthermore, three main housing issues could be addressed in a way felt more appropriate to local circumstance and in a more holistic way:
    - Increasing tenant participation and stakeholder participation;
    - The effective implementation of community planning;
    - The joining up of services in a way best suited to deliver tailor made solutions to individuals and households.

19. The continued existence of tight Section 94 controls is often described as the main obstacle to further housing investment and the main driver of housing transfer when these are, in reality, problems of Central Government accounting. The fact that HRA revenue expenditure is not included in LASFE definitions whilst local authority housing investment is counted against the Assigned Budget, suggests an inconsistency in central Government accounting definitions. **The implementation of a system of prudential ratios may do much to promote the genuine benefits and disadvantages of large-scale transfer and restore the importance of housing as an instrument of social policy.**

EFFECT ON HRA's

20. In considering this Section, recognition needs to be made that not all HRAs are the same. Two or three Councils still receive Housing Support Grant whilst at least one is able to subsidise other services from surpluses generated by the Housing Revenue Account. This is further reflected in the differing balance sheet strengths of several authorities. Some Councils' historic borrowing exceeds the value of their housing stock. Developing systems of prudential ratios will require these factors to be considered. There will be a need for ongoing Government support to some HRAs for the foreseeable future and in a form that guarantees future revenue streams if prudential ratios are not to adversely affect these authorities. However, this represents a small minority of Councils.

CONCLUSIONS

21. **This Section has demonstrated many of the practical difficulties of the council housing capital investment decisions and management. It describes the deficiencies in the system and the problems resulting from central Government's lack of trust of local government. This relationship should be changed to one of partnership. The move to abolish the Section 94 controls and their replacement with a system of prudential ratios will do much to promote a trusting relationship. The move to a system of prudential ratios will do much to address the investment backlog. Investment decisions will be built on sound business cases within a best value framework. Furthermore, it will enable the merits of housing transfer and the modernisation agenda to be considered within a policy as well as a financial context. Finally, the system of prudential ratios offers the Government adequate reassurances on public finances.**

INTRODUCTION

1. In 1996, the former Administration introduced set-aside arrangements for all local authorities whereby councils were required to apply a percentage of receipts generated from the sale of assets to redeem debt. The grounds for this measure were that such an arrangement would address the rising capital debt burden on the Housing Revenue Account and stimulate stock transfer.

2. Initially, the set aside was set at 25%, but the level was raised to 75%, where it has remained. Yet the case for imposing set aside in the first place was not a strong one. Councils were forced, under Government policy of reducing Housing Support Grant and imposing strict limits on capital consent, to use their capital receipts to improve council housing.

3. Local government has strongly argued that the set-aside arrangements should be removed and that there is a clear case for its abolition.

CASE FOR ABOLITION

4. The case for abolition is overwhelming:

   - the Government accepted the case for abolition of set-aside for non-housing capital and this has already been acted on. In keeping the set-aside arrangements for housing capital, it is creating an anomaly within the system.

   - the climate in which set-aside arrangements were introduced has changed dramatically. When set-aside arrangements were first introduced, COSLA and councils were opposed to stock transfer and the then Administration was set firmly on a collision course. That position has changed considerably. The majority of councils are either actively pursuing community ownership or other alternative models of housing provision in their areas.

   - the continuation of set-aside arrangements is seriously restricting much needed investment in housing. Housing Capital Receipts for Scotland amounted to £820m in 1998-99 but, only £205m could be used to support housing investment. Permitting local authorities to deploy all their receipts in housing investment could do much to reduce the backlog in investment.

5. COSLA would accept that the requirement to utilise 75% of Right to Buy receipts has reduced the average loan debt per house and secured savings in loan charges. It has not however resulted in a reduction in overall housing benefit costs as rents have increased to partly offset the reduction in capital investment through enhancement of revenue contributions and as a result of a decrease in housing stock through Right to Buy, demolitions etc. The positive impact of set-aside on public expenditure is eroded because more public money is paid out through the Housing Benefit System. This contradicts the Government's golden rule which states that '*over the economic cycle, the Government will only borrow to invest and not to fund current spending*'.

6. The New Housing Partnership Programme has introduced exceptional provisions whereby local authorities with a high level of outstanding loan debt have either a proportion or the total value of this outstanding amount met through Scottish

Executive funding. COSLA believes there is a strong argument that there should also be flexibility for local authorities who have a below average debt level but nevertheless still have investment requirements and pressures on rent levels which ultimately result in an overall increase in public spending on housing benefit costs.

7. An illustrative practical example of this is: -

Capital resources for Authority A

	£'000	**£'000**
Borrowing Consent		12.3
Total Capital Receipts	20.8	
Less Debt Repayment	15.4	
Useable Receipt		5.4
Revenue Contributions		7.1
TOTAL RESOURCES		24.8

The revenue contribution of £7.1m equates to an average weekly rent equivalent of £2.84 per house based on a housing stock of 48,072. If the Council was able to utilise an additional £7.1m of its capital receipts on investment, the loan charges associated with this cost would amount to £0.7 million, equivalent to a weekly rent figure of 28p per week, again based on a housing stock of 48,072.

The potential revenue, therefore, in the first year of such a scenario could be as follows: -

	£'000
Cost of Revenue Contribution	7.1
Cost of Borrowing	0.7
Potential Revenue Saving	6.4

This saving could in turn reduce pressure on Housing Benefit Costs or alternatively increase/accelerate investment programmes. In terms of the impact on Housing Benefit, based on 64% of all tenants being in receipt of benefit this would be as follows:

	£'000
Total Potential Revenue Saving	6.4
Reduction in Housing Benefit based on 64%	4.1
Reduction in Housing Benefit Subsidy based on 95%	3.9

If the Scottish Executive would provide local authorities with greater flexibility to utilise an increased proportion of capital receipts, the following positive outcomes could be achieved: -

- Increased capital investment for housing;
- Average debt levels being maintained at a level reflecting the increased investment in the stock;
- A slowing-down of the increased cost of housing benefit, and
- Annual rent increases being less than under the current system.

CONCLUSIONS

8. **COSLA and local authorities have continued to lobby Ministers on this issue, but to no avail. Ministers continue to argue that *'there are good reasons for maintaining the set-aside rules in housing'*. However, this is clearly contrary to COSLA's view based on the reasons outlined above for abolition.**

9. **COSLA is strongly of the view that housing receipts set-aside arrangements should be abolished with immediate effect**.

INTRODUCTION

1. This Section considers the question of match funding out of capital resources. Traditionally, capital projects have been funded, in the main, from borrowing and from income derived from the sale of capital assets. However, for some years now, there has been insufficient investment in local government buildings and infrastructure (such as education properties, roads and bridges, etc.), due to inadequate capital consents. This is an escalating problem, as the greater the deterioration in the properties, the greater the required investment to reinstate them to a reasonable condition or to replace them.

2. As a result, local authorities have sought alternative means by which they could enhance the funding available for capital projects. Such alternatives have also been pursued for possibly less critical, but nevertheless desirable and necessary projects such as leisure complexes, etc. These alternative sources of funding include European Structural Funding and National Lottery Funding, etc., in addition to mechanisms such as PFI/PPP.

3. The accessing of external funding from sources such as the European Union and the National Lottery Fund can be both advantageous and disadvantageous.

   Clearly, the main advantage is that any such external funding augments the resources available to a local authority which, in turn, allows it to proceed with a more extensive capital plan than would otherwise be the case.

4. The main disadvantages are that firstly, a project of higher priority may have to be excluded from the capital plan in favour of a lower priority project that can attract external funding. This is due to the local authority having to contribute “match funding” which could otherwise have been earmarked for higher priority projects. Secondly, there can be considerable uncertainty in planning for match funded projects as such projects are normally subject to an application and bidding process and the timing of approvals or refusals does not always sit comfortably with the preparation and agreement of a Council’s annual capital plan.

5. It may be that consideration could be given to the timing frameworks in an endeavour to ascertain whether or not there could be room for manoeuvre that would assist local authorities. However, this could be extremely difficult in view that the funding organisations would be unlikely to change procedures which they operate on a national or European basis.

6. As match funding can be a problem in terms of re-prioritisation of projects, (even during a financial year, when the capital plan has already been agreed some months previously), consideration should perhaps be given as to whether there is scope for examining match funding mechanisms. Again, however, it has to be recognised that any decisions in this regard would then have to be discussed with other partner organisations.

MATCH FUNDING

7. Although external funding can be obtained from other sources (such as Enterprise Companies, Challenge Funding, etc.), it is considered that the European Union and the National Lottery possibly provide the greatest proportion of such funding to local authorities.

8. Generally, the **European Structural Funds** provide grants to organisations to support projects throughout the UK that promote social and economic regeneration and competitiveness. Most of the funding is concentrated on areas of identified greatest need, ie Objective 1 and 2 areas. It is also the case, however, that although public sector organisations can apply for EU funding, it is possible to develop projects that have private sector match funding.

   In general, the proportion of aid from the European Union rises to a maximum of 50% for activities under most of the Objectives except for Objective 1 where the limit is raised to 75%. In Scotland, Objective 1 only covers the Highlands and Islands until 2005.

9. **The National Lottery** currently generates funds for six "good causes" - the arts, sport, heritage, charities, projects to mark the new millennium, and the New Opportunities Fund. It is understood that percentages of funding vary, and can be as high as 70% in the case of the Heritage Lottery Fund.

10. Why do funders like match funding? - It demonstrates the credibility of the project if another funder has already decided that it is "worth" funding. It also stretches funders' resources further so that they can be seen to be supporting more projects. Furthermore, it gives the funder a sense of value for money, as they can be part of a project without having to fund it 100%. Finally, a project which already has some funding in place is less risky to support than one that has no funding.

FOR CONSIDERATION

11. Given the very diverse sources of funding and the complexities of the issues involved, it is clear that further research and investigation is required. However, it is suggested that this should consider the following :

    - **A lesser percentage of match funding by public sector organisations**
      Match funding helps to demonstrate credibility and commitment. It may be, however, that this is more important where the beneficiaries are private organisations, charities, or smaller organisations (particularly where they are run by volunteers). Where the beneficiary is a public organisation whose main remit is to provide quality services within its area, then it may be less important that credibility and commitment have to be actually demonstrated through, say 50% match funding and it may be that a lower percentage could be applied.

      There may therefore be an argument that match funding by public sector organisations should be less as there is not the same necessity to have to demonstrate commitment through significant match funding. This would enable Councils to apply the amount saved, by the match funding reduction, to other capital priorities. It is also recognised, however, that the funding bodies would then have to spread their resources over fewer projects.

    - **The timing of grant payments**
      Grant is generally paid in arrears, and there can therefore be difficulties in relation to: cash flow (interest costs); and annuality (project expenditure incurred in an earlier year than that in which the grant is received). It may be that an argument could be made for a percentage of grant to be paid in parallel with the estimated project expenditure being incurred.

- **The question of grant retentions**
  This can also be problematical. It has been reported that Councils can wait up to five years for payment of retentions. Perhaps, more flexibility and realism could be applied particularly where the receiving organisation is a public body such as a local authority.

- **Less Bureaucracy**
  It is generally the case that public organisations have to complete the same detailed paperwork as other smaller organisations. There may be an argument that “blue chip” public bodies should be asked to complete less onerous paperwork. This could facilitate speed and timing of applications and would reduce the administrative resources required to submit funding bids.

- **Stop Challenge Funding**
  Until the current disadvantages of match funding are resolved or reduced, the Scottish Executive should refrain from setting up further challenge funding initiatives which require match funding.

CONCLUSIONS

12. **In total capital terms, the percentage earmarked within Councils’ capital plans for match funded projects varies considerably, but can be significant.**

13. **Consideration needs to be given to the proposals suggested in this Section. It may be the case that Councils could increase the incidence of match funded projects within their capital plans if lower percentages of match funding and more streamlined application and grant payment procedures could be negotiated.**

INTRODUCTION

1. As part of the proposals for changes in the capital arrangements, further consideration needs to be given to the arrangements for reporting and monitoring of capital spend which may be complementary to and supplement a self-regulated prudential safeguards regime. Crucially, such reporting and monitoring arrangements should be compatible with developments on revenue to introduce local outcome agreements and should appropriately reflect the balance between national and local priorities.

CURRENT ARRANGEMENTS

2. Under current arrangements of capital reporting and monitoring, local authorities are not required to submit a Capital Plan to the Scottish Executive for approval. Monitoring of spend is conducted by way of quarterly returns which report retrospectively and provide forward projections. Separate returns are required for both the Non Housing and the Housing Programmes.

Non Housing Capital Programme

3. Quarterly monitoring returns are required, together with a more detailed end of year return. The guidance accompanying the Scottish Executive forms states:

"*The returns are required for national expenditure limit control purposes as they provide information on net expenditure on all non-housing services. Net expenditure is calculated as gross capital payments not funded from revenue less capital receipts used. The CPR returns separately identify receipts raised from asset sales. This will be used to monitor forecast receipts data provided separately to inform the distribution of capital allocations."*

The details required in the quarterly returns are :

- Summary of financing of capital payments
- Summary of position on receipts
- Service breakdown of capital payments and receipts
- Breakdown of EC receipts by type

4. At the end of the financial year, councils submit a form to the Scottish Executive giving year end actuals and a more detailed service breakdown of the capital payments. That form also provides information on leasing and covenants. Finally, a capital certificate is completed annually and is certified by the external auditor.

Housing Capital Programme

5. Quarterly returns are required.

The details required in the returns are :

- Forecast and actual to date, for borrowing, capital receipts and payments
- Breakdown of forecast and actual to date capital receipts.

A capital certificate is also completed annually and is certified by the external auditor.

DRAWBACKS OF THE CURRENT ARRANGEMENTS

6. The Scottish Executive and COSLA are in the process of developing Local Outcome Agreements which will focus on outcomes rather than inputs (see Part 6). Current reporting and monitoring arrangements focus on capital spend ie. the input and this does not sit neatly with the Local Outcomes Agreement initiative where the focus is on the outcomes. The shift in focus on service delivery needs to be reflected in both revenue and capital returns.

7. The focus in recent years on Best Value has also meant that local authorities have been encouraged to develop capital plans using the principles of Best Value. However, this is not reflected in the returns currently made to the Scottish Executive. Again, the shift in service delivery and focus needs to be reflected in both revenue and capital returns.

8. Whilst arrangements have been put in place for Policy Statements to be provided by individual councils, it is worth reviewing how effectively these are operating. Policy Statements were originally intended to complement the information in the capital returns and to be statements on proposed capital commitments for a specified period.

9. Single Capital consents have now been issued for 3 years. The current reporting and monitoring arrangements only reflect a one year statement and do not take into account the impact of the longer term commitments being made. There is also limited flexibility between years which might have been expected given the multi-year announcements and recognising the fact that capital projects span a number of years.

10. The current capital reporting and monitoring arrangements reflect an annualised consent system. Any shift towards a prudential framework must be accompanied by complementary changes to capital reporting and monitoring arrangement.

PROPOSALS FOR NEW ARRANGEMENTS

11. **New monitoring arrangements should be related to and linked to the principles of local outcome agreements and the operation of a prudential framework for capital investment.** The Planning Framework proposed in Part 3 – Section 1 should address the reporting arrangements in relation to local outcome agreements. However this could be supplemented with a financial plan setting out how the Council intends to fund its investment programme. It is not yet clear what the length of the timeframe will be for Policy Statements, but for the purposes of financial planning they should be on a **minimum 3 year rolling basis and should review progress as well as looking forward.** The prudential framework should be seeking to show that capital expenditure is affordable in terms of its impact on revenue and how it will feed through to Council Tax levels and Council House Rent levels.

12. **It is important that the reporting requirements meet the needs of both the local authority and the Scottish Executive.** The abolition of Section 94 consents, whilst giving local authorities greater freedom in their investment decisions, will also place a much greater responsibility on local authorities to ensure sound financial planning. **Councils share the Scottish Executive's concern to protect services and future Council Tax payers**. It should therefore be possible to agree the detail of monitoring returns which are useful to both parties and not unnecessarily bureaucratic.

13. Policy Statements are a positive way of opening up dialogue between individual local authorities and the Scottish Executive on the delivery of national priorities and how these sit with local policy choices. Policy Statements, with a financial supplement, could be presented annually. The timescale for monitoring returns in relation to the prudential framework would depend on the indicators adopted and the ease with which they could be reported during the year. There may be some indicators which would only lend themselves to reporting annually whilst others may be appropriate for quarterly reporting. Consideration needs to be given to external audit including the prudential framework within the remit of their audit work.

CONCLUSIONS

14. **The current arrangements are inappropriate based on changes in recent years through the issuing of consents covering a three year period and the proposed changes with the introduction of a prudential safeguard regime. They are unduly bureaucratic and ineffective in meeting their intended purposes.**

15. **Changes need to be made which complement the development of Local Outcome Agreements.**

16. **The abolition of Section 94 consents will place responsibility on councils to ensure sound financial planning and this needs to be reflected in revised reporting and monitoring arrangements which meet the needs of both individual local authorities and the Scottish Executive.**

INTRODUCTION

1. This Section proposes the case for an update of the regulatory framework in Scotland for investments. The forthcoming Local Government Bill provides an appropriate opportunity to address the issue.

BACKGROUND

2. The principal reference point for borrowing and lending in Scotland is Schedule 3 of the 1975 Act. It is understood that this, in some measure, is in turn based on much earlier legislation dating back to 1947.

3. This Act only specifically allows lending to other Councils, a harbour authority or community council. Consequently, core treasury investment activity, such as lending to banks and building societies, has had to rely on the general powers of Section 69 of the 1973 Act and related Counsels' opinions in the interim.

4. The position in Scotland can be contrasted with that in England and Wales, where there is in relative terms a more contemporary legislative framework provided by the Local Government and Housing Act 1989 and the Approved Investment Regulations 1990. Indeed, this is currently actively under review and it is anticipated that change will be forthcoming.

5. Whilst a workable *modus operandi* has emerged, the legislative environment in Scotland inevitably causes difficulties and uncertainty for practitioners, market players and auditors from time to time.

6. The Best Value Regime, the rationalisation in the financial markets and an improved climate of dialogue between central and local government also suggest that a review and updating of the regulatory framework for investments is required.

CASE FOR CHANGE

7. The core legislative reference i.e. Schedule 3, 1975 Act is deficient as it fails to provide for the most basic investment activity. As a consequence, undue reliance has had to be placed on the general powers of Section 69, 1973 Act and Counsels' opinions.

8. It is probable that improvements will be made to the regulatory framework in England and Wales. This will further widen the gap with Scotland. There is no valid reason why there should be such divergence.

9. Markets have changed considerably since 1975, both in terms of structure and products available e.g.

    - mergers between banks, between building societies and between banks and other financial institutions resulting in reduced high credit rated investment opportunities.
    - high credit rated, sterling denominated, supranational bonds e.g. European Investment Bank relocating from the London market to Luxembourg

- emergence of AAA Money Market Funds, a stand alone pooled investment vehicle which actively invests in a diversified portfolio of high grade, short term money market instruments
- revisions to the London Code of Conduct

10. Moreover, local authority treasury operations are now more sophisticated and operate within the framework of the CIPFA Treasury Management Code which is periodically revised to reflect changing circumstances. An updated CIPFA Treasury Management Code should be operative from April 2002. This version will reflect a less strict stance on the balance between risk and return to reflect the Best Value environment. The Code, however, still emphasises the overriding importance of effective risk management and the importance of capital protection.

11. The Scottish legislative framework is not in alignment with these developments. The current legislative framework does not sit comfortably with the Best Value Regime.

12. In parallel with this investment initiative, Section 1 refers to proposals for a new Prudential Framework for capital finance. This will be underpinned by a strong element of self-regulation.

13. Also, the regulatory framework compares unfavourably with that in other parts of the public sector. Whilst NHS bodies are considerably constrained, certain registered social landlords and many universities have greater latitude.

WHAT SHOULD THE CHANGE COMPRISE?

14. CIPFA in its response to the DETR's Consultation Paper - "Modernising Local Government Finance : A Green Paper" - specifically recommended that the investment regulations included:-

    - AAA money market funds
    - simple derivatives
    - foreign based AAA products
    - an extension to the 364 day limit

15. AAA money market funds are an attractive investment alternative offering a combination of the highest credit rating/attractive yield/flexibility. This is particularly so for small, risk averse councils which find their relatively small deposits unattractive to the "top division" banks. A similar outcome can impact on other councils as they pursue diversification. For the purpose of authorisation, the Funds would require to be defined.

16. Derivatives have a part to play in the effective management of a treasury operation, particularly for the larger councils. CIPFA has previously submitted to HM Treasury the case for allowing councils to have access to simple derivatives such as SWAPS and Caps. The authorised derivatives would require to be specified and be linked to the underlying investment principal to avoid any risk of trading activity.

17. The 1990 Investment Regulations in England and Wales allowed councils access to sterling denominated supranational securities e.g. European Investment Bank was admitted to the London Stock Exchange. In the interim, however, driven primarily by cost considerations, these securities are now largely registered in Luxembourg.

18. The restriction on investments to under one year may not offer the best value return where the nature of a fund or cash flow projections show that the investment period will extend beyond one year. The current regime would require a series of short term deals when a long term i.e. beyond 364 days, may offer a superior return.

19. The regulations in England allow local authorities to use Certificates of Deposit issued by banks, but they do not allow bonds issued by these same institutions. Debt issues by highly credit-rated banks would have similar risk-reward characteristics to gilts, which the regulations in England do allow. The case for gaining access to these, and other highly rated**,** short-dated corporate bonds, is strengthened by the reduction in new gilt issues reflecting the state of the UK government's finances.

20. The regulations in England do not allow investment in Commercial Paper (an instrument similar to certificates of deposits) issued by highly rated companies.

21. A suitable way forward may be to harness and update the English Approved Investment Regulations 1990. This would include an extension to allow additional investment sources such as AAA money market funds as outlined above. Cross reference may also be made to the list of authorised institutions as provided under the Banking Act 1987, with this also covering a credit rating dimension.

22. This revised regulatory framework would be supplemented by a strong element of self-regulation, achieved primarily through the revised CIPFA Code of Treasury Management.

CONCLUSION

23. **This section makes a compelling case for change, both in terms of a clearer regulatory framework and in the potential range of investments that might be authorised. Progress is being made in England towards a more satisfactory and contemporary investment environment and there is no valid reason why Scotland should not be moving in the same direction. The updated regulations would be supported by a strong element of self-regulation, articulated in the CIPFA Code of Treasury Management, and emphasising core objectives of prudence, diversification and the effective management of risk.**