LGiU

# Constrained autonomy and uncertain viability in Scotland:

## Local government finance challenges in a new political landscape

LOCAL DEMOCRACY RESEARCH CENTRE

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**Published by the LGIU's Local Democracy Research Centre, July 2024**

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# Foreword

In Autumn 2023 LGIU launched the results of our first survey of all council leaders, chief executives, and chief finance officers across local government, investigating their opinions on how local services are financed in Scotland, as well as their confidence in the system.

The results were not positive, to put it mildly.

Just one respondent told us they were confident in the system, while respondents from eight of Scotland's 32 councils said they were at risk of bankruptcy. Meanwhile, the relationship between central and local government was shown to be in a poor state, with only 8% of respondents happy at the progress Scottish Government has made involving local government in decision making.

The 2023 Verity House Agreement between councils and Holyrood had laid the groundwork for a positive and more equitable centre-local relationship. However, the then First Minister's decision to freeze council taxes, without consultation, undermined the foundations of that agreement and removed one of the crucial tools available to local authorities to raise revenues independently. The announcement came just as our survey was opening and undoubtedly shaped responses.

Across the sector there is consensus that local government has not been properly funded in Scotland. Local government's power to independently raise or spend revenue as it sees fit is even more restricted in Scotland than it is in England, itself an international outlier. We know that the system is not working as well as it could, and the sector is calling out for change before the disastrous state of council finances in England is repeated in Scotland. The next question is: how could local government finance be different?

This paper is the fifth in a series of reports on international systems of local government finance by experts at the University of Northumbria. The series has provided a fascinating exercise that helps us to take the next vital step in examining how local government finance systems could be improved. By building a shared understanding of the different ways local services are funded across the world, especially outside of the English-speaking world, we can identify the most effective ways to ensure local governments work for their citizens.

This report is both a detailed assessment of local government finance in Scotland and provides a useful point of comparison with other systems. It covers the historical, legal and constitutional context, as well as some of the politics and peculiarities of the system. There are useful and illuminating lessons to draw for local government elsewhere and this chapter could be read alongside our existing reports on Germany, Italy, Japan and England, there are thought provoking lessons for Scotland too. In due course we will release further reports looking at Ireland, France and Spain. These will reveal more lessons and insights that will be of real interest to anyone working in or interested in local government finance systems around the world.

**Jonathan Carr-West**
**Chief Executive, LGIU**

# 1. Research overview

This report forms part of a wider research collaboration between Northumbria University and the LGIU (Local Government Information Unit). The aim of the research project is to systematically research international local government finance systems. In order to highlight the underlying role of public finance and funding for the efficient running of local government, territorial development and concerns of devolution and decentralisation.

In our system based perspective, the system is made up of multiple agents: for example, local government officers, civil servants, politicians, thinktanks, audit authorities, communities, lenders and financiers who all have their own objectives and decision-making frameworks. All of these elements interact with each other, and coalesce with the technical aspects of budgeting, accounts and monitoring, over time, to form a whole that is more than sum of individual agent or technical objectives.

It is this complex system of actors, regulations and technical institutions that enables and constrains local government finance. Calls for additional funding or tax-raising powers, and more unorthodox borrowing practices, often emerge from, and are constrained by, this broader and connected context. However, the relationships between the different elements of the system are often disregarded, resulting in a partial understanding or misrepresentation of the local government finance challenge. This research maintains it is not possible to comprehend local government by focusing on one component, authority, or agent. A holistic approach is necessary.

## 1.1 The research project

This report focuses on local government finance in Scotland. The local government finance system in Scotland has common ancestry in English practice and shares many of its features. However, while already having longstanding territorial procedures relating to public finance, such as the Barnett Formula for allocating financial resources to Scotland, Wales and Northern Ireland, practice in Scotland has diverged significantly following devolution and the creation of the Scottish Parliament and the Scottish Executive following the Scotland Act in the late 1990s – the basis for the Scottish devolution settlement. We are not aware of any contemporary analysis of the Scottish system as a system. Without such understanding, it is not easy to comprehend the role and significance of individual elements of these systems, how they interact and, in turn, how they could evolve or inform best practice elsewhere.

Perhaps, because Scottish Government (and its associated powers) are devolved, local government finance is also often taken to be progressively devolved in Scotland. With local authorities assumed to have greater freedom and discretion to make decisions and allocate resources. The recent Verity House Agreement has led this assumption more credence, being held up as a more progressive and meaningful basis for intergovernmental relations (COSLA 2023a). However, these perceptions provide little sense of how the Scottish system works in practice, nor how it can be compared or applied to other international local government settings.

The system focus on Scotland provides new understanding for practitioners, policy makers and academics engaged with the financing of local services and those seeking a broader understanding of sub-national governance systems and their relationship with the state and politics. The intention is that the insights in the research can be taken

forward by local government practitioners and policy makers to help articulate how new approaches to local government finance could be implemented effectively. In turn, the same insights have relevance for the local government finance system in Scotland, which is now operating under a very different political reality following the land slide victory for Labour in the recent national election, and indeed any international location that is struggling to finance the increasing demand on local services. The system wide focus adopted in this study examines the following features in Scotland:

- The structure of sub-national governance.
- Local authority functions.
- Local authority expenditure.
- Legal requirements regarding financial management.
- Sources and quantum of revenue, including central transfer grants.
- Powers concerning capital finance.
- Systems of equalising funding between territories.

## 2. Methodology

In order to examine this situation, a mixed research methodology has been developed and utilised within a cross-disciplinary perspective, blending insights from policy, territorial governance, finance, and real estate studies. Taken together, the empirical and secondary information products lay the foundation for creating a total system perspective of each location that is rarely seen in international literature.

The foundation of the empirical research is a multi-phase interview process. Respondents were identified in Scotland based on their expert knowledge (derived from experience in various tiers of Government, oversight organisations and academia) of the respective local government finance systems. Identifying respondents in each location was not straightforward due to the relative dearth of stakeholders with system-wide knowledge and the generally hidden nature of the sector. The Scottish Parliament Information Centre (SPICe) and Audit Scotland were particularly helpful in brokering connections, answering questions and acting as a critical friend in the development of this research.

The interview process included:

- initial scoping interviews to provide context for the research and direction towards relevant resources and information on practice within the local government finance system in Scotland.
- subsequent scoping interviews with local government finance experts to provide context and direction to relevant information sources.
- the research team then returned to the respondents with findings, to cross-reference and sense-check the evidence leading to a valuable process of draft refinement and gap analysis.

More than 30 expert respondents from government, audit, politics and research domains were interviewed at least once in the research across individual, panel and discussion group formats. Alongside interaction with the stakeholders, the research examined information from secondary academic literature, government documentation and legislation regarding the legal structures and institutions underlying practice in Scotland.

Concurrently, data was sourced from Government ministries and allied organisations to reflect the quantity and proportion of income sources in each location and to provide an opportunity for comparison. Reflective of the fragmented situation in many other countries, obtaining detailed and accurate information on the operation of local government finance systems was complicated, with sources sometimes providing contradictory information. In such cases, expert partners from SPICe and Audit Scotland were used as a validating mechanism for stress testing the information sources and the rigour of the interpretation.

## 3. Outputs

This is the fifth international investigation of local government finance systems in this project, following examination of England, Germany, Italy, and Japan. It is the first known system wide enquiry into Scotland, as it relates to the functioning of its local government finance system. This is significant, due to the systematic devolution arrangement between UK and Scottish Government, Scotland is often assumed to exercise decentralised power and resource. However, findings will make clear this is not the case on the ground in Scotland. Resource power is typically held within Scottish Government.

## 4. Context: Political economy in Scotland

In Scotland, in terms of local government working and specifically local government finance, the following challenges are evident:

- In recent years local authorities in Scotland have received marginally more revenue from all sources in cash terms compared to England. However, when adjusted for the impact of inflation they have seen year on year real term decreases (Scottish Government 2024b, Audit Scotland, 2024).

- Local authorities have received marginally more grant funding from the Scottish Government in recent years, in comparison to English authorities. However, this has occurred in tandem with increased ring-fencing and/or tacit expectations that funding will be spent in specific areas – it is still the case that the vast majority of funding for local authorities is derived from Scottish Government (as much as 60% according to the latest local Government Financial Bulletin in 2022/23 (Audit Scotland 2024)). The result is decreased discretion in where funding is allocated at a local level. Protected services (for example adult social care and education) remain resilient in comparative terms while unprotected services (for example planning, culture, leisure, and environmental services) have seen the most cuts.

- Sources of local authority income are heavily reliant on the Scottish Government – sources of income and flexibility to vary this income are even more constrained than in England. Funding is derived mainly from the General Revenue Grant (GRG) and General Capital Grant (GCG), non-domestic property tax (which is collected by local authorities but ultimately redistributed by Scottish Government), council tax (collected and retained by local authorities), additional government grants,

and local fees and charges. In England, there is some provision to retain non-domestic property tax locally. Neither location has access to portions of nationally set income, corporate or value added tax, seen widely in other international locations. This is in stark contrast to the external belief that Scotland is a trail blazer for devolution and decentralisation.

- The recent Verity House Agreement (see Section 5 for more details) agreed between Scottish Government and the Convention of Scottish Local Authorities (COSLA) has called for the end of ring-fencing[1] and directed spending alongside long term funding settlements and more local discretion. This echoed the Local Governance Review in 2021 which demonstrated local people want greater control over where they live. However, while this is a national objective there has been very little practical change[2] in this direction. Indeed, there has recently been a unilateral council tax freeze (without consultation with COSLA) that has further reduced local discretion, disrupted local budget setting, and led to questions about the long-term resilience of Scottish local government finance. To place this in context, the Institute for Fiscal Studies (IFS) in 2023 argued that local authorities would face cuts even if they increased council tax by 5% due to rising social care costs.

- Local authority revenue budgets face significant pressure, with local authorities indicating that a) financial constraints could stop them fulfilling statutory duties and b) non statutory investments faced considerable reduction (LGIU, 2024). Adult social care and children's services faced the greatest pressure in the short, medium, and long term.[3]

- Public sector capital budgets also face pressure across the board, presenting risk for the maintenance and long-term viability of key infrastructure such as roads and pavements and key everyday services such as schools, libraries, community centres and toilets. In addition, this constrained capital financing pressure has the potential to constrict attempts to progress towards climate change/net zero objectives.

- However, in part driven by increased borrowing (52% increase reported in 2022/23), local authority capital expenditure has recently increased in 2022/23 by 16% in cash terms to £3.6bn (Audit Scotland, 2024). Borrowing now accounts for more capital spending than government grants for the same activity. The costs of borrowing have decreased in recent years due to the increased flexibility in profiling debt over longer periods. While this helps the short-term budget position it defers costs into later years without considering the overall financial resilience of capital budgeting and financing via the overall revenue budget.

- Councils are increasingly reliant on savings and reserves as an active part of the year-on-year resource position. In parallel, there is an increasing call for greater transparency in the local authority budget setting and reporting process as increasingly difficult decisions are made that have a direct bearing on local services (Audit Scotland, 2024). It is apparent that significant numbers of local

1 As a default position, from this point onwards, unless there is a clear and shared rationale for it.
2 The 2024/25 budget transferred ('baselined') around £1bn of specific grant funding or funding transferred from other Scottish Government portfolios. However, this remains a small proportion of the overall income base.
3 Despite these service areas being relatively protected compared to other local government services.

authorities have also seen increases in their usable reserves (the total value of reserves is currently £4.46bn – £3.65bn revenue and £0.81bn capital). The reasons for this are currently unclear with some of this potentially down to left over Covid-19 funding, the longer-term profiling of debt finance or planned accumulations to manage challenges in future years.

## 5. Scotland subnational governance structure

Understanding local government finance in Scotland must be foregrounded by understanding the financial relationship between UK and Scottish Governments. The devolved financial settlement is underpinned by the Barnett Formula. Under the Barnett Formula (originally enacted in the late 1970s as a temporary method of managing disparities in income across parts of the UK), the financial settlement (known as the block grant) in any given year is equal to a baseline combined with an assessment of population share as it relates to changes in UK Government spending on responsibilities devolved to the Scottish Parliament – the latest revision to the policy framework associated with the Barnett Formula was the Smith Agreement in 2014[4].

The General Revenue Grant (GRG), General Capital Grant (GCG) and redistributed non-domestic property tax then form the block grant which is allocated to the local government finance system. The revenue is distributed between local authorities using a needs-based distribution formula (see Sections 9 and 11 for more detail) that is reviewed and revised each year in consultation with COSLA.

It is then important to understand the structure of local government in Scotland. Scotland is a constituent country of the United Kingdom which is a unitary state and parliamentary democracy. The current structure of local government in Scotland consists of 32 unitary authorities and came into force from the 1st April 1996 following the 1995 Scottish local elections which were enacted by the Local Government etc. (Scotland) Act 1994. The former two-tier system of regional and district councils introduced by the Local Government (Scotland) Act 1973 was abolished and the district councils (bottom tier) were aggregated into 29 single-tier area bodies, while the regional council areas (upper tier) were abolished. Council areas have population sizes[5] ranging from 51,540 citizens (Clackmannanshire) to 635,130 (City of Glasgow), significantly lower than the 2.5 million citizens that lived in the abolished Strathclyde Regional Council's area. These exclude the island areas: Na h-Eileanan Siar (26,640 pop), Shetland Islands (22,940) and Orkney Islands (22,540), whose councils were given equal status to unitary authorities with the 1994 Act.

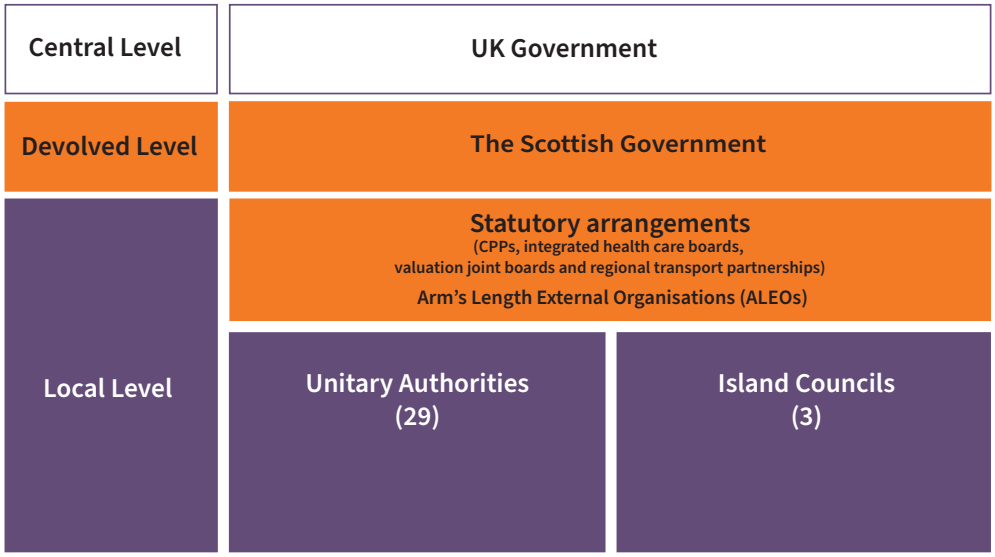
Each local authority is governed by a council composed of councillors elected directly by residents of the area and led by a council leader and cabinet. There are currently 1,227 elected councillors that are usually elected every five years. Their key role generally includes one or all of: executive decision-making, scrutiny of decisions, regulatory functions, or representing their ward (LGIU, 2023). Sitting below the unitary authority are community councils. Community councils were created under the 1973 Act but remained in place following the 1994 Act (district and regional councils were abolished). Community councils serve to bridge the gap between the local authority and the community, with the

4 The Barnett Formula, while planned to be temporary is still the enduring mechanism of financial allocation between England and Scotland. In contrast the Smith Agreement considered the devolution of powers to Scottish parliament, for example taxation, welfare, and social security.

5 Population stats taken from: Population of Scotland 2021, by region | Statista

community council composed of elected volunteers from the community (LGIU, 2023). There are approximately 1,200 active community councils[6] in Scotland, whose main role is to make public bodies aware of the opinions and needs of the communities that they represent. Local authorities have statutory oversight of community councils and are required to consult them on various matters, such as planning applications and licensing (Scottish Government, 2023a). An overview of the local government structure in Scotland is provided in Figure 1.

**Figure 1: Structure of local government in Scotland**




The move towards devolution started in the early 1970s when, following political debate in the 1960s, the Royal Commission on the Constitution reported recommendations in 1973 for a directly-elected Scottish Assembly to deal with most domestic Scottish affairs. The Scotland Act 1978 enacted this proposal, subject to a referendum. However, the *40 per cent rule*[7] electoral threshold was not met and the act was therefore repealed following a parliamentary vote. In 1997, following further political debate in the 1980s and 1990s, a second referendum was held when the Labour Party passed the Referendum (Scotland and Wales) Act 1997, which yielded a 74% majority vote in favour of a Scottish Parliament and a 63% majority vote in favour of tax-varying powers (House of Commons Library, 2023). The Scotland Act 1998 established the Scottish Executive (later renamed Scottish Government) and a range of powers were transferred from Westminster to the new Parliament on 1st July 1999 following the first election. A number of changes and additions to the Scottish Parliament's powers have since been introduced by the Scotland Act 2012 (following the Calman Commission) and Scotland Act 2016 (following the Smith Commission), with each assigning further 'devolved' powers to the Scottish Parliament (see Section 6 for more detail in relation to areas of responsibility).

As a devolved matter, the Scottish Parliament has the power to enact laws regarding local government. There have been a number of reviews and changes to aspects of local government as a result of national policy changes, namely:

6 Community Councils have very few powers or budget provision.
7 The "40 per cent rule" is an electoral threshold that requires 40 per cent of the total electorate to endorse the proposals, rather than of those voting. In other words, 40% of the total Scottish electorate were required to vote for a Scottish Parliament, rather than 40% of voters. This meant a 51.6% majority vote was rejected CBP-8599.pdf (parliament.uk).

1. The Local Government in Scotland Act 2003 introduced new duties for local authorities, including a requirement for councils to collaborate as part of a Community Planning Partnership (CPP). A CPP is the name given to all those services that come together to take part in community planning which includes services such as health boards, enterprise, police, and fire bodies, who are also CPP partners. There are 32 CPPs, one for each council area and each has a Place Director who is a senior civil servant and volunteers for the role alongside their day-to-day responsibilities[8]. CPPs have autonomy to create their own organisational structure but must act to ensure community participation and understand local need to identify local priorities. Two types of plans are produced to describe local priorities with improvement plans and timescales: 1) Local Outcome Improvement Plans, which cover the whole council area; 2) Locality Plans, which cover smaller areas within the CPP and usually focus on areas that will benefit most from improvement.

2. The Local Governance (Scotland) Act 2004 amended the local government elections process to a Single Transferable Vote (STV) system - moving from first past the post elections to one based on ranked preference. This influenced local election results and led to a general shift in local authority control - moving from majority parties to party collaborations, often involving two parties plus Independents and sometimes in the form of a minority coalition. The 2017 elections were particularly notable, with no parties winning outright control of a council area which resulted in 19 coalitions and 10 single party minority administrations. This in contrast to the 1999 elections in which only 4 of Scotland's 32 Councils had no overall control, with a general trend away from majority party councils (SPICe, 2019). Since 2022, 2 of 32 councils are controlled by a majority party: Dundee City Council – Scottish National Party, and West Dunbartonshire Council – Labour Party.

3. Legislation has been introduced by Scottish Parliament that has changed the responsibilities and partnerships of local governments. The Police and Fire Reform (Scotland) Act 2012 reallocated police and fire services from local government to the Scottish Government, with the formation of Police Scotland and Scottish Fire and Rescue Service. Historically, these services would have been provided by the Regional Councils under the Local Government (Scotland) Act 1973. The Public Bodies (Joint Working) (Scotland) Act 2014 introduced Integration Joint Boards to bring NHS and local authority care services under a single partnership.

Significant change has been driven by the Convention of Scottish Local Authorities (COSLA), which was formed in 1975 to act as a link between local authorities and central government to encourage collaboration. COSLA provides some national services, such as employment recruitment through a dedicated employment portal (My Job Scotland), and acts as the employer's association for local authorities. COSLA has convened numerous commissions including the Commission on Strengthening Local Democracy (2014), Commission on Local Tax Reform (2015), and the yet-to-be-concluded Local Governance Review (2017) and, most recently, drove the Verity House Agreement. The Verity House Agreement represents a more collaborative partnership between Scottish Government and local authorities for a new, separate fiscal framework governing fund allocation to councils, moving away from ring-fenced funds (unless there is a joint understanding of and rationale for such arrangements) and towards greater control for local authorities

8 In practice Place Directors have little real influence and power, with local authorities taking the lead in delivery.

over their own budgets. In addition, the agreement calls for early and meaningful budget engagement and simplification, consolidation of the Local Government Settlement and creation of the conditions for multi-year settlements to provide longer-term certainty and to assist with financial planning.

The agreement aims to incorporate the Charter of Local Self-Government into legislation as soon as possible, recognising that public responsibilities shall be exercised by those authorities closest to the citizens. Although progress has stalled following a UK Supreme Court ruling relating to the implications of the bill for reserved competencies. CPPs are recognised as a critical mechanism in the process of aligning local resources (COSLA, 2023). The intention is for the Verity House Agreement to work in tandem with a revised fiscal framework (COSLA, 2023a). The revised framework will have the status of a Memorandum of Understanding and is not a binding agreement, nor does it have legal obligations. It seeks to establish an agreed relationship between local and Scottish Government, reminiscent of the language seen in German and Italian constitutional decrees around fiscal autonomy, subsidiarity, and meaningful intergovernmental engagement (Muldoon-Smith et al, 2023a; Muldoon-Smith et al, 2023b). The intention is to set out norms around role and scope – ensuring stability and certainty in the budget setting process, interterritorial funding (acknowledging that single year funding settlements are inefficient compared with multi-year agreements), local taxation powers and flexibilities (including new sources of income), scrutiny and accountability and governance.

## 6. Responsibilities (shared and exclusive)

In Scotland, responsibilities have to be considered within the intergovernmental relationship between UK Government, Scottish Government, and the local government network. The Scotland Act 1998 (and 2012 and 2014 amendments) details the division of responsibility between the UK Government ("reserved matters"), any matters not listed in the law are the responsibility of Scottish Government ("devolved matters"). Reserved matters include issues that have a UK or international impact such as foreign affairs, defence and national security, and elections to the UK parliament. They also include others matters which have been retained at the discretion of the UK Government, such as employment law and industrial relations, telecommunications, and postal services (Torrance, 2022).

The Scottish Parliament is responsible for education and training, economic development, transport environment, elections, healthcare, housing, local government, and planning. Some responsibilities have been partially devolved with the UK government retaining control of some areas, for example Scottish Parliament is responsible for promoting renewable energy and energy efficiency, but the UK government retains control of ownership and exploitation of coal mines and offshore oil reserves (Scottish Parliament, 2024). Partial devolution is also evident across taxation (see Section 9 for further details on taxation powers).

The reserved matters, as set out in Schedule 5 of the Scotland Act 1998, include:

1. Benefits, some aspects including: Universal Credit, Child Benefit, State Pension and Pension Credit.

2. Betting and gambling, except setting the number of fixed odds betting terminals in new betting premises.

3. Broadcasting.

4. The Constitution including the Crown, the Union, the UK Parliament, and the existence of the (criminal) High Court of Justiciary and (civil) Court of Session.

5. Consumer Protection Policy including product standards and product safety (except in relation to food).

6. Currency.

7. Data protection.

8. Defence and national security.

9. Elections to the UK Parliament.

10. Employment law and industrial relations.

11. Equality legislation (most aspects).

12. Energy policy, some aspects including the generation and supply of electricity, oil and gas, the exploration and extraction of offshore oil reserves, coal ownership and exploitation and deep and opencast coal mining, and nuclear energy and safety.

13. Financial services.

14. Foreign affairs.

15. Immigration, asylum and visas.

16. Nationality and citizenship.

17. Postal services.

18. Taxation, some aspects including VAT rates, fuel duty, income tax (with some exceptions) and corporation tax.

19. Telecommunications.

20. Trade and industry.

21. Transport, some aspects including bus and coach licensing, the highway code, vehicle standards, driver training and testing, drive and vehicle licensing, accessibility of public transport, and safety of maritime, aviation and railway.

The Act does not list devolved matters, but these include:

1. Agriculture, forestry, and fisheries including most aspects of animal welfare but not including animal testing and research.

2. Benefits, including Best Start Grant, Carer's Allowance Support, Child Disability Payment, Child Winter Heating Assistance, Funeral Support Payment, and payment periodicity of Universal Credit.
3. Consumer advocacy and advice.
4. The Crown Estate.
5. Economic development.
6. Education and training.
7. Energy policy, some aspects including promoting renewable energy and energy efficiency, and onshore oil and gas licensing.
8. Elections.
9. Environment.
10. Equality legislation, some aspects such as the appointment of non-executives to the boards of Scottish public bodies.
11. Fire services.
12. Freedom of information.
13. Gaming machine licensing.
14. Health and Social Services.
15. Housing.
16. Justice and Policing.
17. Local Government.
18. Planning.
19. Sports and the arts.
20. Taxation, some aspects including Land and Buildings Transaction Tax, Scottish Landfill Tax Aggregates Levy, Air Departure Tax, and the power to set income tax rates and bands.
21. Tourism.
22. Transport.

Within the devolution framework, the Scottish Parliament may amend the responsibility for devolved matters through enacting legislation. Some matters are the responsibility of central government, such as police and fire (although initially local government), whilst

some are the responsibility of local authorities, such as refuse collection. Broadly speaking, local authorities provide a range of services such as education, housing and planning, social care, roads and transport, economic development, environmental protection, and waste management. Within their sphere of responsibility, councils have three main types of powers and duties, which are set out in various legislation (Scottish Government, 2017):

1. **Mandatory Duties**[9]: powers that local authorities must exercise by law to provide services, such as social care and primary / secondary education.

2. **Permissive Powers**: powers that local authorities possess but are not bound by law to provide, such as economic development and recreation services.

3. **Regulatory Powers**: powers enabling the local authority to monitor businesses operating in the community, such as alcohol licensing, environmental health, and trading standards.

Local government services can be delivered in a variety of ways. Some public services are delivered through statutory arrangements such as community planning partnerships (CPPs), integrated health and social care boards, valuation joint boards, and regional transport partnerships. Other services are delivered directly through the local authority workforce or by commissioning other organisations, such as Arm's Length External Organisations (ALEOs). An ALEO is a body which is formally separate from a council but is subject to its control and influence, usually through a funding agreement. The use of ALEOs grew throughout the 1990s to provide sports and leisure and urban regeneration functions, and they are now an established feature of local government. Unlike statutory arrangements, ALEOs can be created at the discretion of the council within the boundaries set by local government legislation (Audit Scotland, 2018). They usually take the form of:

- Limited company.
- Limited Liability Partnership (LLP).
- Scottish Charitable Incorporations (SCI).
- Community Interest Company (CIC).
- Joint Venture (JV).
- Trust.

The range of ALEOs are extremely diverse in size, function and structure. Almost all local authorities use ALEOs to a varying degree, with urban councils more likely to have a higher number of ALEOs and more likely to use them to achieve commercial objectives, such as property development. There is, however, no legal definition for an ALEO and little consensus between local authorities on what an ALEO is (Local Government and Regeneration Committee, 2016). This makes it difficult to quantify their number, to

9 This is an area of considerable debate with so many multiple legislations committing local authorities to do things that there is no definitive list of what is mandatory and no real basis for confirming what constitute adequate or minimum service provision.

understand best-practice, and to meaningfully regulate[10] (see Section 7 for more details on regulation). Audit Scotland, a statutory public auditing body, estimated in 2018 that there were 130 ALEOs across Scotland with a turnover of £1.3bn. Over half (65) were charitable ALEOs, with a turnover of £550m and benefitting from non-domestic rates relief of £45m (Audit Scotland, 2018).

## 7. The regulatory regime

The Cabinet Secretary for Finance[11] has ultimate responsibility for the resilience of the local government finance system. Elements of expenditure then fall across the remits of additional ministers – for example those with portfolios for education, social care, environmental services, leisure, and recreation. During the spending review process the Cabinet Secretary supporting the Finance and Economy portfolio negotiates with these ministers and COSLA to agree resource for local authority revenue and capital expenditure. Further support is provided by the Local Government and Analytical Services Division (part of the Local Government and Communities Directorate in Scottish Government).

The Settlement and Distribution Group (SDG) is a forum that includes Scottish Government, COSLA, and local authority officials. It considers the financing, structure and operation of the local government finance system and allocation of new funding whilst providing a means of discussing any pressing issues – decisions of the SDG are then sent to COSLA and Scottish Ministers for final approval. It is then the responsibility of each local authority to finalise their spending priorities from available revenue and capital resource after taking into account ring fenced and directed responsibility (Scottish Government, 2024).

Like England, local authorities must produce an annual budget before 11 March each year, in advance of the new financial year beginning on 1 April. Each council is legally obligated to set a balanced budget each year, including details of their forecast income and expenditure (Scottish Government, 2024). The local authority must then subtract the amount they expect to receive in government grants and non-domestic property tax, with the remaining total determining the amount of council tax they must raise. This is a statutory process set out in Section 93 of the Local Government Finance Act 1992. In this situation, council tax holds the balance in local resource (the only local lever[12] to tackle budget shortfalls) and highlights the impact of the recent council tax freeze announcement[13].

Local authority finances are subject to external audit by the Accounts Commission. The Accounts Commission examines how each local authority manages their finances. They hold local authorities to account and support improvement with resource management, promote best value and publish information on council's annual performance. Audit Scotland provides services to the Accounts Commission and the Auditor General for Scotland. Audit Scotland performs the the local financial audit in conjunction with a small

10 They are typically constituted as independent bodies (often companies or trusts) and there is no basis to audit them directly. In recent times, mirroring England, there has been some movement back towards local authorities with ALEOs being brought back in house.

11 The Current title is Deputy First Minister and Cabinet Secretary for Finance

12 Fees and charges contribute very little while there is some potential for a Visitor Levy, but this will only be applicable in visitor destinations.

13 Scottish Government did provide some funding to account for this change in position. In real terms this provision actually accounted for a 5% increase on overall council tax in Scotland. However, there is no reliable information on the council tax increases planned by local authorities which in turn makes it difficult to estimate any real gap in funding due to this situation.

number of private firms. It assesses best value and conducts local government national overview reporting and and performance audits of local government, all of which will reflect on financial performance. This provides the framework of external auditing in Scotland. Audit Scotland[14] carries out an annual financial audit of each local authority[15], as well as Valuation Joint Boards, Integration Joint Boards and Regional Transport Partnerships. The audited reports are submitted to the Accounts Commission[16] to assess the performance of each local authority.

An important aspect of the auditing process is the local authority's statutory duty to pursue principles of best value, as set out in Part 1 of the Local Government in Scotland Act 2003. Best value is defined as "continuous improvement in the performance of the authority's functions" and is an approach that ensures the local authority's commitment to deliver better quality and efficient public services. In practice, this forms part of the annual audit process under which audit conclusions for each council are reported through an Annual Audit Report. The Accounts Commission holds statutory powers to request information from local authorities to enable an assessment of best value. In addition, the Controller of Audit will present a best value report to the Accounts Commission usually once every five years (Scottish Government, 2018). To achieve best value, local authorities are expected and encouraged to engage with service delivery providers and partners, such as those integrated in Community Planning Partnerships.

Local authorities must also undertake internal audits, under Regulation 7 of the Local Authority Accounts (Scotland) Regulations 2014. Internal audits are conducted through an audit committee, whose purpose is to examine the performance and management of risk within the council. In some cases, these committees are led by a non-councillor or an opposition member of the council.

The flexibility available in using ALEOs to deliver public services can present issues. As no legal definition exists, interpretation of ALEOs can differ from council to council and disputes can arise, for example, when a council considers an organisation to be an ALEO whereas the organisation does not (Local Government and Regeneration Committee, 2016). This lack of clarity appears to lead to confusion relating to the appropriate level of scrutiny and monitoring to be carried out by the council and the level of reporting to be undertaken by the given organisation. In addition, ALEOs that are set up as charities have to comply with the Charities and Trustee Investment (Scotland) Act 2004 which creates a further layer of complexity in scrutiny. The Inquiry into arm's length external organisations recommended Scottish Government legally define ALEOs, to enable better governance and scrutiny, but this has as yet not been actioned.

## 8. Capital finance

In Scotland, local authority capital expenditure relates to the provision or improvement of non-current assets including the initial costs of acquisition and construction and subsequent costs incurred to: add to or replace part of, or service, the asset (excluding day-to-day services). In this sense, capital expenditure is used to purchase, construct and maintain buildings and infrastructure necessary to provide services, such as schools, care homes, flood defences, roads, vehicles, plant, and machinery (Audit Scotland, 2024).

14 Audit Scotland was established under the Public Finance and Accountability (Scotland) Act 2000.
15 Or sub-contract to private companies operating in the of Audit Scotland.
16 The Accounts Commission was introduced in the Local Government (Scotland) Act 1973 as an auditing body for local authorities in Scotland.

In 2022-23, total local authority Capital expenditure was £3.6bn, 16% more than the previous year (Audit Scotland, 2024). The majority of this increase was driven by a 52% increase in borrowing – seeing borrowing surpass government capital grant for the first time as the main source of capital finance. The majority of expenditure related to new construction, conversion and enhancements to existing buildings, which has been the largest proportion of capital expenditure over the last five years (Scottish Government, 2024). The service receiving the most capital expenditure in 2022-2023 was the Housing Revenue Account (HRA), followed by roads and transport and then with slightly less, education. This was followed by social services, central services, and trading services. And finally, building, planning and development, environmental services and non-HRA housing (Scottish Government, 2024). On an individual level, local authority areas can vary considerably in terms of capital expenditure. This, in part, reflects the different priorities of local authorities and the timing of capital projects. Expenditure on such projects can be highly variable as some can be high-value and infrequent. Expenditure per head in local authority areas will therefore be quite dynamic over time, possibly substantially, as projects begin and end.

The primary sources of local authority capital financing in 2022-2023 were borrowed funds from the Loans Fund and capital grants and contributions. According to Scottish Government (2024) these represented £1.53bn and £1.61bn of total expenditure, respectively. In addition to borrowing and grants, the other main forms of capital financing include contributions from capital or revenue reserve funds and capital receipts from the sale of assets. The fluctuations in borrowing reflect the nature of capital and type of expenditure in each year and, in particular, the reduction of new construction and conversions as a result of the covid pandemic (Scottish Government, 2024).

Local authorities have legal powers to borrow money under Section 69 of the Local Government (Scotland) Act 1973. The Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016 sets out the purposes for which a local authority may borrow, which includes capital expenditure. The majority of borrowing is from the Public Works Loan Board (PWLB), which is a statutory body within the UK Debt Management Office and functions to lend money from the National Loans Fund, whilst other sources of borrowing include credit arrangements such as leases and service concession arrangements including Public Private Partnerships and Private Finance Initiatives. The source and type of borrowing is not specified in the regulations and is a matter for each local authority to decide. Similarly, there are no central imposed limits on individual local authority borrowing, with overall borrowing only controlled through the overall national limit. However, local authorities must apply the CIPFA Prudential Code principles of affordability, prudence and sustainability when deciding how much they can afford to borrow. The 2016 regulations require that all borrowing must be secured on local authority revenues, meaning authorities cannot mortgage or charge any property as security (Scottish Government, 2016). All money borrowed is paid through the loans fund and ranked equally without any priority (Scottish Government, 2016).

Capital grants and contributions are provided by central government to support local authorities with their capital expenditure. The funding is provided in the form of two types of grant: 1) General Capital Grant and 2) Specific Capital Grant. The General Capital Grant is provided as part of the annual Local Government Settlement, which is the total amount of money paid to local government by the Scottish government. General Capital Grants are offered to individual councils each year through the issue of a grant offer letter. Councils have relative freedom to spend the grant on capital projects to meet local and

national priorities. Specific Capital Grants however are ring-fenced funding and may only be used by local authorities to fund specific capital expenditure.

Local authorities may use accumulated surplus income, also known as Useable Reserves, to finance future capital expenditure. They hold two capital reserves: 1) the Capital Fund / Capital Receipts Reserve and 2) the Capital Grants Unapplied Account (Scottish Government, 2024b). The Capital Fund and Capital Receipts Reserve, previously separate funds, may be used for meeting capital expenditure and repayment of principle debt on loans, but not interest. The Capital Grants Unapplied Account holds funds that have been received but not yet used for capital expenditure, or capital receipts pending funding of specific expenditure as permitted by Scottish Ministers (Scottish Government, 2016). Capital expenditure can also be funded by the General Fund, which is the principle revenue reserve of the local authority (Scottish Local Government Finance Statistics, 2024).

Local authorities can generate funds from the sale or disposal of their assets, such as land or council housing, which is termed Capital Receipts[17]. Capital Receipts may only be used to fund capital expenditure or for a purpose specified by statute or statutory guidance. Capital receipts can be kept in reserve for future use, which means the value of capital receipts raised may not equal the amount spent in a given year. In 2022-23, £324m of Capital Receipts were raised and £104m were used. The use of funds was: £76m to fund capital expenditure; £23m to repay debt and £5m to fund transformation projects (Scottish Local Government Finance Statistics, 2024).

## 9. Sources of revenue

When considering the sources of local government revenue in Scotland, it is important to consider the framework of devolution and distribution of income from the central level, as asymmetric devolution has resulted in a complex system of revenue funding from the central level which plays a major role in local government revenue. This is in order to understand the flows of money from UK Government to Scottish Government, and then from the latter to Scottish local government. The first flow regards the funding of a nation and then second flow the local government finance system. Each year, the Scottish Government publishes a balanced budget setting out spending plans on devolved matters, known as the Scottish Budget. From the Scottish Budget, the Scottish Government pays each local authority a General Revenue Grant (GRG) to support local authority general net revenue expenditure. The amount payable is calculated to bridge the difference between local authorities' spending assessments and the sum of resources obtained from council tax and non-domestic property rates (see Section 10 for further details on the operation of non-domestic property rates income). The final allocation amount is calculated by using Grant Aided Expenditure (GAE) calculations and projections to determine the individual grants for each local authority, based on relative need (Scottish Government, 2022).

The funding method for the Scottish Budget is set out in The Fiscal Framework (see Section 5 and 10 for further details) and is composed of the following major components (Fraser of Allander Institute[18], 2023):

17 Any income from such decisions is minimal with most viable disposals already having taken place – only accounting for 2.5% of capital in 2022/23. Asset disposals are not a sustainable way to bridge gaps in finance due to their diminishing quantity.

18 The summary of the Scottish budget setting position, as it relates to local government finance is based on the Scottish Budget Guide published by the Fraser of Alexander Institute and Eiser, 2016.

1. **The Block Grant** is an annual grant received from the UK Government. The block grant is composed of two parts: 1) the baseline – which is the total block grant paid the previous year, and 2) the Barnett Consequential – which is an annual adjustment to reflect additional UK Government spending on comparable matters in England. For example, if the UK Government increased spending on education in England by £100m, the Barnett Consequential would be calculated as £100m x 9.71% (population share of Scotland) x 100% (comparability factor), equating to an additional £10m for the block grant. Comparability is a measure of the degree to which a particular public service is devolved, and The Fiscal Framework defines the comparability factors for all functions. Funds allocated through the Block Grant (including the Barnett Consequential) are not ring-fenced and the Scottish Government is free to decide how they spend the revenue. The grant has been the Scottish Government's core source of funding since devolution in 1999. As part of the UK Budget, the Block Grant is funded by reserved taxes that are collected across all UK nations, which includes: Corporation Tax, National Insurance, Value-added Tax, Capital gains tax, Inheritance Tax, Aggregates levy Insurance Premium Tax and Motoring taxes. Block grants are the primary funding method used in the UK for its devolved administrations.

2. **Devolved, Partially Devolved and Assigned Taxes** are the second largest component of the budget. Devolved taxes are those wholly determined within Scotland that are administered and collected by Scottish Public Bodies, whereas partially devolved and assigned taxes are administered and collected by Her Majesty's Revenue and Customs (HMRC) on behalf of Scottish Government.

    i. *Fully Devolved taxes* include Land and Buildings Transactions Tax (LBTT), Landfill Tax, Council Tax and Non-Domestic Rates. The Scottish Government makes decisions about devolved taxes and has autonomous powers to set the rates. LBTT and Landfill tax are pooled centrally, non-domestic rates are pooled centrally and distributed locally whereas council tax is retained by local authorities. The Scotland Act 2016 enables the Scottish Government to devolve Aggregates Levy and Air Departure Tax, though powers have not yet passed through Scottish Parliament to this effect. A draft bill is being developed to devolve Scottish aggregates tax (Revenue Scotland, 2023), while the Highlands and Islands exemption issue remains a barrier to introducing Air Departure Tax (Scottish Government State Aid team, 2018)

    ii. *Partially devolved taxes* are those which the Scottish Government and UK Government both have an element of control over. Non-savings and non-dividends (NSND) income tax is the only partially devolved tax. The Scottish Government has the power to set tax bands and the rates, whilst the UK Government controls reliefs and allowances. in the Scotland Act 2012, which gave the Scottish Parliament the power to set a Scottish rate known as the Scottish Rate of Income Tax (SRIT) in addition to a reduced UK base rate. Powers were extended by the Scotland Act 2016 and gave Scottish Parliament the ability to set the tax band thresholds as well as the rates, which replaced SRIT with Scottish Income Tax (Scottish Government, 2024). HMRC collects and manages Scottish Income Tax, which is then paid to the Scottish Government.

    iii. *Assigned taxes* are those taxes that are reserved by the UK Government and

a proportion of the collected revenue is paid to the Scottish Government. Value Added Tax (VAT) is legislated under the Scotland Act 2016 to be an assigned tax, with half of VAT receipts and reduced rate VAT receipts raised in Scotland to be paid to the Scottish Government. The current VAT rate is 20% and reduced rate VAT (on hospitality and other industries) is 12.5%. It is not possible to extract Scottish VAT receipts from the current VAT collection process, therefore a VAT assignment methodology is used to estimate the amount of VAT receipts raised in Scotland (Scottish Government, 2024). The Scottish Government and HM registry agreed to delay implementation of VAT assignment until the fiscal framework review[19].

4. **Block Grant Adjustment for Tax** is a deduction made to the block grant to account for devolved taxes. The adjustment is a deduction from the Block Grant to reflect that a proportion of the Scottish Budget is funded by Scottish tax revenues that were previously retained by the UK Government (Scottish Government, 2023c). The adjustment is calculated for each devolved tax individually as a two-step process: 1) an initial deduction is made equating to the amount of tax revenue collected in Scotland in the year prior to the devolution of the tax power, 2) the Scottish block grant is reduced in line with the growth in equivalent tax revenue (per person) in the rest of the UK as an Indexed Per Capita (IPC) model. The implication is that, if the devolved tax revenues in Scotland grow faster than that rest of the UK then the Scottish Budget is better off relative to pre-devolution, and vice versa. This transfers the benefit, and risk, of tax devolution to the Scottish Government whilst protecting the UK Government from bearing the costs of decisions that reduce revenue or increase expenditures made by Scottish Parliament on devolved matters (Eiser, 2016).

5. **Block Grant Adjustment for Welfare** is an addition to the block grant to account for devolved social welfare costs. The adjustment involves a transfer of revenue from the UK Government to reflect the transfer of responsibility. Similarly to the adjustment for tax, the adjustment is calculated for each devolved power individually as a two-step process: 1) a baseline addition is made equating to the amount of expenditure UK Government spent in the year prior to the devolution of the welfare powers, 2) the baseline is adjusted initially by the Barnett Formula (the Scottish population share of UK spending on the devolved power) and then indexed by the IPC mechanism for the financial year (the percentage change in per capita spending on the devolved power) accounting for changes in Scotland's population (Eiser, 2016). The IPC mechanism updates the Block Grant Adjustments each year such that if Scotland's devolved tax revenues grow and welfare spending reduces at the same rate per capita than the rest of the UK, then the Scottish budget is no better than pre-devolved powers. The devolved budget is thus tied to the relative performance of the tax base and welfare spending at the central level (Fraser of Alexander Institute, 2023).

6. **Reconciliations** are adjustments in the previous Scottish budget made to reflect differences between forecasts and actual revenue and spending. When the Scottish Budget is published, it is based on forecasts of devolved and assigned revenues, social welfare, and Block Grant Adjustments (themselves based on

19 This was finally published at the end of 2023 but the potential for VAT assignment was not resolved – only agreeing to keep discussing the proposal. The main difficulty is calculating the VAT split between Scotland and England.

forecasts of the UK). As the data becomes available, forecasts are replaced by outturn data and the net difference is applied to the upcoming Scottish budget. Not all outturn data for revenues and spending is available with the same periodicity, which results in different reconciliation processes dependant on the availability of data (Scottish Government, 2023d).

7. **Borrowing** is available to the Scottish Government for some resource funding purposes. These are for in-year cash management, errors in forecasting and in the case of a Scotland-specific economic shock[20]. Resource borrowing cannot be accessed to increase the resource budget per se – it must be due to an unforeseen event. The Fiscal Framework also makes provision for a cash reserve – the 'Scotland Reserve' – which can be built when revenues are higher than forecast. The Scottish Government is able to pay into the reserves to a total of £700m and draw down at a rate of up to £250m a year for resource spending and £100m a year for capital spending (Eiser, 2016).

In addition to the General Revenue Grant, local governments have access to four other revenue funding streams: grants, council tax, the Housing Revenue Account, and customer and client receipts. These funding sources are a mixture of general and ring-fenced revenue and can be seen below in order of their overall contribution in the 2022-23 financial year (Scottish Government, 2024b).

**Grants** relate to funding received by local authorities from the Scottish Government and from other sources that are generally provided for specific services and policies. Ring-fenced grants may be provided by the Scottish Government for specific policy initiatives and must be used for their specified purpose, such as Early Learning and Childcare Expansion, the Pupil Equity Fund and Criminal Justice Social Work. Other grants and contributions may be received from the NHS Boards and Integrated Joint Boards to commission social care services (Scottish Local Government Finance Statistics, 2024). In 2022-2023, grants from the Scottish Government and other sources accounted for 11.6% of local authority revenue (Scottish Local Government Finance Statistics, 2024). **Other grants, reimbursements and contributions** include contributions from NHS Boards and income from IJBs to commission social care services, which accounted for 17.9% of local authority revenue.

**Customer and client receipts** are income charged by councils for their services such as licensing, planning, some environmental services, parking, and rent. The income is directly linked to the council services being charged for and can only be used for the stated purpose (Liddell 2021). In 2022-2023, customer and client receipt income accounted for 11.1% of local authority revenue (Scottish Local Government Finance Statistics, 2024).

**Council tax** is a tax on domestic properties that each local authority is responsible for administering. Within set parameters, each individual council sets the rate of council tax in their area and is responsible for collecting the tax[21]. The local authority has discretion to decide how council tax receipts are used to fund local services. Legislation has recently

20 A Scotland-specific economic shock (SES) is defined when onshore Scottish real GDP growth is below 1% in absolute terms on a rolling four-quarter basis and 1% below UK real GDP growth over the same period. It may be triggered from outturn data or forecasts.

21 Compared with England, the upper and lower ceilings for local discretion are not as restrictive, nor are there local referendums on any increases. However, in practice council tax rates have been frozen almost every year since the Scottish National Party came into power in 2007.

been passed in relation to council tax and second homes (via the Variation for Unoccupied Dwellings (Scotland) Amendment Regulations 2023) following consultations on reform convened by Scottish Ministers in the form of a joint consultation with COSLA (COSLA, 2023b). In 2022-2023, council tax accounted for 10.6% of local authority revenue (Scottish Local Government Finance Statistics, 2024).

**Housing Revenue Account**: income from the housing revenue account relates to income generated by council housing, typically via rent. Housing Revenue Accounts are composed almost entirely of rents from social housing, which accounts for 94% of housing income. All income from council housing must be held in a Housing Revenue Account which ensures rent payers' money is only spent on housing related expenditure. In 2022-2023, Housing Revenue Account rents accounted for 5% of local authority revenue (Scottish Local Government Finance Statistics, 2024).

## 10. Degree of own budgeting and accounting

Local authority revenue expenditure is accounted for in two principal funds: The General Fund and Housing Revenue Account (HRA). All local authorities are required to have a General Fund, which is their principle revenue reserve and accounts for all general revenue activity, including income and expenditure. Where a council has housing stock, all expenditure and income relating to the direct provision of housing must be accounted for separately in the HRA. In 2022-23, the General Fund accounted for 96.5% (£22.6bn) of local authority service expenditure, with the remaining 3.5% (£826m) accounted for in the HRA. The Orkney and Shetland local authorities are also required to hold a Harbour Account specifically for harbour undertakings and may transfer money between their General Fund and Harbour Accounts.

Revenue expenditure is principally funded through service income and general funding. Service income is income that a local authority receives directly in relation to services they provide, generally in the form of ring-fenced and specified grants as well as customer and client receipts. General funding is income received principally through GRG, the NDR Distributable Amount and council tax, which is used to fund net revenue expenditure. Net Revenue Expenditure represents the net cost of services and is calculated as gross service expenditure minus gross service income. Any deficits in funding are met by local authority reserves, and any surplus funds are added to the reserves and carried forward to the next year.

Table 1 (reproduced from the annual publication of Scottish Local Government Finance Statistics based on audited accounts of each local authority) displays the revenue expenditure income sources during the period 2018-2019 to 2022-2023, in comparative and percentage format.

**Table 1: Revenue expenditure**[22]

| Income Type | 2018-19 | 2019-20 | 2020-21 | 2021-22 | 2022-23 |
|---|---|---|---|---|---|
| Government Grants | 2,380 (11.6%) | 2,559 (12.0% | 2,866 (12.4%) | 2,884 (12.2%) | 2,857 (11.6%) |
| Other Grants, Reimbursements and Contributions | 3,638 (17.7%) | 3,772 (17.7%) | 4,003 (17.2%) | 4,249 (17.9%) | 4,676 18.9% |
| Customer and Client Receipts | 2,598 (12.7%) | 2,685 (12.6%) | 2,685 (12.6%) | 2,715 (11.5%) | 2,907 11.8% |
| **Gross Service Income** | **8,616 (42.0%)** | **9,016 (42.3%)** | **9,363 (40.4%)** | **9,849 (41.6%)** | **10,440 42.3%** |
| GRG | 6,885 (33.5%) | 6,937 (32.5%) | 9,308 (40.1%) | 9,014 (38.2%) | 8,673 35.2% |
| NDR Distributable Amount | 2,636 (12.8%) | 2,853 (13.4%) | 1,868 (8.1%) | 2,090 (8.9%) | 2,765 11.2% |
| Council Tax | 2,376 (11.6%) | 2,493 (11.7%) | 2,581 (11.1%) | 2,640 (11.1%) | 2,765 11.2% |
| Other Funding | 13 (<0.1%) | 40 (0.1%) | 77 (0.3%) | 44 (0.2%) | 30 (0.1%) |
| **Total General Funding** | **11,910 (58.0%)** | **12,323 (57.7%)** | **13,834 (59.6%)** | **13,788 (58.4%)** | **14,233 57.7%** |
| **Total** | **20,526** | **21,339** | **23,197** | **23,634** | **24,673** |

*(Table adapted from information in the Scottish Local Government Finance Statistics 2022-23 release)*

The change in income sources show the effect of the Covid-19 pandemic on revenue expenditure (Scottish Government, 2024b). Service income fell as reduced demand for services led to a reduction in customer and client receipts, while government grants increased as central government responded to funding challenges during the pandemic in the form of Covid-19 service specific grants.

The same trend for locally collected (though not locally retained) funds is true for general funding (Scottish Government, 2024b): NDR accounted for 11.2% of total funding in 2022-23, down from pre-pandemic levels of 13.4%. This was primarily due to the introduction of two new business rates reliefs in response to the pandemic, with £0.9bn of relief granted as part of the Retail, Hospitality, Leisure, and Aviation Relief introduced by the Scottish Government. This has a direct impact on GRG as the combined amount of NDR and GRG provided to local authorities is guaranteed, therefore any decrease in the amount of NDR is compensated for by increased GRG (see Section 11 for more details on NDR and fund

22 Note the figures reflect the amount of funds used in the year specified, which may not match the amount of funding received in that year.

allocation). Consequently, GRG accounted for 35.2% of all revenue expenditure in 2022-23, increasing from pre-pandemic levels of 32.5%, and peaked at 40.1% in 2020-21 (which included £515m of additional Covid-19 funding). Pre-pandemic, GRG was on a gradual decline as a share of total income, with service income accounting for an increasing proportion of revenue expenditure through formally and informally ring-fenced grants[23]. This has the effect of removing local discretion and flexibility on how funds can be used, which mirrors the lack of control over funding that local authorities have experienced in England and can be seen in contrast to the core values in the Verity House Agreement. In addition, and in contrast with decentralised countries such as Italy and Germany, Scotland has a far less varied basket of revenue resources to draw on and relies heavily on central government funding.

In total, local authorities spent £23.4bn of revenue funding in support of public services in 2022-2023 (Scottish Government, 2024b). Gross spending was dominated by statutory services, with social services and education accounting for the greatest quantities of expenditure. When considering expenditure met by service-related income, social service-related activity receives the largest amount of service income (Liddell, 2021). However, this is derived from grants received from Integration Joint Boards to commission social care services, as well as contributions received from NHS Boards rather than conventional payment for services from customers. In contrast, education-based services receive comparatively less service income, most of which are in the form of ring-fenced grants, and therefore have to rely heavily on general funding[24]. Notwithstanding, both services rely heavily on grants, each receiving the majority of funding through central government or other public bodies (whether ring-fenced or general revenue). On the other hand, HRA, Environmental Services and Culture & Related Services received the majority of revenue expenditure through service income, particularly customer and client receipts. In the case of HRA, service income from rents exceeded service expenditure, which generated a surplus for the HRA reserve (Scottish Government, 2024b).

## 11. Territorial equalisation methodology

In Scotland, according to the Green Book for Grant Aided Expenditure published by Scottish Government, the distribution of funds is achieved through a system of general fund allocation to local authorities (Scottish Government, 2022). The process involves a 'needs-based' methodology to distribute central grant funds, i.e. the Local Government Finance Settlement, to each local authority. Grant distribution is calculated on the basis of each council's individual need to deliver services and pay debts, before applying 'funding floors' to ensure no councils are disproportionately disadvantaged (Scottish Government, 2019). The process of allocation is calculated as follows:

1. **Estimated Service Expenditure (ESE)** is the estimated funding a local authority needs to deliver its services (Scottish Government, 2019). Two components form ESE: Grant Aided Expenditure (GAE) and Special Islands Needs Allowance (SINA). GAE forms the 'needs-based' mechanism; it is divided into services and sub-services to calculate the local authority relative need of delivering each service. Each sub-service, known as GAE 'lines', have a different allocation formula, though all follow the same principles of assessment. Once calculated,

23 Informally ring-fenced grants are funds provided by Scottish Government that are not formally ring-fenced but provided under the expectation they will be used for a specific purpose.

24 Education services are consistently the highest net revenue expenditure, accounting for 47.6% of total net revenue expenditure in 2021-2022.

the lines are totalled to give GAE service totals for each local authority. The Local Funding Settlement is then apportioned based on each local authority's relative GAE. SINA is then calculated for Local authorities with significant island authorities. This is to compensate for the additional costs of island communities that are not compensated for in the needs-based assessment. Broadly speaking, SINA generally adds 10% onto the total funding for island authorities (Scottish Government, 2019).

2. **Total Estimated Expenditure (TEE)** is the estimated amount each local government needs to deliver services and service its debts. Estimated Service Expenditure forms the basis of TEE and further allocations are added. This includes additional funding for Scottish Government's policy commitments since 2007-08, including former ring-fenced grants. Policy-related ring-fenced funding is then added, such as Early-Learning and Childcare, Gaelic, and Pupil Equity funding. A further total of non-specific changes to grant allocations and local authorities' commitments in respect of certain historic loan charges are also added (Berthier et al, 2018).

3. **Funding Floors** are then mechanisms applied to the TEE to ensure a local authority's funding allocation will not fall by more than a set amount each year Berthier et al, 2018). Each council's allocated share of funding is compared with the previous year and the average percentage change is calculated. The floor is set slightly below average, and any councils above the floor pay into a pool, which is then distributed to other councils to bring them up to the floor. In 2020-21, 22 councils paid into the pool and 10 council's received additional floor funding. There is also an 85% floor, which ensures no local authority receives less than 85% of the Scottish average per head revenue support.

4. **Locally generated property taxes** (council tax and commercial property tax) are then deducted from the floor-adjusted funding to calculate the amount of General Revenue Grant councils will receive. Tax revenues are based on forecasts for the new financial year. This works as a balancing item: the amount each council can raise from these locally generated property taxes depends on the size of population and number of businesses, so the general revenue grant provides the remainder of the needed funding (Berthier et al, 2018).

It is important to note that, since 2008-09, the local government finance settlement is pre-determined by the Scottish Government after consultations with COSLA (Berthier et al, 2018). GAE therefore does not decide the total amount of TEE that each local authority receives, but rather determines the proportion each local authority receives. GAE and TEE are therefore calculated for needs-based distribution only – they do not function as a budget and local authorities are not expected to spend the estimated amounts on each service.

The current system of equalisation described above was solidified in the financial years 2008-11. COSLA and the Scottish Government set out a 'new relationship' between central and local government, with the intention to give local authorities more autonomy to spend the money allocated to them. Consequently, many formally ring-fenced grants were subsumed into the GRG, although the methods for estimating the allocated funds remained unchanged, meaning local authorities still receive the same amount of funding but have greater discretion to spend it as they see fit. In terms of equalisation

between territory, it can be seen that the method deployed in Scotland is almost entirely vertical, with the only horizontal intervention seen in the operation of the funding floors. Ultimately, the general grant is provided to local authorities on the basis that it will be used firstly to fulfil their statutory obligations and local and national priorities. This sits in contrast to the English system: whilst central funding is also the key funding mechanism for local government in Scotland, the cessation of the 'needs assessment' in 2012-2013 in England has led to greater reliance on allocated ring-fenced grants.

## 12. Conclusion

The advent of devolution in Scotland in 1999 had significant implications for local government. The years leading up to devolution saw the removal of the traditional two-tier structure and its replacement with 32 local councils with increased discretion and responsibility over education, social services, housing and planning. However, while the structure of local government is now more reflective of the locations it serves, it is limited by comparatively less discretion over fiscal resources to fulfil local objectives. In this sense there is similarity with the situation in England, where the devolution of responsibility has not kept pace with the decentralisation of resource. The following observations can be made about the local government finance system in Scotland, as it relates to the potential for change in England:

- The Scottish local government finance system is a complex adaptive system that includes a needs based assessment between Scottish Government and local authorities but also Scottish and England Government.

- Fiscal devolution is hardwired into the devolved relationship between Scotland and England, allocated via the Barnett Formula mechanism. However, while there is a long-standing interaction between the relative countries, fiscal devolution and associated discretion is less constrained between Scottish Government and local authorities.

- While the relative needs assessment on paper appears to afford greater discretion and certainly for local authorities, there is very little discretion at the local level in terms of the basket of available income sources – with council tax regularly frozen for political purposes. In some respects, this is a mirror image of the situation in England where there is heavy reliance on central funding – although in England there is an element of local retention associated with commercial property tax.

- Consequently, there is inherent contradiction within Scottish local government finance, and more broadly Scottish local government. There is evidence of genuine joint working with COSLA and the Verity House agreement is a positive base for local-state relations. However, other aspects of the system are very restrictive and even imposed. The sense is then one of unfulfilled good intentions and short-term tactical adjustments.

- Reflecting the institutional connection with England and tone of the financial system debate within that government, there is little debate around the assignment of big-ticket revenue sources (for example VAT and income tax) to local authorities. Although Scottish Government does have its own powers over the rate of income tax, separate to England.

- Reflecting the same situation in England in recent years, debt financing has increased substantially in recent years, increasing 52% in 2022/23. Debt financing for capital works now outstrips capital related grants from Scottish Government. Concurrently local authorities are dipping into their reserves with greater regularity.

- This starts to reflect some of the overall local government viability warning signs that were evident in England in the late 2010s, as local authorities began to explore lending as a) a viable means of investment and b) as a means of restricting local government accounts. This can be seen along side the warnings from COSLA in late 2023 in relation to the solvency of the local government finance system if funding is not increased in line with cost pressures.

- The Verity House Agreement has at its heart the principles of meaningful partnership, financial resilience, and fiscal decentralisation. Yet the rhetoric contained in the document, at the time of writing, has not been reflected in the practice of local government finance. Perhaps this is because it has no legal or constitutional basis, in contrast to more decentralised locations like Germany and Italy.

- While certainly not helped by the further freezing of council tax (COSLA declared formal dispute with the SNP Government), the journey of the Verity House Agreement into meaningful practice reveals a note of warning for emerging place-based practice in England. The Government in England has recently indicated that it will give local areas the levers to turbo charge their futures – moving from buck passing (Muldoon-Smith and Greenhalgh, 2015) to partnership in achieving common goals – with the potential Take Back Control Act evoking many of the principles seen in Verity House.

- There is now a very different political landscape in Scotland. It is important the momentum behind Verity House is not lost and instead becomes a positive totem for the respective political parties to coalesce around and deliver in practice. While Verity House sets out principles for working there is no real declared purpose or shared objectives, with clear ways of working. Work in this area could form the basis of the meaningful delivery of Verity House, focusing in on how to build in some degree of fiscal and related policy discretion at the local level.

- The result is that what Scotland is often held up as an example of devolution and decentralisation, this is far from the view on the ground is that the workings of local government finance are constrained and controlled by central government.

## Acknowledgements

Any comprehensive analysis of intergovernmental systems are reliant on the stakeholders and professionals who make these systems work on a day to day basis. Thanks in particular to the Accounts Commission and SPICe for being an invaluable sounding board throughout this exercise.

### Contact

This is an ongoing project. For information about the ongoing research, and requests to participate, please contact:
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The **LGIU** – Local Government Information Unit – is a not-for-profit, non-partisan membership organisation. We are for local government and anyone with an interest in local democracy and finding local solutions to the challenges that we all face. Councils from across the UK, Ireland and Australia are supported by our full member benefits, including in-depth policy analysis and other resources, innovative research and local government training. Our new Global Local subscription service now brings colleagues from other countries into the LGIU community.

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