Agenda Item	**14**
Report No	**HC/29/17**

HIGHLAND COUNCIL

Committee: Highland Council

Date: 7th September 2017

Report Title: Financial Approach 2018 - 2023

Report By: Director of Finance

1. Purpose/Executive Summary

1.1 At its meeting on the 29th June the Council was presented with a Financial Outlook for the period 2018 - 2023. That report outlined the budget gap the Council would face under three different scenarios, a 2%, 3.5% or 5% reduction in grant funding from the Scottish Government.

1.2 In absolute terms those percentage reductions led to a budget gap (the difference between expected expenditure and income) of £129.7m, £159.2m and £186.9m respectively.

1.3 In light of those future scenarios the Council believes it can no longer continue to provide the same services, at the same level, in the same way as before.

1.4 This paper provides details of the financial approach the Council will use to identify proposals to reduce expenditure or raise additional income to deliver a balanced budget over the period 2018 -2023.

2. Recommendations

2.1 Members are asked to:

i. Note the approach being taken to address the budget gap.

ii. Support the principle of multi-year budget setting.

iii. Agree to reinstate the Council's non earmarked reserve to a minimum level of 2% of the Council's annual revenue budget by 2023.

3. Context

3.1 The 5 year scenario planning done as part of the financial outlook as reported to Council in June 2017 identified a potential budget gap of between £129m and £186m over the period 2018-2023. Whilst this is a wide range based on a number of assumptions, particularly around the level of Scottish Government Grant funding, an approach to meet this budget gap needs to be identified.

3.2 The approach will be based on the middle scenario - with a 5 year total saving requirement of £159.2m. The key assumptions underpinning that gap include:

- Annual pay inflation of 1.5%. Other costs inflation at 1%
- Annual 0.5% increase in pension contribution rates
- A provision for general budget pressures of £7.5m annually
- An annual increase of £2.5m in loans charges
- No change in the basic rate of Council Tax (although an increase in the tax base assumed)
- An annual reduction of 3.5% in Scottish Government grant funding

3.3 The approach will have the flexibility to either slip or accelerate actions as the true picture emerges over the period and will be kept under review over the period in order that ample time is given to the identification of additional action if required.

3.4 The estimated budget gap by year over the 5 year period is detailed in the table below:

	2018/19	**2019/20**	**2020/21**	**2021/22**	**2022/23**	**Total**
Budget gap	£33.5m	£32.4m	£31.2m	£30.7m	£31.4m	**£159.2m**

4. The requirement to set a balanced budget

4.1 By law the Council is required to set a balanced budget for every financial year. In doing so the Council matches its planned expenditure with its planned income with any difference between the two reflecting the usage of, or a contribution to, the council's reserves and balances.

4.2 The Council therefore has three significant levers it can use to deliver a balanced budget, namely it can adjust its expenditure, adjust its income or use its reserves. Each of those levers is described in more detail in the sections below with the figures quoted coming from the Council's adjusted unaudited accounts for 2016/17.

5. Income

5.1 The Council's primary income source is the annual grant funding it receives from the Scottish Government. This includes two main elements, the Revenue Support Grant and the Council's allocation of Non Domestic Rates from the national pool. In 2016/17 the total income from this source was £441.0m. The Council has no control over this income stream which is decided by the Scottish Government as part of their budget setting process.

5.2 For 2017/18 Scottish Government Grant funding will total £439.6m although this figure is not directly comparable with the 2016/17 figure as it includes new funding elements ring-fenced for specific projects. At its peak in 2015/16 this funding source totalled £456.8m. The share of the Scottish Government budget allocated to local authorities has declined from 29.7% in 2014/15 to 26.6% in 2017/18.

5.3 In recent years the Scottish Government has only given single year grant settlements, meaning the Council has absolutely no indication of any changes to that funding that may occur in subsequent years. Whilst this makes longer term financial planning incredibly challenging it actually strengthens the argument for developing a multi-year financial approach, and modelling various scenarios, in order to plan and prioritise accordingly and give the flexibility to deal with any late and unexpected changes to underlying assumptions.

5.4 The Council also raises income from Council Tax, a charge the Council levies on all properties within the Highland Council area. Net of discounts the Council raised income of £105.6m from this source in 2016/17. Due to Scottish Government policy the Council currently only has minimal control over this tax with property bandings being determined nationally.

5.5 In recent years the Council has been unable to increase the level of this tax due to threat of significant financial penalty from the Scottish Government with 2017/18 being the first year when the Council has been able to increase the charge, albeit capped by the Scottish Government at 3%.

5.6 The Council's final source of income is broadly termed 'service income' and in 2016/17 totalled £186.1m. This income generally is attributed to one or other of the Council's Services and reflects amongst other things the income the Council receives from levying fees and charges on some of the services that it provides. This income category also includes revenue grant funding that the Council receives, normally relating to a specific project or initiative.

5.7 Whilst 'service income' is the income category over which the Council has the most control there are certain elements that are governed by legislation, others where fees charged are very market sensitive and other that are completely out with the Council's control or may not occur in more than one financial year. Nearly all of the Welfare Services income is directly linked to housing benefit payments made.

5.8 The table below gives a breakdown of the 2016/17 income by Council Service.

Service	2016-17 Income from Services £m
Care & Learning	25.689
Chief Executives Office	1.154
Corporate Development	11.591
Community Services	56.246
Development & Infrastructure	34.502
Finance Service	6.574
Welfare Services	50.315
Total income	**186.071**

6. Expenditure

6.1 Members will undoubtedly be aware of the many and varied areas in which the Council spends its money. In 2016/17 the Council's total gross expenditure was £737.0m and comprised £293.0m of expenditure on staffing related costs, £55.8m on financing costs and £388.2m on all other costs.

6.2 Gross expenditure by service is detailed in the table below.

2016/17	Total expenditure £m
Care and Learning	**413.513**
Chief Executives Office	**6.243**
Corporate Development	**29.536**
Community Services	**115.190**
Development & Infrastructure	**41.778**
Finance Service	**19.501**
Welfare Services	**53.004**
Loan Charges	**55.785**
Joint Board Requisitions	
Valuation Joint Board	**2.404**
Highland and Islands Transport Partnership	**0.091**
	737.045

6.3 The Council's anticipated expenditure for 2017/18 will be lower than for 2016/17 due to budget reductions required as part of the 2017/18 budget setting process.

6.4 The Council has considerable control over its expenditure and historically control of this lever has been the key tool in the budget setting process. Increasingly however the Council is finding that a greater proportion of its expenditure is less controllable whether by Government imposed targets such as a freeze on reducing teacher numbers or long term contractual expenditure commitments such as PPP schools.

6.5 The Council is also beholden to choices and commitments made by previous administrations, most principally around capital investment. Borrowing forms the major funding source for the capital programme and the Council needs to pay off debt over the lifetime of any asset financed this way, together with the interest cost of that debt (much of which is at a fixed rate).

7. Reserves and Balances

7.1 Any difference between expenditure and income affects the Council's reserves and balances. In 2016/17 expenditure exceeded income by £4.4m and the Council's reserves reduced by this amount as a result. Much of that reduction was planned with £4.1m of funding coming from reserves that has been held for the purposes of specific expenditure.

7.2 Overall the Council's 'useable reserves' sat at £66.6m at the end of 2016/17. The vast majority of these reserves are held for specific purposes and may not be used for other purposes.

7.3 The Council's General Fund Non-Earmarked Reserve, its only reserve held for general purposes, was £11.4m at the end of 2016/17. This equates to 2% of the Council's net revenue budget. Guidance from Audit Scotland suggests Councils should aim to have this reserve within a range of 2% to 4% of their annual net revenue budget.

7.4 Once commitments made from this reserve in 2017/18 are taken into account it now sits below the recommended 2% minimum level. It is also anticipated that the reserve may be reduced further as it is likely to be needed to facilitate some of the transformational change required to address the budget gap the Council is facing over the next five years.

7.5 As part of this Financial Approach Council is asked to confirm their commitment to having this reserve at least equal to the minimum recommended level of 2% of the annual revenue budget by the end of the period under consideration.

7.6 Given the comparatively low levels of reserves held by the Council it is not possible for these to be a significant lever that can be used to address the budget gap over the next five years.

8. Financial Approach 2018 – 2023

8.1 Audit Scotland produced a report in December 2016 outlining their overview of local government finances in Scotland. A follow up report was released in March 2017. Both these reports make a major play on the need for councils to have long term financial plans that are linked to the strategic plans of the council.

8.2 Whilst the financial environment for local government is extremely challenging and uncertain, especially with single year grant settlements, this actually strengthens the argument for developing a five year financial plan in order to enable councillors to plan and prioritise accordingly.

8.3 This Financial Approach therefore looks at the anticipated budget gap over the 5 year period from 2018-23 and proposes an approach for how the Council will address it. For working purposes the approach will focus on the middle of the three scenarios outlined, that of a year-on-year 3.5% reduction in Scottish Government funding equating to a £159.2m gap over the period, but with the ability to flex should future circumstance demand it.

8.4 In light of the three levers outlined in sections 4 to 7 of this report the suggested approach will identify 5 key thematic areas where work will take place to identify ways of delivering a balanced budget. Work will be led jointly by the Council's Senior Management Team and the Administration's Budget Group.

8.5 Flexibility throughout the process will be vitally important. The key assumptions outlined in section 3.2 will need to be kept under constant review and the approach needs to be able to absorb the adverse impact of any changes in those assumptions.

8.6 As the process develops targets will be allocated to each thematic area but again these will likely need to flex throughout the process. Given the level of significant change that will ensue as a result of the budget gap, and the time to deliver any change that may be required, certain themes may not be able to deliver savings at the start of the period. In years 1 and 2 it is anticipated that the prioritisation and income streams may provide the majority of proposals.

8.7 The size of the budget gap presents an unprecedented challenge to the Council and will require creative and innovative ideas. The reality of the situation is that some incredibly difficult decisions will need to be taken where expenditure will need to be reduced or income increased. Either way the Council's residents, visitors, customers and partners will notice significant changes which they may find unpalatable.

9. Thematic area 1- Prioritisation

9.1 This work stream will look to ensure that the Council's resources are appropriately directed towards the delivery of the Council's stated priorities. High priority areas will be reviewed to ensure they are being resourced appropriately but low priority areas will see either reductions in service or complete removals of services.

9.2 As the outcomes of this theme will result in significant cuts in certain service areas and the complete removal of other services it is acknowledged that the choices made in this area will impact significantly on service users. To this end the Council will aim to ensure that priority areas are protected as much as is possible from the brunt of these cuts.

9.3 Key tools that will inform this work stream will include performance and benchmarking information. This will help the Council understand how well it is currently performing and what the potential impact of any prioritisation choices might be. Work done at an early stage of the Council redesign about the services the Council provides and which are statutory, those with discretion as to service levels, and those that are completely discretionary will also support this strand.

10. Thematic area 2- Efficiency

10.1 This work stream will look to deliver savings by making process and other efficiencies but still achieving target service and performance levels. The work will be underpinned by a number of corporate initiatives that will bring efficiencies across the organisation such as a new approach to procurement from the new shared service.

10.2 Use of tools, such as the LEAN or Kaizen methodologies, should help all managers make savings of this nature. A key element of this work stream will be to ensure that the use of such tools happens across all areas of the organisation.

10.3 A number of individual projects will need to be established under the efficiency banner, including a review of how the Council uses its properties.

11. Thematic area 3- Redesign

11.1 This theme will expand upon the existing redesign programme, which has hitherto just looked at delivery of individual services, by looking to fundamentally change the way in which the Council provides all of its services to the public.

11.2 A number of strands will make up this theme, including increasing the use of digital technologies to deliver and support service provisions; looking at how the Council can partner with and enable community organisations to provide services; and examining how a desire for increased localism will impact on service provision.

11.3 This strand will also impact on the Council's operational structure with the scope to review specific services in their entirety and look at alternative delivery models, both internally as well as externally. This may include shared services with other local partners or with other local authorities across Scotland.

12. Thematic area 4- Commercial

12.1 This theme will look to explore how the Council can generate a profit from undertaking new activities of a commercial nature. The activities are likely to leverage the Council's existing expertise and assets but use them to provide what would otherwise be, if not for the profit motive, non-core services.

12.2 As part of this theme the Council will need to explore its attitude to risk as well as consider how any required investment may be financed. Part of this stream will examine the opportunities available to the Council from operating arm's length companies.

12.3 For all projects a robust business case will be needed to properly inform decision making. That business case will illustrate costs and risks in order that the possibility of successful outcomes can be balanced against the impact of any project that may be unsuccessful.

13. Thematic area 5- Income

13.1 This work stream will look at the income the Council generates from local taxation as well as from charges for services that it already provides.

13.2 The taxation strand will look at Council tax as a key work stream with a view to setting a Council tax policy in line with the administration's priorities. Significant lobbying of national government may need to take place if local priorities for Council tax diverge from a national cap on Council tax rises. For illustration purposes an annual 3% increase in Council tax will generate around £3.5- £4m of additional income annually.

13.3 This work stream will also look at other ways the Council does, or could, raise income through local taxation and will explore amongst other things the potential for a 'Tourist tax' to be introduced.

13.4 The part of this theme that looks at the Council's income from fees and charges will review the existing fees and charges policy and also look at the services that the Council is not currently charging for but could.

14. Cost and demographic pressures

14.1 As outlined in section 3.2 of the report the Council anticipates that certain costs will increase over the 5 year period and assumptions have been made over the likely cost impact to identify the budget gap. As part of the financial approach these assumptions will need to be kept under review as any change may impact positively or negatively on the gap to be addressed.

14.2 Most significantly the modelled gap allows for £7.5m of budget pressures annually, a figure based on historic experience. This amount reflects money that would need to be allocated to service budgets to reflect demographic change, contractual cost increases, changes in legislation that increase our costs, additional revenue costs as a result of capital investment, or any other item that might increase our costs.

14.3 Alongside the process of identifying savings these cost pressures will need to be identified and challenged. Certain pressures will be easier to identify than others, for example, early estimates will be able to be made about the revenue implications of the capital programme. Other items, such as cost increases as a result of legislative change would be harder to identify- in many cases new or increased taxes, such as the introduction of the apprenticeship levy or ending of ‘contracting out’ of national insurance have been introduced in a relatively short timeframe.

14.4 Changing demographics and the potential impact on demand for services will also need to be considered. Many of the Council’s most costly services are directed at the young and the old and those groups have seen significant shifts in populations over the period from 2011 to 2016. Over that period the number of 0 – 15 years olds decreased by 3.3% (from 41,334 to 39,972) whilst the number of over 65 year olds increased by 15.3% (from 43,424 to 50,076).

14.5 The local impact of those population changes will also need to be considered as an overall decrease in school age children may mask increases in certain areas and decreases in others. There may be limited opportunity to make cost reductions as a result of the decreases whereas the increases may have immediate cost implications.

15. Capital programme review

15.1 In light of the identified budget gap the Council’s capital programme is under review, to both ensure it is aligned to the Council’s priorities but also to ensure that capital investment is appropriately prioritised in alignment with revenue spend. Decisions taken on capital spend cannot be divorced from revenue budget decisions.

15.2 All capital investment impacts on the Council’s revenue budget, whether that be the cost of borrowing and repayment to make the investment, additional running costs as a result of the investment, or revenue savings that the investment enables.

15.3 It is however acknowledged that pressures on the Council’s asset base, such as the condition of roads and bridges or the capacity in our schools also present challenges that need to be addressed.

15.4 The challenge to formulate a capital programme that is prudent, sustainable and affordable, yet addresses the pressures on our asset base is significant. Again difficult decisions will need to be taken as any net increase in our revenue costs as a result of the capital programme will necessitate cost savings to be made or additional income to be generated.

15.5 It is intended to bring any capital item that requires urgent decision to the full Council meeting in October with a more detailed programme in December. At that point Members will be informed of the direct impact on the revenue budget of any programme that may be approved.

16. Summary

16.1 Whilst we are not yet at the stage of taking any decisions on individual proposals to address the budget gap the Council recognises that all of the decisions taken will have an impact locally. The Council is committed to becoming as efficient, economic and effective an organisation as it can in order that any impact on services is mitigated in so far as is possible.

16.2 Efficiencies in the way the Council operates will only go so far and services that are highly valued may have to stop, reduce or be charged for in order that the Council can deliver a balanced budget.

16.3 Given the five year planning horizon it is key that a plan of work is developed that will ensure that savings can be delivered across the period. It is likely that the bulk of proposals will need to be developed at the start of the period in order that delivery of them can be planned appropriately across the piece.

16.4 Work has already begun to identify proposals on the themes identified. The Council meeting in February 2018 will seek approval of the 2018/19 budget and, if possible, agreement of balanced budgets for subsequent years.

16.5 Some early decisions may need to be taken in order to deliver savings as early as possible and the Council meetings in October and December would afford the opportunity for such decisions to be made.

16.6 The draft Scottish Government budget for 2018/19 is expected to be announced in early to mid-December and, if timings permit, an update on that budget will be brought to the December Council meeting.

17. Implications

17.1 Resource – Wider resource implications are as outlined in the report. The approach will require substantial input from officers across the organisation to identify, plan and deliver savings.

There are no specific Legal, Community (Equality, Poverty and Rural), Climate Change/Carbon Clever or Gaelic implications at this stage. Any proposals that are developed to address the budget gap may well have implications of this nature.

Risk – The budget gap figure of £159.2m is based upon a number of assumptions. Any changes in those assumptions may have a significant effect on the budget gap as outlined by the scenarios mentioned in section 3.1 of the report. The approach being taken is intended to be flexible to be able to absorb changes to those assumptions.

Designation: Director of Finance

Date: 29th August 2017

Author: Edward Foster, Head of Corporate Finance

Background Papers:

http://www.highland.gov.uk/download/meetings/id/72187/item_9_financial_outlook_2018-2023