



**Call for Evidence on the long-term sustainability of local government
Response to Scottish Parliament Local Government and Communities
Committee**

29 August 2019

INTRODUCTION

1. The Institute of Chartered Accountants of Scotland (ICAS) is the oldest professional body of accountants and represents over 22,000 members who advise and lead business across the UK and in almost 100 countries across the world. Our members work across the public, private and third sectors. We have drawn on their experience and understanding in responding to this consultation.
2. ICAS's Charter requires it to primarily act in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and protect their interests. On the rare occasion that these are at odds with the public interest, the public interest must be paramount.

KEY MESSAGES

3. We have highlighted key points in response to questions 1 and 3 of the inquiry, identifying what we consider are among the significant longer-term challenges to financial sustainability and practical steps we consider councils could take to deal with financial risks. Our aim is to offer an independent perspective to inform debate and share practice across other sectors. Some of these challenges may require longer term actions and transitional arrangements but we hope this helps to inform your assessment on the direction of travel.

A holistic review of funding

4. Local government funding is evolving with increasing sources of income and greater diversification of taxes. This offers flexibility but it increases administration and collection costs with the risk of volatility and potential variations across different council areas. This is not consistent with simplification of taxes and a broadening base of revenue generation increases complexity. Council tax is a reliable source but a small proportion of overall income¹; it also serves to support local accountability needs².
5. We believe that it is time to take stock of the various developments and challenges affecting local government funding. A more holistic review of local government funding and taxation could enable a more strategic approach to this challenge, to pull together the various issues and evolving practice across authorities. Such a review would need to consider the wider context of strategic change, devolution, local government funding and tax to give a clearer perspective of current and projected priorities, needs and challenges.
6. The statutory powers and purpose of local taxation need to be defined and clear principles articulated to provide a framework for setting direction and assessing options. Further comments on council tax are set out in our response to the [review of local taxation 2015](#).

Transparency and accountability

7. There is a complicated landscape of funding, services and responsibilities split between central and local government. Taxpayers need a clearer picture of what they are paying for, how resources are used and how well the authority performs. This includes improved clarity on where councils are complying with statutory levels of service and where they exercise discretion.
8. Transparency and accountability are essential, particularly during times of cost efficiencies, increasing commercialisation and revenue diversification. Financial reporting is an important mechanism for holding decision-makers to account yet local authority accounts are still specialised, complex and not particularly user-friendly³ which is inconsistent with the needs of the public – either in their role as taxpayers or as service users.
9. We are concerned that local authority financial statements do not give a clear picture of the true cost of providing services. This is not in the public interest. In particular, we recommend that the statutory framework, which conflates the council tax calculation and accounting purpose of financial statements, is amended to remove this barrier to simpler and more understandable accounts. This

¹ Source: Audit Scotland [Local government in Scotland: Financial overview 2016/17](#) and [Scottish Local Government Financial Statistics 2016-17](#) Scot Gov (page 47)

² We note the comparatively lower level of local council election turnout compared to UK elections in the [UK parliament research briefing 2017](#).

³ See more in paragraphs 24 and 25 of ICAS's [review of local taxation 2015](#)

would help to increase the transparency of the performance of local government and support engagement.

10. We also believe that, as in other sectors, local authorities should introduce an annual report as the key publication for communicating with stakeholders. This is not currently a requirement for local authorities although elements such as a management commentary are attached to the financial statements and various other publications exist. An annual report would help to consolidate the key messages and communicate in a more easily accessible format and support effective independent challenge and scrutiny.
11. Moreover, as councils evolve their funding arrangements (e.g. bond issues and other commercial activity), there is potentially a wider stakeholder group reading financial statements.

Pension reform

12. There are a variety of cost pressures facing local government, such as meeting the financial implications of increasing demands for social care services, upkeep of infrastructure, digital transformation, security requirements and environmental considerations. One area of significant cost is pensions and we have drawn on our experience of both public, third and private sectors to inform debate.
13. We believe that options for further reducing the cost of providing pensions in the local government sector should be subject to further review. There has been a significant reduction in defined benefit (DB) pension provision in the private sector, with many schemes now closed to future accrual. We illustrate the extent of this in Annex A. In summary, the reduction in private sector DB provision is due to the cost and associated risks carried by employers, including, for example, the risk that deficit contributions may need to increase following triennial funding valuations. De-risking in relation to DB pension provision can be important for the long-term future of an employer in the private sector, or in the case of the public sector, the overall sustainability of the public finances and public services.
14. In our view, the financial and sustainability risks borne by Community Admission Bodies (CABs) participating in the Scottish Local Government Pensions Scheme (LGPS), specifically charities, which may also be responsible for delivering council services, should fall within the scope of this review. Charities can find themselves unable to afford on-going participation in the LGPS (Scotland) and unable to afford the cost of exiting the scheme. We observe that many CABs have been subject to real pressures and have closed to new entrants. We also recognise that some charities have managed to negotiate an exit from the scheme. Further details are provided in Annex A.

Governance and internal control

15. We note the growing need for other income and actions to fill the funding gap with other sources of revenue, including greater commercial activity. Whilst this offers diversity of income sources, it also brings risks and councils will need to ensure they are able to increase the commercial experience and knowledge across the governance structure including operational, oversight and scrutiny levels. For example, we suggest that at least one but preferably two independent audit committee members would be beneficial to bring a different perspective and challenge.
16. Within the context of increasing financial pressures and demands, we stress the importance of maintaining a sound governance and control framework. Internal controls, wider responsibilities and risks (reputational as well as operational and quality) need to be considered to inform a balanced and holistic decision, where cost pressures are appropriately balanced with other priorities.
17. The role of the financial professional is key, as is ensuring that the finance team is appropriately resourced, qualified and represented. This is not dissimilar to the importance of professional expertise in other areas e.g. building regulations. We note the example of costly errors in school building projects where the on-site oversight role of a clerk of works was cut as well as examples of various failures in internal control highlighted by annual audit reports. Whilst motivations to prioritise front-line services over back office services may be understandable, weakening the internal and financial controls environment can be a false economy.

Taxation

18. Existing tax rules can inadvertently influence delivery structures. There are inconsistencies in the VAT rules which affect local authorities but also other public sector bodies. As the ability to reclaim VAT is by organisation type rather than by activity, this can act as a disincentive to implementing new strategies for

delivering public services. We believe that a more level playing field would facilitate organisational reform, reduce complexity and improve efficiency. This is further explained with examples in our paper to the [OTS - Review of Value Added Tax 2017](#) from page 21 onwards.

19. Another example is that tax rules can encourage setting up alternative business structures, such as a charitable company for delivering services. This may be attractive as it offers certain tax benefits. We would question whether tax rules should be the driver of structural form as it increases complexity and risk which brings its own costs. We highlight the importance of “following the public pound” and sound governance.
20. With scope for diversifying local taxes (e.g. tourist tax), it is essential that any such proposals are subject to robust public debate before a decision is made. Further comments on the factors for consideration on local taxes are in Annex B.

Sharing innovation and expertise

21. The establishment of the Scottish Futures Trust has shown financial and risk benefits of a central pool of expertise for focusing on large construction and infrastructure projects. We suggest that a review of other potential large projects managed by individual councils (such as IT and digital) could highlight opportunities for a centre of excellence to help facilitate pooling and sharing of expertise, commercial and negotiation skills. This could help to reduce the risk and cost of planning and delivering large, complex projects.

Shared services and structure

22. Although there have been various developments and innovations around collaboration, partnership and joint working, there has been limited progress on shared services per se as an option for reducing costs. A question for debate is whether an element of structural reorganisation could provide a needed opportunity to help drive broader shared services, particularly around back-office functions to achieve further cost savings.

Long-term planning

23. We stress the importance of long-term planning to help address risk and uncertainty in future needs and services as well as ensuring that appropriate conditions are in place to support robust and reliable information. For example, greater certainty of multi-year funding supports longer term financial and scenario planning and option appraisal.
24. Workforce profiles in particular sectors raise a question around the risk to service provision and potential liability of addressing succession planning. For example, data from an integrated joint board in Scotland of their social care workforce profile shows a significantly ageing workforce profile compared to that for health. Only 3% of staff are under 25. The largest category of staff falls within the 50-54 years of age category for health and social care.

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Pension reform

Public service pension provision in the UK is largely defined benefit (DB) while in the private sector defined contribution (DC) provision has become the norm. The decline in private sector DB provision has more than one specific cause. In summary, however, both the cost of DB provision and the associated risks carried by the employer have contributed to the reduction in the number of private sector DB schemes from 7,800 in 2006 to 5,450 in 2018. The percentage of schemes closed to future accrual has risen to 41% in 2018 compared to 12% in 2006⁴.

The implementation of pensions auto-enrolment has increased the number of people across the UK saving for a pension by more than ten million since its roll out began in 2012 so there is some good news for those working in the private sector. But the minimum contribution rate, which increased to 8% of qualifying earnings in April 2019, is too low to provide a meaningful retirement. At a UK-wide level there is still a pressing need to increase the number of workers who are saving for a pension, particularly those who are self-employed, and for those who are saving to increase their contributions.

Steps have been taken over the years across the UK to make the provision of public service pensions more sustainable, for example, uprating pensions in payment by the Consumer Price Index rather than the Retail Price Index, moving to a career average model rather than final salary model and Local Government Pension Scheme (LGPS) pooling arrangements in England and Wales. A restructure of the Scottish LGPS is under consideration following a stakeholder consultation by the Scheme Advisory Board in 2018. The Committee may wish to scrutinise the Scottish Government's favoured option for reform and any anticipated cost savings as part of this inquiry.

Plans to make workplace pensions more sustainable are understandably not well received by scheme members as these can lead to having to work longer than planned, taking a reduction in anticipated income or taking on risks previously borne by their employer. However, de-risking can be important for the long-term future of the employer, or in the case of the public sector, the overall sustainability of the public finances and public services.

In July this year, the UK government confirmed that the Court of Appeal ruling, in the McCloud case, applies to all public service pension schemes. The Court of Appeal ruled that transitional arrangements established for judges' and firefighters' pensions as part of the move from financial salary to career average were discriminatory. Initial UK Government estimates suggest that the cost to the public purse to remedy the discrimination will be around £4bn. The McCloud case, and the related Sargeant case, illustrate how challenging public service pension reform can be with the impact of unanticipated changes now needing to be taken into account. The LGPS Cost Cap review was paused earlier this year pending the outcome of McCloud.

The UK government is keen to make changes to pension regulation so that collective defined contribution (CDC) schemes can be established. Broadly speaking, CDC schemes mean the collective sharing of risk by members and while a specific level of retirement income can be targeted, there is the potential to reduce benefits if investment returns are insufficient.

UK government policy in this area has been prompted by Royal Mail's desire to provide its employees with a CDC arrangement. This plan is supported by the Communications Workers Union. There are considerable challenges both technical and practical to introducing CDC in the UK and key to any success will be scale.

Within existing legislation, there have also been changes made by some of the largest UK pension schemes, such as the Universities Superannuation Scheme (USS). USS now limits defined benefits at a certain salary level with defined contribution benefits provided in excess and this is something which could also be considered in terms of the future cost sustainability of public service schemes.

For several years, ICAS has had concerns about the affordability of community admission bodies, specifically charities, participating in Scottish LGPS particularly those with a small number of active members and no third-party guarantees. We have made recommendations, via the Scottish Public Pensions Agency (SPPA) in the past, designed to enable charities to exit in an equitable and affordable manner. Broadly speaking the position of charities remains the same today, although we acknowledge steps taken by some scheme funds to assist charities to exit in a financially sustainable way.

⁴ The information on private sector DB schemes has been sourced from the [Pension Protection Fund's Purple Book 2018](#).

Current practice means that charities must keep at least one employee within a scheme fund to avoid triggering an expensive cessation (or exit) debt. Charities which do not have the funds to pay the cessation debt are not in a position to close to future accrual in a managed way and are forced to keep active members in the scheme fund, building up additional pension liabilities they cannot afford which threatens their future sustainability. Recent changes to regulation gave scheme funds the power to issue suspension notices, effectively suspending a charity's cessation debt. However, in practice this power has not been used.

Charities also risk inadvertently triggering a cessation debt, for example, when their last employee in a scheme fund retires. This leaves a charity's trustees with a sudden unplanned for debt which could put their charity at immediate risk of collapse. Other employers in the scheme will be liable for any irrecoverable debt and the local authority will need to step in to ensure the continuity of any public services provided by the charity on their behalf.

Charities may inherit liabilities relating to staff who transfer to them from a public sector employer. LGPS (Scotland) funds do not appear to be able to segregate the service given by individuals across multiple employers, which means that the later employer, which could be a charity, inherits all the historic liabilities.

A charity in this position experiencing a cessation event is responsible for these historic liabilities on the much higher cessation basis compared to the on-going basis which would have applied had it been a public sector body. We acknowledge that there is some good practice out there in the treatment of charities in this position which makes those charities and the public services they provide more sustainable. For example, Lothian Pension Fund has recognised that where service was accrued under local government employment and transferred to a charity employer, that employer should be dealt with in a different way and have any exit debt calculated on an on-going basis. However, this approach still leaves charities with pension debt incurred by earlier employers and this practice, while beneficial even if limited in scope, is not applied consistently across Scottish LGPS funds.

A key challenge from a policy-making perspective is that there is no data available which considers the ability of charity employers, who are 'at risk' of triggering a cessation debt, to continue as going concern if a cessation event occurs. Due to the absence of data, this is an issue which is not sufficiently visible to gain either the attention or action it needs from policymakers.

Diversification of taxes at local authority level

Some proposed taxes lend themselves to being set and administered at a local level by local authorities such as the Transient Visitor Levy and the tax on Vacant Land, where:

- the tax base may be localised, and
- there is little scope for the respective tax bases to relocate across local authority boundaries.

On the other hand, it may be more efficient given the large number of local authorities to have one tax designed and applied nationally; or designed nationally but with, say, flexible locally applied rates.

With local tax raising, it may open up the possibility that such taxes create a cycle of funding inequalities between local authorities that increases over time – i.e. those local authorities with, say, strong tourist demand would be able to raise most revenue from a levy, which in turn enables them to strengthen the tourist offering further. This also raises questions about how revenues should be distributed and goes back to one of the questions about the purposes of tax in general and whether it should have a redistributive element.

Approach

There are a number of factors that need to be considered before introducing any new tax, such as the rationale for the individual taxes put forward, the revenues likely to be raised, the potential for the tax to have perverse or undesirable effects, and practical administrative issues associated with tax design and revenue collection.

This also needs to be evaluated within a clear understanding of the Scottish approach to taxation, and give consideration to the purpose of taxation in general – should it be to help the economy? Should it be purely for revenue-raising? Should tax have a role in driving behaviours? Does it have a role in redistributing wealth (common good)? There should be a long-term strategy that outlines the broad principles underlying the role of taxation in Scotland.

If a problem or issue is identified, before automatically viewing tax as the solution, there is a need to ask whether it is the correct solution or whether there are other, better alternatives than using tax mechanisms.