THE DAVID HUME INSTITUTE

Re-Shaping the Public Finances

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FOREWORD

Coping with the public finances has to be the most difficult, but at the same time the most urgent, for all parts of the UK for the foreseeable future. We at the David Hume Institute (DHI) have undertaken and supported various activities – research, publications and seminars – of relevance in recent years. However, we realised early this year that there was a priority to do more both urgently and with as much engagement across a broad spectrum as was possible. We were delighted that our friends at the Scottish Policy Innovation Forum (SPIF) agreed to work with us on this venture; and we are most grateful to IBM for their generous support.

The first step that SPIF and DHI took was to organise a Round Table discussion at the Royal Society of Edinburgh in the spring of 2010. We invited to this session a variety of the key players and received positive responses from the great majority of those whom we invited. This round table helped us to identify the key issues for further examination and to demonstrate our bon fides so far as the subject matter was concerned.

Subsequently, with IBM support, we set out on a three pronged approach. First we commissioned from participants at the Round Table and others the series of essays that is now being distributed. Second we were very fortunate to be able to arrange, with the close co-operation of Paul Grice and others at the Scottish Parliament, a Round Table discussion with members of the Parliament's Finance Committee and some convenors of other committees. This took place in late September and was attended by the authors of these essays and Sir Neil McIntosh from the Independent Budget Review Group. Finally, we organised a seminar in late October with Carl Emmerson, Acting Director of the Institute of Fiscal Studies, as the main speaker supported by Professor David Bell to cover the Scottish dimension and chaired by Jim Gallagher of SPIF. The seminar was impeccably timed, given the announcement by the UK Government of the public finance figures for the years ahead on 20th October – and the IFS is better placed than anyone else in the UK to provide expert and incisive commentary.

These essays are thus one part of an integrated programme attempting to assist the process of preparing for a range of difficult decisions to be taken in Scotland in the months ahead. In addition the Institute organised a seminar specifically in financing of Higher Education in Scotland, on 11th October, the date of the publication of the Browne Report on financing of HE in England; and I am sure that there will be further events and papers to follow.

You will see that Jim Gallagher and I have tried to provide an overview of issues flowing from the attached essays. However, I do commend all the essays to you; reading our effort should in no way be seen as sufficient to capture the interesting and important content which follows. The next two essays address the key factors first from the economic perspective (by Anton Muscatelli) and then on the financial front (by Robert Black). Then comes a number of issue based contributions, each of which tackles an important topic and draws upon the vast experience of our authors and their organisations.

There is no silver bullet to solve the public finance problems to be faced across Scotland. A range of different solutions, some involving distinct discomfort, will be required. Our hope is that these papers and the various discussions which we have arranged will illuminate the debate and, albeit at the margin, enhance decision making. Suggestions as to where we should go next would always be welcomed.

It is important to emphasise, as do several of our authors, that there will be issues to be faced over the medium to longer term as well as in the immediate future. This debate must run and run – always looking to means to achieve the public finance solutions at minimum cost to economic and social welfare in Scotland.

I am extremely grateful to Lesley Sutton and Joan Orr of the DHI and Darragh Hare of SPIF for all their efforts to ensure that this valuable document was produced on time and in a manner likely to add such value to this crucial debate.

In closing I must, as ever, note that as a wholly independent and charitable organisation the David Hume Institute and its Trustees has no views of its own on any of the subjects covered and simply wishes to enhance the debate. As a network of people interested in public policy, SPIF has no views either.

Jeremy A Peat
Director
David Hume Institute
October 2010

The Authors

Jim Gallagher FRSE is visiting Professor of Government in Glasgow University and Gwylim Gibbon Fellow at Nuffield College, Oxford. He was Director General Devolution for the UK Government and served an advisor in No 10 to both Gordon Brown and Tony Blair. He also held a number of senior civil service posts in Scotland including head of the Scottish Justice Department.

Jeremy Peat has been Director of the David Hume Institute since 2005. Previously he was Senior Economic Adviser at the Scottish Office from 1985 to 1993 and Group Chief Economist at the Royal Bank of Scotland from 1993 to 2005. He is also a member of the Competition Commission, BBC National Trustee for Scotland and. He is an Honorary Professor at Heriot Watt University.

Anton Muscatelli is Principal and Vice-Chancellor of the University of Glasgow since 2009. He was previously Principal and Vice-Chancellor of the University of Glasgow. An academic economist, he has held a variety of appointments at the University of Glasgow, including Daniel Jack Professor of Economics (1992-2007). He has held visiting appointments in a number of Universities in Europe and the USA, as well as the World Bank and the IMF. Prior to devolution he was on the Panel of Economic Advisers of the Secretary of State for Scotland (1998-2000), and has acted as a Special Adviser (since 1997) to the House of Commons Treasury Select Committee.

Robert W Black is the first Auditor General for Scotland; His statutory duty is to arrange for the audit of the expenditure of most public bodies in Scotland, including the Scottish Parliament and departments of the Scottish Executive but excluding individual local authorities, and to make reports to the Scottish Parliament. He is the accountable officer, and therefore in effect the chief executive, of Audit Scotland. His previous post was Controller of Audit for Scotland, and his earlier career was mainly in local government. He was Chief Executive of Tayside Regional Council between 1990 and 1995, until just before its abolition. Before that, he was Chief Executive of Stirling District Council, and his earlier career was in policy planning and research with Strathclyde Regional Council and Nottinghamshire County Council.

David Bell is currently Professor of Economics at Stirling University. He is a Budget Advisor to the Finance Committee of the Scottish Parliament and is co-director of Scotecon - the Scottish Economic Policy Network. He has lectured at both Glasgow and St Andrew's Universities and was a member of the Independent Expert Group advising the Calman Commission on Scottish Devolution.

Richard Kerley is currently Professor of Management at Queen Margaret University where he has been since January 2003. He was previously at the University of Edinburgh and the Scottish Local Authorities Management Centre, University of Strathclyde . Before entering academic life Richard worked in advertising ; hospitality and in prison education . His most recent publications include an occasional paper on the current UK fiscal crisis ; a book chapter on performance in public services; and journal articles on the management of urban car parking as an example of effective practice in public management .Richard chaired the Scottish Executive Working Party on Renewing Local Democracy; the report of which was published in July 2000 and which was legislated for in June 2004 as the Local Governance Act.

David Hume is Chief Executive of Scottish Borders Council. He is a native of Edinburgh and a graduate of the Universities of St Andrews, Wales and Edinburgh. He has a keen interest in all aspects of modern public services and their role and contribution towards the creation of resilient, sustainable and healthy communities**.**

Kal Osmani leads IBM's Public Sector business and has over 20 years experience working with the public sector, primarily focussed on Local Government. Kal's career started working for Newcastle City Council during times of major reorganisation and implementation of change initiatives such as CCTA. Kal has worked with the Scottish public sector since 1997 across central and local government.

Professor Eddie Frizzell CB MA FRSA has been Visiting Professor in Public Service Management at Queen Margaret University, Edinburgh since his retirement from the Civil Service in 2006 where he was Head of the then Scottish Executive's Enterprise Transport and Lifelong Learning Department. Between 1991 and 1999 he was Chief Executive of the Scottish Prison Service. In both roles he was responsible for the leadership and management of public service organisational and cultural change.

John Aldridge worked for 29 years for the Scottish Office and Scottish Executive covering a wide range of the Scottish administration's responsibilities. His last post was Finance Director. He was a member of the Independent Finance Group established to support the work of the Calman Commission on the constitution, and currently chairs the audit committees of the Scottish Prison Service and of the Scotland Office and Office of the Advocate General.

Re-Shaping the Public Finances
An Overview

Jim Gallagher and Jeremy Peat

Introduction

Both the David Hume Institute and the Scottish Policy Innovation Forum are delighted with the essays collected together in this document and very grateful to all the authors for their efforts. Our task here is to provide an overview of the tales told and suggestions made in the essays, and to bring out some of the key issues and themes to assist further discussion. Any contribution that can be made to a complex and problematic policy debate must be of value.

There are *four key points* which we wish to emphasise from the very outset.

1. First there is <u>no simple or single solution</u> to the problem of rebalancing Scotland's public finances over the years ahead.
2. Second, <u>the problems faced are not short term in nature</u>. As several of our essayists note Scotland – along with the UK as a whole – faces a task which will continue for a number of years. It has been suggested by many observers that over the past decade or so the public finances were operated on the basis of unrealistic assumptions about the productive capacity of the UK economy, i.e. an unrealistically high estimate of the sustainable trend growth rate. If that is correct, then the implication is that some considerable time will be required to bring about a return to stability. Hence the deficit issue will be resolved in the medium or longer term rather than forthwith.
3. This makes it even more important to think through <u>a range of means of responding to the challenge</u>. The objective must be to put together an appropriate package – silver buckshot rather than silver bullet - including, for example, efficiency savings, raising additional revenue and changes in ways of financing activity - alongside cuts in service and spending per se.
4. Finally, all efforts must be made to achieve the savings and changes required in such a manner that there is the <u>minimum necessary adverse impact on economic and social welfare</u>. Delivering such welfare is the key objective of any government, and means of minimising impact require examination in a longer rather than short term context.

Clearly we are not alone in pondering the implications of public finance constraints for Scotland. We wish to acknowledge the transparent way in which the topic is being addressed. Our authors frequently refer to the work of Andrew Goudie, Chief Economic Adviser at the Scottish Government, who has set out starkly the scale of the challenges that lie ahead. The other major reference is to the work of the Independent Budget Review (IBR) group, the 'Three Wise Men'. We are particularly pleased that one of those sages was present at our Round Table last spring and will be present again at the Holyrood discussion in October; and that one of his colleagues will be with us for the October seminar. Our authors clearly agree with a great deal of the analysis by Goudie and the IBR, and attempt to build upon rather than duplicate their work.

The Challenge

Our first two papers, by Muscatelli and Black, provide a lucid if scary statement of the challenge. As Muscatelli makes clear, the worldwide recession has accentuated the problems already building in the UK as a result of heavy borrowing by consumers and the public sector.

There is debate as to the balance of causation between external and internal factors, just as there is on the pace and timing of a return to a stable path (see Bell in particular). However, there is no disagreement with the view from Goudie and others that major reductions will be required and that a prolonged programme will be essential.

Black is clear on the growth in public sector spend and headcount in Scotland in recent years. He estimates the former at 5% real growth per annum for ten years. As Bell notes, there has at the same time been an increase in the extent of 'universal' services, some available only in Scotland. In addition some capital investments have been funded 'off balance sheet' and these cannot be ignored. 'The combined costs of PFI contracts, non-profit-distributing commitments and capital charges is around £3.2 billion a year' (See Black.) Further, again as emphasised by Black, there is a backlog in maintaining the public sector physical estate, despite the decade of real growth in public spending.

We should also note some factors in the broader environment which accentuate the difficulties ahead. Scotland has an ageing population. As emphasised in 2009 papers for the DHI by Ermisch and Wright[1] an ageing population (*ceteris paribus*) results in the heady combination of lower tax revenues and heavy demands for additional public expenditure. Then there is the question of public sector pensions, worthy of a set of papers on its own, not to mention the financial pressures associated with attempts to meet tough targets for the reduction of greenhouse gas emissions in Scotland. Even without any existing excess deficit to be coped with, these issues alone would have resulted in severe challenges for government.

One final point under this heading is that several authors suggest that the record on efficiency gains in the Scottish public sector has been disappointing. This is not least because of the lack of suitable data to produce meaningful targets that can be readily monitored. The plain fact is that cost reduction through improved efficiency has, with a few notable exceptions, been poor. Two or three years back the DHI looked closely at means of achieving efficiency gains, based upon positive experience in Scottish Water[2]. Further research by Armstrong for the DHI then emphasised the importance of clear and measurable targets, plus incentive mechanisms related to target achievement. This work becomes even more important in the present context and Armstrong's work provides a ready starting point for real progress to be made across sectors of public sector activity[3]/[4].

The Options

As The Wise Men emphasised the full range of options has to be examined. We have already referred above to efficiencies and here the papers by Frizzell and Hume merit close examination, while taking account of the cautionary words by Kerley. There is no quick or easy fix.

Both Aldridge and Bell consider aspects related to revenues. Bell notes that there may be some appetite for tax rises in Scotland, albeit the SVR is not popular with either MSPs or the Scottish Government and (see Aldridge) its use is all but ruled out. The question of unfreezing Council Tax is being much debated, but any benefit would not necessarily flow to council-related services.

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[1] Ermisch, J, Lisenkova, K and Wright, R (Feb. 2009). *Essays on Demography and Ageing*, Hume Occasional Paper No. 82

[2] Byatt, I (April 2006). *Balancing Regulation and Competition in the Water Business in Scotland*, Hume Occasional Paper No. 67

[3] Armstrong J (Nov. 2007). *Improving Productivity in Scotland's Public Services*, Hume Occasional Paper No. 74.

[4] Armstrong, J (Feb. 2008). *Improving Productivity in Scotland's Public Services – Policy Lessons*, Hume Occasional Paper No. 76

As the report from the IBR emphasised there are opportunities for charging for some of those services which have recently been made free. Indeed consideration might also be given to selective charging for some services which have been free for an extended period – as Kerley and Aldridge point out, why look only at recent additions? What about inter-urban or intra-urban road charging (theoretically efficient from an economic viewpoint), charging for some library services or even components of NHS spend? We must also mention the question of Scottish Water, as stressed by the IBR team. No quick fix is feasible here, but given the long term nature of our problem a change in structure and/or financing of Scottish Water must merit urgent consideration.

In his November 2009 Report, the Auditor General for Scotland, identified recurrent costs of almost £1bn a year for services now being provided free in Scotland. Bell provides a rigorous examination of the universality versus selectivity debate. As he notes, many 'free' services are seen as entitlements and opening up the means-testing issue would provoke a trenchant debate. But we need to examine carefully all real options and to consider not just what may be seen as politically feasible but also what makes sense rationally in these tough times.

There will be particular pressures in the Higher Education sector, not least because of competition with England, where the Browne Report on the sector's finances is expected in the first half of October. Indeed it looks as if that will emerge on the very day (11th October) that DHI has organised a discussion on Scottish aspects of the issue – involving Frances Cairncross of the Council of Economic Advisers, Sir Andrew Cubie and Professor Neil Shephard of Oxford University. The existing regime in Scotland is unsustainable in the current and prospective public finance environment. No options should be ruled out at this stage. Universities Scotland is – rightly – rigorously assessing options and a Scottish Government paper is expected in late 2010/early 2011. However important HE is to Scotland's economic prospects, financial aspects of the sector, including the position for students, should be a key element of the overall debate discussed in these essays.

As we note above, a combination of measures will be needed to deal with this problem, and attention will need to be given to their timing, as some will yield benefits more quickly than others. Early progress on cost-reducing efficiency gains and revenue-raising by different means could help to take the strain of sorting out the public finances in the shorter term. They may be deliverable in a somewhat shorter time horizon than cuts in services, and certainly quicker than structural change to achieve continuing efficiency gains in future. Prioritising effort initially in these directions could permit a more measured approach to the implementation of painful service and staffing reductions.

Cutting Services

But cuts cannot be avoided. Painful choices will be required. Will health be immune in Scotland as in England? Is that a reasonable rather than purely emotional line to take? Clearly there are heavy pressures on the health budget from above inflation cost increases (some related to quality enhancements) and demand pressures (not least due to ageing).

However, there are choices to be considered – for example some argue a preference on financial and wider grounds for care for the elderly being increasingly undertaken out of hospital – perhaps with 'personal' budgets. Such external care would fall to budgets other than the NHS, mostly those of local authorities. Should the balance of cuts reflect this and other factors?

We must also note that pay and pension costs constitute the dominant element of spend on most public services. Scottish and UK Ministers have both borne down on pay, and there have been some modest changes to some pension schemes; although neither by any means as sharply as in the Republic of Ireland. Now decisions will be required as to what happens next on pay and pensions. Should Scotland stay within UK deals or stand alone in some areas? There is no obvious logic to the present pattern, and no clear evidence as to which approach delivers the best results.

There is, however, only limited evidence of pay deals in the public sector being linked to positive efficiency changes or overall cost reductions. We refer back to the earlier Armstrong work and the reference by Black and others to the lack of suitable measures of efficiency/productivity. The importance of productivity-related pay arrangements simply further underscores the critical importance of appropriate target measures, reliable data and suitable incentive mechanisms.

We do not understate the importance of learning from others. The Byatt paper on Scottish Water is one highly pertinent example. The IBM/Osmani paper included in this set of essays another. CBI (Scotland), the IoD and others will have (much) more to add. Practically all Scottish companies have been through highly painful cost reduction exercises since recession struck. There are positive – and negative – lessons to be learned from their experiences.

The Longer Term – driving efficiency

We recognise from these essays and other sources that structural change and alternative means of delivery of services must be deployed to help achieve the public finance relief required while minimising the adverse economic and social effects. Kerley, however, rightly reminds us that reorganisation does not of itself deliver savings. It is tempting to propose simplification of the Scottish public sector landscape – which has grown rather than been designed – and previous Scottish Ministers toyed with the idea of reform of this sort. But the main costs will always remain tied up in the delivery of services, rather than their managerial or political oversight.

But we must look to the longer term as well as meeting the immediate pressure of cost reduction. It is clear that the present structures do not create the right opportunities and incentives for continuing improvements in efficiency and reductions in cost. At the macro level the Scottish Parliament and Government are funded almost wholly by Westminster grant, though that is set to change in future as the Coalition Government is pledged to implement the recommendations of the Calman Commission

The Armstrong work also addresses the issue of efficient delivery, seeking to introduce some of the benefits of the market mechanism, where feasible, while retaining policy control. An earlier DHI paper by Gallagher et al[5] considered means of enhancing the efficiency of delivery whilst at the same time increasing local democracy and accountability. In brief, there are, he suggested, areas where local authority delivery yields neither efficiency nor accountability.

Hume also addresses some key issues, as does Frizzell whose thoughts on cultural change merit a careful read. Joint working has to be considered in some areas, as does the question of whether we have simply too many institutions for efficient service delivery in some parts of the public sector.

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[5] Gallagher, J, Gibb, K, Mills, C (Jan. 2007). *Rethinking Central Local Government Relations in Scotland: Back to the Future?*, Hume Occasional Paper No.70

Private sector bodies, and others, have achieved truly significant savings via more efficient and better managed procurement and contracting out – with proper policy oversight retained in-house. No rush to change will generally be desirable but the 'Total Place' approach clearly also merits attention.

Even some very simple incentives do not always work the right way. As one example some HE and FE institutions might wish to consider efficiency gains via contracting out some services (HR, finance, property, etc) jointly or severally. However, we understand that if they did then the costs involved would become liable for VAT. Why would VAT apply on a more efficient option when this is not the case for solo in-house services? This is a classic example of a perverse incentive and one within the scope of UK Government action. If creative accountants cannot find a way through this impasse, then an obliging Chancellor could do so post haste.

Another point raised by Frizzell, which chimes with points made by Hume and Kerley, is that there must be a willingness to empower organisations and managers to run tight ships without political micromanagement. Of course going down this route requires good managers[6] and the appropriate incentives and basis for oversight. We are back to the issue of performance measures.

A special work-stream by Government on service delivery and organisational efficiency, with private sector and local authority input and undertaken transparently, could well help progress matters at a suitable pace so that changes could be introduced in time to limit the full extent of service cuts which would otherwise be required.

The Longer Term – Watch the Economy

Without entering the debate on precise Government Expenditure and Revenue figures[7] it is widely accepted that the Scottish economy is highly public sector dependent. The wider impact of cuts in Scotland, via employment and 'multiplier' effects, may be proportionally more significant than at the UK level. The construction sector has, if data are to be believed, been a driving force for UK growth in the first part of 2010. Work by IFS and others makes it very clear that capital spend will be hit particularly hard by budget cuts and this will be very bad news for the construction sector. In strategic terms heavy cuts on infrastructure spend (physical and human capital) in Scotland risk severe damage to Scotland's competitive position, at a time when this will be critical to the timing of emergence from stagnant economic growth.

Of course any impact on unemployment and incomes in Scotland will further damage consumer confidence (already dramatically damaged by a variety of UK-wide and Scotland-specific factors) and induce a further downward ratchet on confidence and spend – with housing market effects as well. If only some change to the funding system and fiscal accountability provided a magic and speedy salvation. Nevertheless, as Bell and Aldridge emphasise, the Scottish government should have a financial stake in the future of our economy.

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[6] Mathias, M, Reddington, E (Jan. 2006). *Good People, Good Systems – What Public Service Managers Say*, The SERCO Institute

[7] GERS (2010), *Government Expenditure and Revenue Scotland 2008-09*, Office of the Chief Economic Advisor, The Scottish Government, Edinburgh.

Apart from anything else slower economic growth will mean both slower revenue growth and higher demand for services, taken together meaning that the public finance problem would remain significantly worse for longer. Enhanced fiscal accountability, as in the Calman proposals, may only be at the margin, but must be one change of incentives for the better.

And So?

We make no claim to have the final answers. We do claim that these essays will help inform and, we hope, stimulate the debate. We believe that our thoughts are wholly consistent with those of the three 'Wise Men', and in particular we agree that no options should be excluded without thought and that difficult choices are required.

In the short term that will mean **renewed emphasis on efficiency**, but in a manner that provides confidence that genuine gains will be delivered. At the same time the tricky question of **universality and free delivery** across a range of services must not be ducked. There are no easy answers.

Subsequently **cuts will be essential**, as will reinforcement of efficiency gains associated with structural change and reviewed delivery mechanisms – matching efficient deliverers with the services they are fit for purpose and with strategic oversight and well structured monitoring of delivery, with workable performance measures and effective incentive mechanisms.

Changing the culture will be critical. We are in a different era from the past decade and that must be reflected across the thinking and approach in all parts of the public sector. Challenge should be the key. Nothing should be accepted as given unless it is clearly efficient and effective and a critical component of services for Scotland.

Strong management and sound and accessible data will also be essential. Even strong managers need reliable data and the appropriate incentives. Setting such incentives is not feasible without both clarity on objectives and straightforward means of assessing progress.

Finally, **transparency will assist**. Publication of the work of the Chief Economic Adviser and the report of the Independent Budget Review group was hugely welcome. Perhaps the IBR group should have a continuing role. Certainly the answer is not to take everything – analysis and consideration of options - within the house. The final choices will be for Government and Parliament. But being as open as possible will not only keep folk informed but should also result in decisions with a better – less bad? – result for Scotland

Jim Gallagher – SPIF
Jeremy A Peat – Director, David Hume Institute

The Great Recession and Fiscal Retrenchment in the UK

Anton Muscatelli

Introduction

The post-2008 economic crisis which engulfed the world economy took most observers by surprise. The crisis was, in many respects, the economic equivalent of a 'perfect storm'. There were several contributing and interlinked elements[1]. These included: an asset bubble covering both stock markets and especially property markets in the United States and many Western countries; the creation of complex and non-transparent financial derivatives many of which permeated the balance sheets of banks and other financial institutions in the US, UK and other OECD countries; and a systemic banking crisis which hit these countries, matched by a collapse in trust towards financial intermediaries, especially banks. The asset bubbles were fuelled by major financial imbalances in the world economy, whereby low savings rates and current account deficits in the US and some other Western countries were financed by large current account surpluses in China and other emerging economies.

The adjustment was triggered by the sub-prime mortgage crisis in the US in 2007, which quickly spread through both financial and trade linkages to the UK and the rest of the world. Some have labelled the current economic slow-down the 'Great Recession'. The suggestion has been made that had there not been a concerted monetary and fiscal expansion in many G20 countries to counteract the crisis, the world economy might have slipped into a new 'Great Depression'[2].

A full analysis of what caused the 'Great Recession' is beyond the scope of this short paper. In what follows, I will instead focus on the consequences of the crisis for the UK's fiscal position and the current UK Government's policy stance, as this is central to understanding Scotland's budgetary position under the current devolution arrangements. First, I will show that in the run-up to the crisis in 2007-08 the UK's fiscal position was weaker than might have been desirable. Second, I will analyse the reasons why the 'Great Recession' widened the UK's fiscal deficit, and triggered the need for a fiscal retrenchment in 2010. Finally I will consider whether the current moves in the UK and other countries to tackle the huge budget deficits through budget cuts and/or tax increases are desirable and will produce a sustainable outcome.

Prelude to the Fiscal Crisis: Fiscal Imbalances in 2007-08

The economic slowdown across the world economy post-2008 led to the first *worldwide* recession since the Second World War. In 2008-09 the world economy shrank for the first time since 1945, by -0.6%, with the advanced economies shrinking by -3.2%. Trading economies like Germany and Japan suffered a particularly sharp slowdown, as world trade fell by a remarkable -11.3% in 2008-09, but those economies with large financial sectors which were particularly affected by the crisis, like the UK, also experienced a major recession[3].

[1] Readers will note that there were both elements of financial contagion, and common shocks across countries, in the current crisis (for a good account, see Reinhart and Rogoff, 2009, ch.15)
[2] For an interesting comparison of the current slowdown to the Great Depression, see Eichengreen and O'Rourke (2010).
[3] For a comparative account, see the IMF's World Economic Outlook update for July 2010, http://www.imf.org/external/pubs/ft/weo/2010/update/02/

The sudden slowdown produced a determined effort by the major economies to forestall a new 'Great Depression'. At the London summit on 2 April 2009, the G20 leaders issued a clear commitment to restore economic growth through a co-ordinated fiscal and monetary expansion:

"…We are undertaking an unprecedented and concerted fiscal expansion, which will save or create millions of jobs which would otherwise have been destroyed, and that will, by the end of next year, amount to $5 trillion, raise output by 4 per cent, and accelerate the transition to a green economy. We are committed to deliver the scale of sustained fiscal effort necessary to restore growth.

Our central banks have also taken exceptional action. Interest rates have been cut aggressively in most countries, and our central banks have pledged to maintain expansionary policies for as long as needed and to use the full range of monetary policy instruments, including unconventional instruments, consistent with price stability.

Taken together, these actions will constitute the largest fiscal and monetary stimulus and the most comprehensive support programme for the financial sector in modern times…"

From G20 Leaders Statement[4], London summit, 2 April 2009

One of the problems facing a number of countries, however, was that they already expected large structural budget deficits in 2007-08 before the crisis hit, and so the fiscal stimulus came on top of what was already a worsening budgetary situation. Indeed, in some countries this limited the extent to which an additional fiscal stimulus could be injected into the economy.

Table 1 shows the fiscal picture across a number of OECD countries for 2007-08, with forecast data drawn from the OECD Economic Outlook 2007, and actual OECD data from OECD Economic Outlook 2009. The first column shows that a number of OECD countries, but especially in the G7, were already experiencing structural fiscal deficits in 2007-08. The UK's deficit in 2008 was estimated at 2.5% of potential GDP, and it had been even greater 3-4 years earlier. Measures of structural deficits are notoriously sensitive to assumptions made about potential GDP (the level of domestic output which is sustainable in the long run given current resources and productivity), and there is no doubt that by 2007-08 most of the advanced economies were experiencing an unsustainable boom. In other words the estimated levels of potential GDP were probably exaggerated, and these structural deficits were underestimated[5]. As a result, governments saw their fiscal ground shifting underneath them. As an illustration, the second column of Table 1 shows that only two years later, in 2009, the US and UK structural fiscal deficit in 2008 was estimated at about 6% of potential GDP. Table 1 also shows that small countries like Iceland and Ireland that were very dependent on their financial sector or suffered large property price bubbles suffered more than larger economies like Germany and Italy where the financial sector was initially less exposed[6].

[4] See http://www.g20.org/Documents/g20_communique_020409.pdf

[5] See Suyker (1999). Indeed, Table 1 shows that some countries which suffered major contractions such as Iceland and Ireland went into the 2008 crisis with marginal structural fiscal *surpluses* as estimated by the OECD in 2007. These surpluses were quickly swamped by events.

[6] That does not mean that these countries are immune in future, especially given the exposure of many continental European banks to sovereign debt.

Table 1: Fiscal Deficits (Forecast and Structural) in some OECD economies 2007-10

Country	Structural Fiscal Deficit for 2008 (as measured in 2007)	Structural Fiscal Deficit for 2008 (as measured in 2009)	Fiscal Deficit, 2009 (Forecast in 2009)	Fiscal Deficit, 2010 (Forecast in 2009)	Structural Fiscal Deficit, 2010 (Forecast in 2009)
UK	-2.5%	-5.8%	-12.8%	-14.0%	-10.4%
Australia	+1.0%	+1.3%	-4.9%	-5.0%	-2.6%
France	-1.3%	-3.9%	-6.7%	-7.9%	-5.2%
Germany	-1.0%	-1.1%	-3.7%	-6.2%	-3.2%
Iceland	+0.9%	-14.8%	-10.7%	-7.2%	-3.5%
Ireland	+1.4%	-7.0%	-11.5%	-13.6%	-9.2%
Italy	-2.3%	-2.5%	-5.3%	-5.8%	-2.3%
Spain	+1.4%	-3.3%	-9.1%	-9.6%	-5.0%
USA	-2.8%	-5.7%	-10.2%	-11.2%	-8.8%

Source: OECD Economic Outlook n.81, and 85;
Structural Deficits Measured as percentages of potential GDP; Actual Deficits as percentages of GDP.

All this means that even absent a world financial crisis, in 2007 it was clear that the UK would have had to put in place some form of fiscal retrenchment in 2010-11. Instead, of course, the crisis widened the deficit, and the recession meant that adjustment had to be delayed. The financial crisis had become a fiscal and government debt crisis.

The UK Response to the Crisis: Fiscal Stimulus followed by Retrenchment 2008-10.

If one looks across the OECD countries in 2009-10 one sees that most of the countries undertook some sort of fiscal stimulus. Table 2 shows the estimated discretionary fiscal stimulus in 2009 (decomposed into government spending and taxation revenues) and in 2010 for some selected OECD countries. The fiscal packages shown cover the period 2008-10, and varied across countries in terms of timing.

Table 2: Cumulative Discretionary Fiscal Stimulus in Selected OECD Countries (as a % of 2008 GDP)

Country	Impact on Expenditures	Impact on Taxation	Total
UK	0.0%	-1.5%	-1.4%
Canada	-1.7%	-2.4%	-4.1%
France	-0.4%	-0.2%	-0.6%
Germany	-1.4%	-1.6%	-3.0%
Italy	-0.3%	+0.3%	0.0%
Spain	-1.9%	-1.6%	-3.5%
USA	-2.4%	-3.2%	-5.6%

Source: OECD Economic Outlook; European Commission
Notes: These figures include discretionary fiscal measures following the financial crisis; they do not include figures for the recapitalisations of the banking sector, bank guarantee schemes and other financial operations; most fiscal packages were announced for the period 2008-10; a negative figure indicates a fiscal stimulus; figures may not add up due to rounding.

It is worth noting that in many countries the stimulus was not large. Recall that these figures look large, but cover three financial years, so they average 1-1.5% of GDP per year. But as already noted, most of these countries were already suffering major deficits, and there was little room for manoeuvre. In particular, the UK also saw one of the largest increases in its actual fiscal deficit, which was expected to rise to around 14% of GDP in 2010, a post-war record (see Table 1).

The responses reflect different approaches to delivering the fiscal stimulus across the OECD, but also existing commitments. In particular, the UK went into the crisis with a comprehensive spending review in 2007 which planned large increases in real discretionary government spending. These spending plans were largely maintained during the crisis, despite the fact that government revenues were much smaller than expected.

Chart 1 shows the UK's fiscal problem in stark terms. It plots government expenditure and revenues as a percentage of GDP as estimated in the 2007 Pre-Budget Report, and as subsequently turned out in the March 2010 Budget.

Chart 1: Projected Expenditures and Revenues UK PBR 2007 and March 2010 Budget

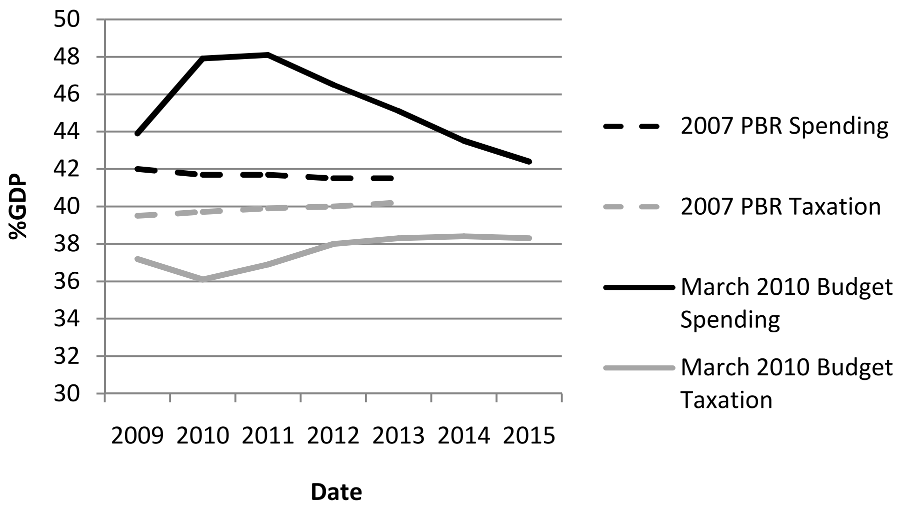


Chart 1 shows that the major increase in the fiscal gap which was estimated by the Treasury. As shown above, estimates of the structural deficit were increased. A major part of this was due to a downward adjustment, of around 5%, in estimates of potential GDP by the Treasury. This was estimated to add 3.5% to the UK's structural deficit as a percentage of GDP. Other reasons behind the increases in the estimated structural deficit were a 'reverse fiscal drag' effect over the period to 2013-14: inflation was forecast as lower over the cycle, thus depressing taxation revenues more than expenditures. In addition, reductions in estimates of asset prices (house and stock prices) and in estimates of corporate taxation (especially from the banking and financial sector) also lowered estimates of medium-term taxation revenues, raising the estimated structural deficit.

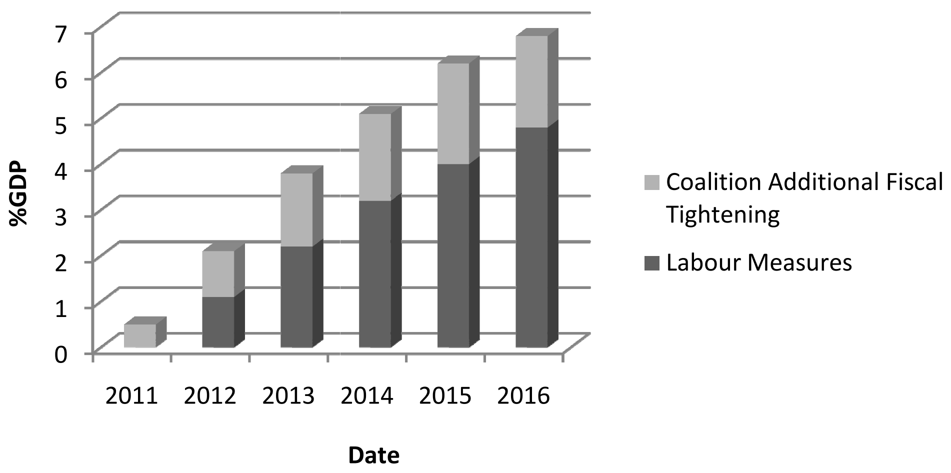
The three main political parties went into the 2010 UK general election with slightly different policy prescriptions in terms of speed of fiscal retrenchment and the balance between spending reductions and taxation increases to reduce the deficit. But all three proposed a reduction in the deficit over a period of 6-7 years[7] in the May 2010 election.

[7] For a good comparison of the incumbent Labour Government's fiscal stance in its 2010 pre-election budget and the new Liberal-Conservative manifesto pledges on fiscal policy see Emmerson (2010).

As it transpired, on June 22nd 2010, the new UK Coalition Government accelerated the fiscal retrenchment relative to what might have been expected from the two government parties' manifesto pledges. The 2010 emergency budget included projected *additional* reductions in spending relative to the Labour pre-election budget of about £52bn in 2010 prices by 2015-16, divided into around £44bn spending cuts and about £8bn in net tax increases. The new measures meant that expenditure reductions made up about 84% of the total and about 77% of the total when taken together with Labour's original budget measures[8].

Chart 2 shows the original Labour budget plans in the March 2010 pre-election budget and the additional tightening in the June 2010 emergency budget by the coalition (the sum of additional spending cuts and tax increases) as a percentage of GDP. As can be seen, the Labour government had planned to introduce a gradual tightening in 2011-12, followed by a fiscal adjustment of just under 5% of GDP by 2015-16. In contrast the Lib-Con coalition government introduced an additional fiscal contraction of £8.1bn already from 2010-11, largely due to a cut in current and investment spending of £5.3bn. By 2015-16, the total fiscal contraction is estimated at just under 7% of GDP.

<u>Chart 2: Additional Impact of June 2010 Emergency Budget</u>



After the General Election the new Chancellor of the Exchequer, George Osborne also announced the creation of the Office for Budget Responsibility (OBR). The OBR's role is to make independent assessments of the public finances and the economy, thus separating the forecast function from ministerial control.

The OBR will also be required to present a range of potential outcomes around its forecasts to show the degree of uncertainty around fiscal policy[9]. This mirrors the approach followed for GDP and inflation forecasts for some years by the Bank of England in its *Inflation* Report. The purpose of these forecasts is to show whether the Government's policy is consistent with a better than 50 per cent chance of achieving the 'fiscal mandate' for deficit reduction set by the Chancellor. This is stated by the Treasury as follows[10]:

"…The Government's forward-looking fiscal mandate is to achieve cyclically-adjusted current balance by the end of the rolling five-year forecast period.

[8] For a good account of the 2010 emergency budget's impact on the public finances, see Tetlow (2010).
[9] In addition the OBR will also play a part in making an independent assessment of the public sector balance sheet (e.g. analysing the costs of ageing, public service pensions and Private Finance Initiative contracts).
[10] See http://www.hm-treasury.gov.uk/pfg_deficit_reduction.htm

At this time of rapidly rising debt, the fiscal mandate will be supplemented by a target for public sector net debt as a percentage of GDP to be falling at a fixed date of 2015-16, ensuring that the public finances are returned to a sustainable path…"

Note that the mandate plans for the elimination in the structural or cyclically-adjusted deficit and an inversion in the path of the Debt-GDP ratio by 2015-16. This is in essence a short-term replacement for the original 'fiscal rules' which were launched by the Labour Government in 1998 when Gordon Brown was Chancellor.

Those were designed to ensure that the budget was roughly balanced around the economic cycle and that debt was maintained at a sustainable level. To be precise, the two rules introduced in 1998 were:

- The *golden rule*, which stated that over the economic cycle, the government would borrow only to invest and not to fund current spending.
- The *sustainable debt (investment)* rule which stated that public sector net debt as a proportion of GDP would be maintained over the economic cycle at a stable and prudent level (defined at the time as 40% of GDP).

Both of these fiscal rules were of course broken by the financial and economic crisis, although, as noted above, arguably the golden rule had already been abandoned by 2007 *before* the crisis struck.

Is George Osborne's short-term mandate a useful replacement rule? One advantage of a forward-looking rule is that it is not conditioned by one-off past shocks such as the current financial crisis. Also, focusing on the structural deficit ensures that there is no incentive to make fiscal policy pro-cyclical. The main problem is that if the forward-looking interval for the mandate is variable and set by the Chancellor[11], it is subject to some manipulation. Also the second element of the rule, which relates to the debt-GDP ratio is very likely to be met if there is a cyclically adjusted surplus. This of course depends on the stock of debt and projected interest rates. But on current scenarios, it looks likely that the debt-GDP ratio will be falling by the end of the forecast horizon.

Fiscal Retrenchment: Too Far, too Fast? A Tentative Conclusion

Most economists are in agreement that without a swift and co-ordinated fiscal stimulus in 2008 the world economy would have risked a much deeper recession. Indeed, given the size of the panic caused by the financial crisis it is arguable that there was little choice but to use both expansionary fiscal and monetary policy to avoid a re-run of mistakes which caused the Great Depression.

More recently there has been a more active debate amongst economists on the appropriate fiscal stance going forward. The June 2010 budget has been criticised by opposition parties as putting the recovery at risk by withdrawing domestic demand too quickly. The argument for delaying a fiscal correction is the standard Keynesian perspective on macroeconomics: with private spending (consumption and investment) still weak after the financial crisis, and net exports unlikely to fill the gap (notwithstanding the devaluation of sterling since the crisis), the argument is that output can only be sustained by public spending. The argument for immediate action on fiscal retrenchment is based on one or both of the following premises, both based on expectations about the future. Both these premises suggest that fiscal expansions can be good to stabilise recessions, but they must be temporary[12].

[11] Although the budget statement said that the interval would 'shorten in future'.

[12] For instance, Corsetti *et al.* (2009) argue that temporary fiscal expansions can be more powerful because if financial markets expect expenditure to return below trend, long-term interest rates remain lower thus avoiding the crowding out of private consumer and investment spending.

First, that in the absence of decisive action on the deficit, financial and currency markets will become worried about the government's ability to finance its intertemporal budget constraint. In turn this will lead to difficulties in selling government debt and will put pressure on Sterling as foreign creditors will begin to doubt the UK's creditworthiness. Rising government bond yields and imported inflation could then exacerbate the macroeconomic policy problem for the Bank of England and the Treasury, and might even lead to stagflation, depending on how well-anchored inflationary expectations are. The recent pressures on some Eurozone economies, particularly Greece and Ireland, has been cited as an example of how quickly fiscal crises can emerge.

Second, it is sometimes argued that private sector consumption and investment spending is not invariant to expectations about future taxation. This Ricardian view of the world stresses that government spending cuts might actually encourage greater private sector expenditures as consumers and firms expect lower future taxation as a result. In other words, a fiscal retrenchment might actually assist the economic recovery. The evidence on how fiscal shocks impact on output (i.e. whether cuts in spending reduce consumer spending or increase it) is surprisingly mixed[13].

However, most economists would concur that what matters most for future expectations is that the plan for fiscal retrenchment has to be credible. In that context, the coalition government probably felt that to add to the credibility of the fiscal retrenchment, some evidence had to be provided of action *now*, and not simply of future intentions. Indeed, there is evidence from past fiscal consolidations in some small European countries[14] in the 1980s, that putting credible plans into place can assist sustainable economic recovery.

The one area which makes this fiscal contraction more worrying, in my view, is the fact that it is not being carried out by the UK in isolation. Many other countries, especially in the Eurozone (which is the UK's biggest market) are putting in place fiscal consolidations. It is the co-ordinated fiscal contraction across the Western economies, which provides the biggest threat to the current economic recovery.

The nature of the recovery will also be crucial in determining the shape of fiscal policy, especially given the forward-looking fiscal mandate. Continued weak growth could cause the fiscal rule to be violated (the OBR estimates a 40% probability that a structural budget surplus will not be restored by 2015-16). Given the OBR's buoyant median GDP growth forecasts for 2013 onwards, it is difficult to see a moderation of the current planned spending reductions.

To conclude, there is more disagreement between the UK coalition government and the opposition parties on the timing of the fiscal consolidation, than about the need to have a major correction of between 5-6% of GDP by 2015-16. Given that prior to 2015 there are unlikely to be major changes in the way devolved governments are allocated budgets through the Barnett formula, this sets a very tight budgetary envelope for the Scottish Parliament. There is unlikely to be any upside from economic growth, given the OBR's forecasts, and indeed most economic forecasts. At the time of writing, the *Bank of England's August 2010 Inflation Report* has downgraded the Bank's GDP growth forecast, and many forecasters expect further downward adjustments over the next 6 months.

The main upside to devolved budgets would come if there were structural improvements in taxation revenues (such as a reversal of the recent collapse of corporation taxes), or structural changes in spending (due, say, to major welfare reforms), which would allow a reshaping of the plan whilst staying within the terms of the fiscal mandate, or a reallocation of spending towards areas of departmental expenditure which are devolved. At the moment, neither can be anticipated.

[13] There is a large and varied empirical literature which examines the impact of fiscal shocks on consumption and output. See for instance, Blanchard and Perotti (2002), and more recently Mountford and Uhlig (2009).
[14] See Giavazzi and Pagano (1990).

This therefore sets the scene for the tightest spending review of the post-war era, for both the UK and the devolved administrations.

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Cost Pressures on Scotland's Public Finance

Robert W Black

A historical breakpoint

In November of last year Audit Scotland published a report on Scotland's public finances[1]. Building on issues identified in Audit Scotland's reports over recent years, the aim was to widen the understanding of the financial pressures and commitments that lie ahead and to help to instil a sense of urgency and realism into policy making and political debate in Scotland. Since then, there have been many authoritative commentaries on Scotland's public finances.

In his July 2010 assessment of the prospects for Scotland's public finances, the Chief Economic Adviser to the Scottish Government suggested that it could take until 2025/26 for the Scottish Government Budget to return to 2009/10 levels. Although this was based on a trend projection which has been the subject of criticism, it is widely accepted that the Scottish public sector is heading into an extremely challenging financial period which is likely to last for several years.

The last ten years have seen the biggest and longest spending spree that anyone can remember – 5% real terms growth on average annually since devolution. Looking to the future, a report in July 2010 by an Independent Budget Review group said that the public spending challenge was unmatched since the Second World War[2]. So our public sector is facing the prospect of going from fifth gear to reverse gear without slowing down.

The new Scottish Parliament was born into an unusually benign public spending environment. This was good for bedding in devolved government, but it does mean that the system hasn't been tested in times of financial constraint. The long period of continuing growth is for many of our top managers, professionals and also for some politicians, the only environment in which they have worked at a senior level.

We are at a historical breakpoint in public finances, and there are some grounds for caution bordering on pessimism about the prospects for the public purse. The UK has had the worst deterioration in its public finances of any OECD country. Financial sector debt in the UK reached the extreme level of 500% of GDP. At the time of the Audit Scotland report the Treasury was saying that the UK's ability to produce goods and services had fallen by 5% in the long run, a percentage estimate that has subsequently been increased by the new Office of Budget Responsibility to a structural deficit of 7.4% for 2010/11. This affects tax revenues and the ability to get the debt down. With national debt likely to peak at about 70% GDP, the fiscal deficit will be difficult to cut without strong demand recovery, but despite a significant devaluation of the Pound the export response has not, on the whole, been encouraging. The UK coalition government has committed to a policy of clearing the structural deficit by 2014/15, involving £99 billion of spending cuts and £29 billion of tax increases within the period of one full Parliament. The Chief Economic Adviser to the Scottish Government has suggested that Scottish government DEL expenditure could fall on average by 3.3% a year in real terms over the four years of the next Spending review 2011/12 to 2014/15. The biggest adjustment will be in 2011/12. Although this projection might change slightly in light of the Comprehensive Spending Review, which is due to be reported on 20 October, the prospects for the Scottish Budget are serious and unavoidable.

[1] Audit Scotland(2009) Scotland's Public Finances: Preparing for the Future (November)
[2] Independent Budget Review Panel (2010) Report (July)

Fewer resources and more commitments

The media commentators tend to concentrate on the prospective size of future cuts in public spending. But an equally big concern should be the financial pressures arising from unavoidable costs and spending commitments that have been entered into in the past. From recent Audit Scotland reports, it is possible to obtain a general picture of the pressures that are building in our public finances.

The backlog in maintaining the physical estate

There is a backlog in the maintenance of the physical estate across Scotland's public sector. The maintenance and repair needs are in excess of £4 billion. And this is the situation after ten years of 5% real growth per year in public spending.

Councils' properties have a maintenance backlog of £1.4 billion. At the rate of progress shown in 2007/08 it was going to take up to 20 years to remove all schools from poor or bad condition. The cost of bringing Scotland's roads up to standard was estimated in 2004 at £1.7 billion and this estimate has been rising. About 45% of the higher education estate was not in a sound condition in 2007, when the maintenance backlog was £700 million and continuing to grow. Almost a third of the NHS estate will need major upgrading soon, with over £500 million required to address all the outstanding maintenance issues. Sportscotland said that the upgrading and maintenance of sports facilities would require £110 million a year for 25 years.

PFI and similar cost

The combined costs of PFI contracts, non-profit-distributing commitments and capital charges are around £3.2 billion a year.

Waste management targets

Councils were recently spending around £340 million a year on waste management, and will need to spend about £580 million a year by 2020 to meet national targets.

Public sector pension schemes

There are six main pension schemes in the Scottish public sector. Employer contribution rates in 2009/10 ranged from 13.5% to 22% and these have generally been rising. The employer contributions for Scottish teachers are £322 million and for health staff the contributions are £561 million. The recent actuarial valuation of the Local Government Pension Scheme has increased the employers' contribution. The unfunded liabilities of the police and fire-fighters' pensions were £6.3 billion and £1.7 billion in 2008.

The growing older population

Increasing demands will come from a projected growth of 31% in the population over 65 in the next 25 years, with an 84% increase in the number aged 75 and over.

Older people are living longer, but they are not always living in good health. Older people tend to have more long term conditions such as dementia, diabetes and chronic obstructive pulmonary disease. People with these conditions account for 80% of all GP consultations and 60% of hospital bed days, and they are twice as likely to be readmitted to hospital.

Older people account for over 40% of emergency admissions to hospital, and more of them need more than one emergency admission each year.

The pressures on health and social care services will increase significantly as a result of these trends. The Scottish Government has reported that around £4.5 billion was spent on health and social care services for people over 65 in 2006/07 and that this figure will need to increase by £1.1 billion by 2016 and by £3.5 billion by 2031 if the health and care systems remain as they are now.

Services free at the point of delivery

The total cost of providing free personal and nursing care rose on average by 15% a year between 2003/04 and 2006/07. The cost is likely to exceed £560 million in 2010/11. The cost of free prescription charges is likely to be over £57 million by 2011/12. Free eye tests will cost over £90 million in 2010/11. The concessionary fare travel scheme will cost almost £190 million in 2010/11.

Other pressures on the health service and local government

Cost pressures in the NHS have been significant in recent years. The cost of NHS salaries (excluding GPs, dentists, pharmacists and opticians) rose in cash terms from just under £3 billion in 2003/04 to around £5 billion in 2008/09. There have been pay bill pressures in local government, with the pay bill now around £7 billion.

Drugs prescribing costs more than doubled between 1996/97 and 2008/09 to over £1 billion. Hospital energy costs increased by nearly 75% between 2004/05 and 2007/08 and for councils, the prices of electricity and gas doubled between 2004 and 2008.

Sources of income

Sources of income within Scotland's public sector are also under pressure. The Council tax freeze requires compensation of £70 million a year being provided to councils by the Scottish Government. If the policy is continued, then according to the Independent Budget Review, the cost to the Scottish Government in its 2014/15 budget would be about £490 million.

Other current sources of income are declining, especially revenue from asset sales which have been significant in the past. For example, in 2006/07, NHS bodies disposed of assets with a net book value of £51 million, generating a profit of £82 million. However, in 2007/08 the NHS disposed of assets with a net book value of £9 million, generating a profit of £1 million. There will be an element of the phasing of receipts between financial years, but this is a significant decrease.

Efficiency productivity and quality

The Efficient Government Programme

The Scottish Government set a target of delivering £1.6 billion efficiency savings between 2008/09 and 2010/11. For the first year of this Efficient Government Programme Audit Scotland found that the public sector was reporting £839 million of efficiency gains. This is 57 per cent higher than the £534 million target. Of the reported savings, £254 million (30 per cent) have been delivered through better purchasing, better asset management and shared services.

It was clear from the Audit Scotland report that the Programme was delivering important results, but the auditors could not validate the numbers used because the quality of the information supplied by public bodies still needed to be much better.

Public bodies had overall cost information but they still did not have sufficient information on unit costs and costs related to activity and quality of services. This information is needed to demonstrate improvements in efficiency and productivity and to provide assurance that the savings reported through the Programme are being delivered. Audit Scotland concluded that the public sector needs to understand better the relationship between the costs, volume and quality of services to get improvements in productivity and reductions in cost.

National outcomes, quality and productivity

As part of the 2007 Spending Review, the Scottish Government introduced a National Performance Framework with 7 purpose targets, 5 strategic objectives, 15 national outcomes and 45 national indicators and targets. The national outcomes provide important long-term goals, but clearly the needs of the Scottish people must be met by the continuing provision of high-quality services at an acceptable cost. For example, the outcome of a longer healthy life expectancy in areas of social deprivation presents the immediate challenge of ensuring good health and social care services to support people with conditions such as chronic obstructive pulmonary disease, cardiovascular disease, or diabetes. In addition to a concern for monitoring progress towards long-term targets and outcomes, the Scottish Parliament must have an interest in whether essential services are delivered efficiently and effectively on a continuing basis in the shorter term. This can only be done if there is better cost, activity and performance information across the public sector.

Measuring the productivity of public services has never been easy. Otherwise it would have been done well years ago. To understand productivity we need data on quality as well as on activity and costs.

Quality is the Dark Matter of public sector productivity measurement. It is there in some form, but it can be hard to identify and report it. This is one of the most urgent problems in public sector management. An example from the NHS may illustrate why this is such an important issue.

Reported activity levels in Scottish hospitals have not shown a significant increase in activity in recent years despite big increases in resources (mainly pay costs). Audit Scotland reports such as a recent one on orthopaedic services show costs have been rising much faster than measured activity. But these sorts of measure tell us very little about the quality of the activity, which may be keeping people out of hospitals and improving their health.

In 2008, the Office for National Statistics produced a report indicating that productivity in the health service fell by 10 per cent between 1995 and 2006. That was because health care output measures, such as occupied bed days or the numbers of patients treated, grew over that period but the input costs, such as staffing and infrastructure costs, rose even more rapidly. Therefore, the arithmetic is that productivity is reported as falling, but the assessment did not include adequate measures of quality.

There was a Government review of how NHS output and productivity at the UK level were measured.

The Atkinson review said that we need to measure more things, measure them differently and try to find ways of measuring the less tangible outputs, such as the effectiveness of public health campaigns and the improvements in quality as a result of improved techniques and technology – improvements which might reduce the number of interventions but improve the outcomes. None of this is easy, but without good information on whether quality is improving, the NHS will continue to be at risk of presenting an imperfect picture of its productivity and performance

This is an increasingly unacceptable position as the NHS with the rest of the public sector attempts to plan rationally for much smaller budgets in future years.

Linking smaller budgets to top priorities

The Scottish Parliament, the Scottish Government and the public sector as a whole are facing cuts in resources that will require strong leadership and hard choices between competing priorities. The National Performance Framework is an important first step towards a priority-based approach to budgeting. The six key questions in a priority based approach would be:

1. What money is available?
2. What are the objectives?
3. What are the most important services that must be delivered?
4. What options for delivering these are possible, and which are the most efficient and effective?
5. Is the spending delivering high-quality accessible services in line with the objectives?
6. Are these objectives contributing to the outcomes?

These key questions should be asked in relation to both current and capital budgets. Deciding on investment spending priorities in a time of shrinking resources is one of the major strategic issues for the Scottish Government and the Parliament.

Robert W Black

Means Testing and Universal Services

David Bell

Introduction

At a time when the Sword of Damocles hangs over Scotland's public spending, this paper considers the case for and against means testing of public services in Scotland. Before looking at the gory details of the impending cuts, let's start with a small thought experiment. Suppose we could start afresh and design Scotland's public services and benefits from scratch. To do this democratically, we'd have to ask some fundamental questions of the electorate.

First we might ask which services the Scottish Government should provide and which should be left to the market. Some of the answers would be quite easy. We generally leave defence to the state, since private armies are generally frowned on. And it is difficult to believe that a state regulation would distribute apples as efficiently as does the market. But other choices are more difficult. One of these is care for the elderly - should this be a state responsibility, a family responsibility or should people be expected to buy their own care from private or third sector providers?

The public's view of such decisions is influenced by whether they believe that their taxes will have to increase to pay for public services. Since Scotland's funding largely comes from a Treasury block grant, Scotland's voters have largely been insulated from the tax consequences of spending decisions. This will no longer be the case if the Calman Commission proposals, or variants thereof, are introduced over the course of the current UK Parliament.

Decisions about the services in which the public sector is involved are made at different levels of government. Central government, devolved government and local authorities may have constitutional or legal duties to address particular services. There may also be interrelationships between the different layers of government. For example, central government may have a role as regulator, while local government provides the service. Provision of services by different layers of government may make them more locally relevant, but on the other hand may lead to economies of scale not being realised and to inefficient competition between different levels of government.

The second group of questions hinges on the question of provision. The state may decide that it has a role in purchasing services on behalf of its citizens. But being the purchaser does not necessarily mean that it should also be the provider. Instead, it can choose to purchase services on behalf its citizens from private or third sector providers. So long as the market operates efficiently, this should result in provision at minimum cost.

Where the state is providing some form of service, there is the option of purchasing the service on the client's behalf or providing the client with cash to buy the service from the market. To put it another way, the state can support clients with either cash or in-kind benefits. Giving cash to clients should, in theory, ensure that the services purchased are tailored to their particular needs and less to producer preferences. The extension of the "direct payments" agenda by the previous UK government indicated a desire to move towards cash benefits and away from in-kind benefits.

The third set of questions concerns how costs should be divided between the taxpayer and the person receiving the benefit or service. A common argument is that services should not be provided free to high-income individuals or households, because the value of their benefits to the rich is less than it is to the relatively poor.

If the more affluent are expected to contribute, the state has to determine, on an individual basis for each service, whether eligible individuals should pay. The mechanism for doing this is known as a "means test". Where the taxpayer foots the entire bill, the benefit or service is described as "universal". Universal services are also frequently described as "free at the point of delivery". This is a misleading since no public services are truly “free”. Rather, if paid out of general taxation, the costs are borne by each taxpayer, with the size of their contribution reflecting how much in aggregate they pay in tax.

Our argument now focuses on the choice between means testing and universal benefits for public services. It is relevant to debates about the draconian cuts in public expenditure that will happen over the next four years in Scotland because one obvious mechanism for reducing public spending is to increase the share of costs being met by more affluent individuals and families. This would imply an extension of means testing at the expense of universal benefits.
But extensions to means testing should be considered in the context of the other issues described above. In reality, we cannot redesign Scotland's public services from scratch, but changes at the margin in the services themselves, how efficiently they are delivered, and by what type of organisation, will interact with decisions about who should pay for them and how much. It is also important to bear in mind that non-means tested benefits are supplied in Scotland by both the UK and the Scottish Governments. They cannot be treated in isolation. For example, benefits to older people provided by the Scottish Government should be considered within the context of the benefits provided by Westminster. But first we consider means testing in isolation, discussing the key arguments in its favour and the principal arguments against.

Arguments for and Against Means Testing

The economic case for means testing is strong. By targeting resources where they are most needed, the taxpayer is not subsidising those who could purchase the service anyway. Resources can then be released to other priorities or taxes can be reduced. More targeting also implies that the state interferes less with market provision. This results in less distortion of the private market. For example, where individuals are contributing to costs, they are more likely to argue on their own behalf for quality improvements, something that is unlikely to happen when the argument is being made on behalf of society as a whole.

Universal benefits quickly enter the general perception as entitlements. Once a free universal service is granted, it tends to acquire a political base that is strongly resistant to change. It is much easier to vary the details of a means testing system to make it either more or less generous.

There are invariably moral hazard problems associated with free services. Where the price of the service is zero, demand will be inflated. Individuals may indulge in risky actions, knowing that they will not personally bear the costs of mitigating these. The existence of heavily-subsidised medical care in Scotland is certainly not a disincentive to risky health behaviours. There is also the issue of fairness across generations. Universal services provided for a particular age group and subsequently withdrawn mean that this group has benefited relative to those younger and older than themselves. The average age of a UK taxpayer is around 40. The average age of a recipient of universal services is likely to be significantly higher. In essence, the 40-year-old is paying for the services that older people receive.

This could be part of an equitable intergenerational contract if the 40-year-old receives the same services once he or she is older. But if one particular age group receives services that are not subsequently available to others, then the principle of fairness between generations is violated. When assessing the fairness of universal provision, one should not only look at the impact on the rich and poor at present, but one should also consider its impact on fairness between generations.

The arguments against means testing and in favour of universalism are generally more subtle. For example, Korpi and Palme (1998, p. 663) argue that there is a "paradox of redistribution", where increasing means tested benefits increases the social divide between those paying for public services and those receiving them, who come to be regarded as a stigmatised underclass. Eventually, this weakens political support for redistribution, which only increases the plight of the poor. There is some evidence to support this thesis, particularly since the UK and USA which both extensively used means testing, also have among the most unequal income distributions in the OECD.

There are high private costs associated with means tests. On the applicant's side, some may wish to avoid the test due to a fear of stigmatisation. Or, perhaps mistakenly, they believe that the return will not be worth the effort. There is known to be low take-up of certain benefits particularly those affecting the elderly. But as Hancock et al (2005) argue, take-up is greater among those with greater entitlement. Those who do not claim anticipate, perhaps correctly, that the return for going through the bureaucracy of a claim will be low.

Governments also incur significant administrative and data processing costs. The more the system is fine-tuned to deal with specific types of case, the more complex it becomes. Greater complexity imposes additional costs on both clients and providers.

One final argument against means testing is that it deters saving. There is little rationale for saving if, in so doing, one stays above some means test limit. Better to consume now and receive public service free in the future. From the perspective of the UK economy as a whole, which has a dismal savings record, means testing has little to commend itself. However, the current imperative of macro policy is to reduce the budget deficit. Disincentives to saving are perhaps not the immediate concern. The short run economic case is overwhelmingly in favour of replacing universal benefits with means tested benefits, simply on the grounds of reducing expenditure.

Which Public Services/Benefits in Scotland are not Means Tested?

From the UK perspective, some of the more important universal benefits provided in Scotland include:

- *Child benefit:* in August 2009, there were 621,000 Scottish families receiving Child Benefit from HMRC. This amounted to more than one in four Scottish families and covered just over 1 million children. In April 2010 the rates were £20.30 per week for the eldest child and £13.40 per week for other children. It was available to all families irrespective of income and cost the UK government £11.6bn in 2008-09. Around £880 million pounds of this was given to families in Scotland.

- *Winter fuel payment:* this is a non-means tested payment made to those aged 60 and above. In 2009-10, payments of £250 per household for those aged under 80 and £400 for those aged 18 or over were made. In 2009-10, this annual payment cost the UK government £2.1 billion. The value to Scots pensioners was around £170million.
- *Attendance allowance:* this is a weekly payment to those assessed as needing personal care aged 65 and over. In Scotland, around 140,000 individuals receive Attendance Allowance - around 16% of pensioners.
- *Disability Living Allowance:* this is a weekly payment to those assessed as needing personal care aged less than 65 when they first claim. In November 2009, there were 3.1 million Disability Living Allowance claimants in the UK as a whole, and 342,000 claimants in Scotland.

Neither Attendance Allowance nor Disability Living Allowance is means tested. To give an idea of sums involved, payment of these benefits to those aged 65 and over in Scotland is estimated to have cost around £800 million in 2008.

This is not an exhaustive list of universal be benefits paid by the UK government in Scotland. But it captures some of the main benefits that are not means tested and gives some idea of the huge amounts of resources tied up by these measures. It also shows the number of benefit recipients is extremely large and hence any attempt to introduce means testing is likely to meet with a great deal of political opposition.

Over the years, successive Scottish governments have also introduced a number of non-means tested benefits. These include:

- *Free bus passes for those aged over 60*: Labelled as "concessionary fares" within the Scottish budget, these cost £194 million in 2010-11. These are largely benefits in kind, which do have the disadvantage that they are of no value to those who cannot access the service. Thus, for example, bus passes are of little value to pensioners in the most rural parts of Scotland where bus services are relatively uncommon.

- *Free personal care:* Introduced in 2001, eligibility for the benefits of this policy depends on local authority assessment of a need for personal care. The individual must also be aged 65+. Their income and/or wealth are not taken into account. In 2008-09, the cost of this policy was £376 million.
- *No tuition fees for Scottish students at Scottish universities:* in 2000-01, the Scottish Parliament decided to scrap up front tuition fees for Scottish students at Scottish universities. Although tuition fees are payable for all students at Scottish universities, the Scottish government covers the costs of fees for Scottish students. Scottish students used to have to pay a graduate endowment but this was abolished in February 2008, by which time its annual value had reached £2289. In contrast, English universities were enabled to charge fees from 2006. By 2007-08 they had raised £1.3 billion, 25% of which was spent on bursaries and support for widening access. The equivalent amount of income foregone for Scottish institutions would have been around £130 million.
- *Movement towards free prescriptions:* Scotland has been reducing the cost of prescriptions with the aim of following Wales, where there is no charge. Since large numbers of people are already exempted from paying for prescriptions, the net cost of finally making prescriptions available free to everyone could be relatively small. Nevertheless, it may seem somewhat perverse that free prescriptions be introduced at a time when the drugs budget is one of the most rapidly growing components of the NHS budget (around 8% per annum).

Although the table above is not exhaustive, comparisons of expenditure on the UK and Scottish universal benefits indicate that the bulk of such spending in Scotland is made by the UK government rather than the Scottish government. Nevertheless, those benefiting in Scotland from Scottish Government measures are likely to take a very negative view of any attempt to means test these benefits.

There is also an important note of caution. Making real savings from means testing may be more difficult than imagined. First, the administrative costs of means testing are likely to be substantial. Second, individuals will react to the new prices for the public services they consume. For example, individuals who find they have to pay for something that used to be free may choose to buy instead from the private sector. This may have an adverse effect on public sector efficiency, and so the reduction in costs may not be as large as envisaged. Third, increased charges could actually have an adverse effect on aggregate spending in some circumstances.

For example, taking a holistic view of the Scottish Government's budget increased charging of individuals for home care services might result in increased hospital admissions. Increased NHS costs might eliminate any net saving from means testing at local authority level.

To operate a system where services are free only to some citizens, while others must pay, requires a precise means test and a schedule of charges for those excluded from free provision. Means tests are normally based on income and/or wealth. It is unjust to focus simply on current income, which varies substantially over the lifetime. Nevertheless, a focus on wealth is difficult for older people, many of whom are income poor and asset rich, with many of these assets being particularly illiquid in the form of housing. In social care, the inclusion of assets in the means test has led to the difficult issues associated with older people having to sell their homes to pay for their long-term care.

Next, there are many ways to design charges once the existence of sufficient means is established. Flat rate fees (e.g. for bus passes) are easy to administer, but are regressive. They would fall most heavily on those with incomes just above the means test limit. An alternative would be to increase charges in proportion, or possibly more than in proportion, with income. This would create a progressive charging structure, but charges would always have to be limited by the market price of the service. The more affluent would always drop out of public provision once the amount they were being charged exceeded the market price.

Means Testing and Inequality

If all Scots families had the same income, there would be no point in means tests. For means tests to have some value, income must be unequally distributed. But the extent of inequality in Scotland is a subject rarely touched upon. It is generally believed that the UK has one of the more unequal societies in Europe. This is confirmed in Figure 1, which shows OECD estimates of income inequality after taking account of taxes and transfers during the mid-2000s. Inequality is measured using the Gini coefficient: larger values imply increased inequality. Two measures are shown, one for those of working age and another for those aged 65+. The UK is relatively high on both measures although lower than countries like the United States and Italy in respect of working age inequality.

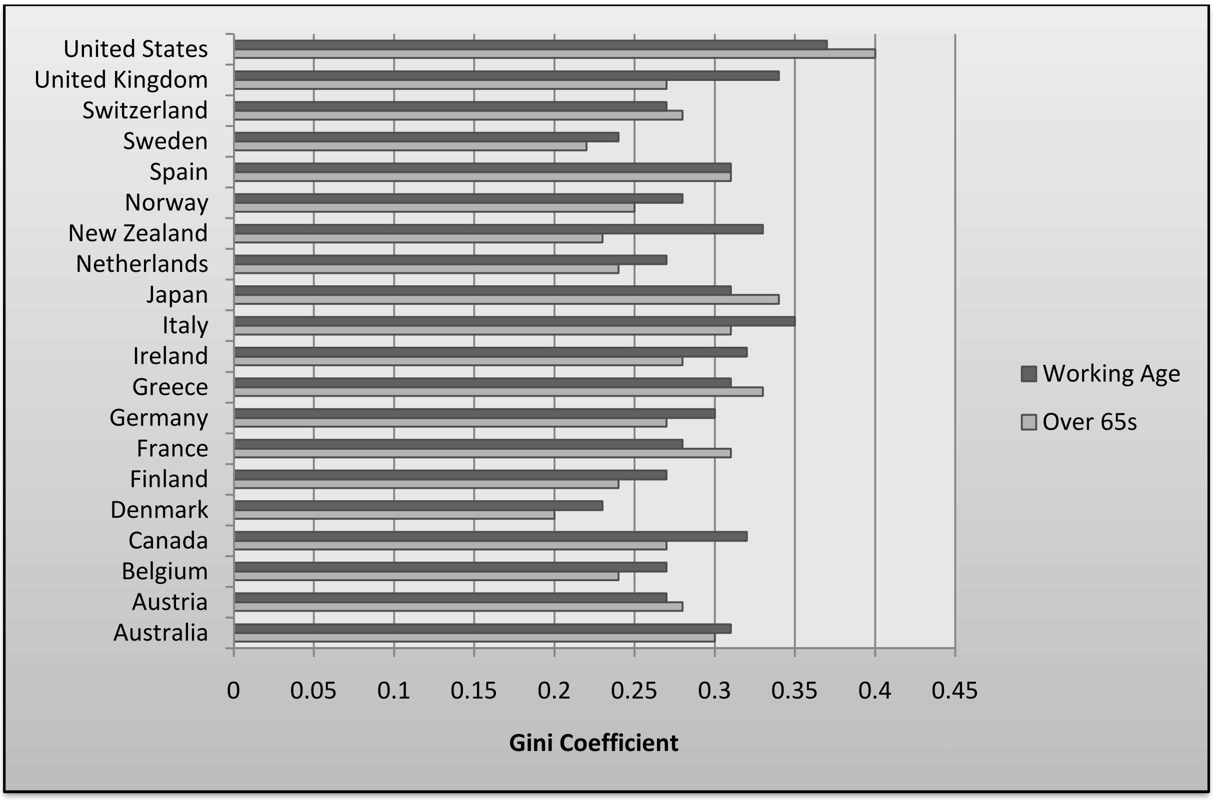


Figure 1: Income Inequality in OECD Countries, Mid 2000s
Source: OECD

So how does Scotland compare with the rest of the UK? Table 1, which is taken from National Equality Panel (2010) report on economic inequality in the UK, shows that on a number of metrics, inequality in Scotland is only slightly less than in England and therefore approximately the same as in the UK as a whole. It calibrates inequality measured by hourly wages, weekly earnings, net individual incomes and equivalised (adjusted for family size) net income before housing costs for the periods 1995-97 and 2006-08. The first two columns show the median for the relevant statistic in each country relative to the UK median, indexed on 100. The third and fourth columns show inequality as measured by the ratio of the earnings of someone whose income is higher than all but 10% of earners to those of someone whose income is lower than all but 10% of earners. Larger numbers imply greater inequality. On most measures, inequality in Scotland is somewhat lower than in England, but higher than in Northern Ireland and Wales.

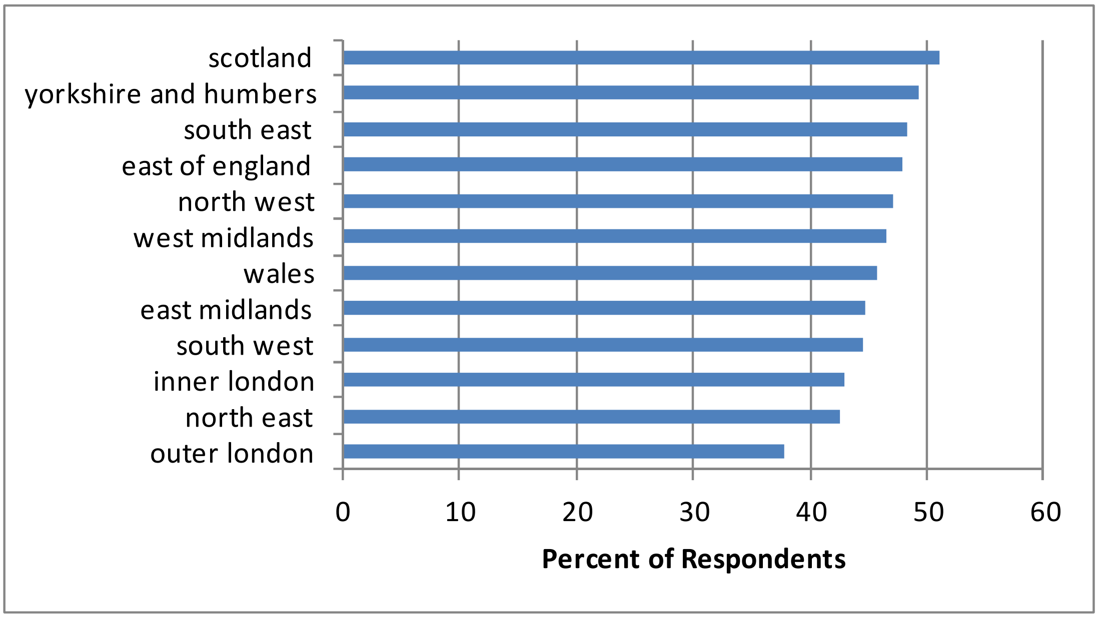
Taken together these numbers imply that inequality in Scotland is relatively high, and therefore that there are likely to be significant numbers of relatively more affluent citizens for whom one might argue receipt of universal benefits is inappropriate when the government has other pressing priorities.

Table 1: Economic inequality by year and country within the UK

	Group median as a percentage of overall median		Inequality within groups (90:10 ratio)	
	1995-97	2006-08	1995-97	2006-08
(a) Hourly wages				
England	102	101	4.2	3.9
Northern Ireland	84	90	3.9	3.3
Scotland	96	98	4	3.7
Wales	93	92	3.8	3.4
(b) Weekly earnings				
England	102	102	3.8	3.8
Northern Ireland	81	86	3.6	3.3
Scotland	94	96	3.6	3.5
Wales	92	91	3.5	3.3
(c) Net individual incomes				
England	101	102	9.9	10
Scotland	96	98	8.9	8.6
Wales	89	93	8.6	8.9
(d) Equivalent net income (BHC)				
England	101	101	4.2	4.2
Scotland	98	99	3.9	3.8
Wales	92	91	3.7	3.8
Source: LFS (UK 1995 to 1997; 2006 to 2008), NEP from Individual Income Series (GB 1996-97 to 1998-99; UK 2005-06 to 2007-08), DWP based on HBAI dataset (GB 1997-98; UK 2007-08). Note: The time frame is 1996-97 to 1998-99 and 2005-06 to 2007-08 for net individual incomes; 1997-98 and 2007-08 for equivalent net income. Higher of each pair of figures shown in bold.				

If proposals for extending Scotland's fiscal powers are realised, another option to maintain universal benefits would be to increase taxes. Again, there is a general perception that Scots are attracted to an economy characterised by higher taxes and higher public spending. There is some weak evidence that this may be true. Figure 2 plots the proportion of respondents to the British Social Attitudes Survey who agree with the proposition that taxes should be increased to pay for public services. Scotland has a higher rate of agreement with this proposition than any other part of the UK, and indeed is the only part where the majority of respondents are in favour of higher taxes.

Figure 2: Percentage of Respondents Agreeing That Government Should Increase Taxes by UK Region



Source: British Social Attitudes Survey 2005-2008

However, the differences between Scotland and other areas, including both the South East and the East of England, are relatively small. And when one tries to explain what characteristics determine whether an individual responds positively to this question, region of domicile plays only a minor role. Age and gender are far more important: older women, in particular, are more likely to be in favour of higher taxes.

Thus although higher taxes might be one route for maintaining universal services, there is no current knowledge about whether the Scottish electorate would be willing to increase income tax specifically to continue support for policies such as free personal care and free university tuition. Both of these policies focus support on the moderate and fairly affluent rather than those close to, or below, the poverty line.

Conclusions

The Scottish Government's budget is largely fixed. The more it pays for one public service, the less is available to fund its other activities. Even if it had tax raising powers, it would still face budget constraints in the current UK public spending climate. So tough choices cannot be avoided. Given the aggregate costs associated with universal services, these cannot be ignored when considering budget lines that might be pared back. The Independent Budget Review has already urged the Scottish Government to "undertake immediate work to review whether all free or subsidised universal services should be retained in their current form". Unfortunately, there are no votes in taking away or reducing what people have come to regard as an entitlement.

But it may be possible for the policies to continue in some form. Costs can be contained by freezing or cutting back on the value of benefits. Thus, for example, allowances to care homes for free personal care could be once again frozen. And we already know, at a UK level, that child benefit will be frozen for the next three years. Alternatively, eligibility criteria could be strengthened. So perhaps free bus passes and winter fuel payments could be restricted to those aged over 70. Neither of these would be popular, but they might be grudgingly accepted, partly because there would be a perception that the policy is not being wholly abandoned.

Although the UK government clearly has a larger problem in relation to universal benefits, the Scottish government has to confront the important question of whether spending on other priorities would have a more beneficial effect on society and the economy. Over the whole range of Scottish government policies, it is difficult to believe that some are not higher priority than the provision of universal benefits which mainly assist the moderately or very affluent. Certainly it is difficult to make a strong case for universal benefits as a driver for economic growth. They do not typically enhance Scotland's infrastructure or its capital stock, whether physical or human. Although there may be a social case for their continuation, the short term priority must be to consider means testing what are currently universal services as part of the solution to Scotland's budgetary difficulties.

David Bell

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Cutting public expenditure – air war or slogging in the trenches?

Richard Kerley

Introduction

The Independent Budget Review (IBR) has now provided context, substantive data, and some analysis that will facilitate the necessary public discussion about how and over what timescale we might address the fiscal and financial crisis that affects the United Kingdom and hence Scotland.

As is entirely appropriate to such an exercise, particularly given their express remit and the constrained time frame, the review panel took a strategic overview. Their discussion often focuses on courses of action that if introduced would impact on large component blocks of the Departmental Expenditure Limit within which the Parliament works. So a review of options for action on the workforce in 'the public sector' and their remuneration discusses potential savings in the order of £1bn through action on pay and a reduction of 15,000 in employment in a year. In taking this approach it expressed such possible choices as part of a range of options. This contrasted with the approach of an earlier Scottish Executive Budget Review of 2006[1] that took a simultaneously fine-grained but often rather brutal approach to suggesting budget reductions; e.g. 'Merge Scottish Fire and Police Colleges – save £1.7M p.a' [2]

The IBR panel also acknowledge that when it comes to finding efficiencies in the public services that is much better achieved by those who are directly involved the fine grain of service configuration and delivery – 'those closest to the work'.

However, where this leaves the country, the Parliament, and the government is in a position where the broad landscape is outlined, the scale of the exercise is now better known but the detailed implications of choosing and following certain courses of action still must be examined and understood before some of the suggested options can even be developed and better understood, leave alone acted upon.

In some respects I suggest that the IBR takes too elevated a view; it operates from the high ground, which can mislead. As Lord Raglan found at Balaclava, the view from the hills was not a view shared by colleagues in the valley – with consequences we know. What such a high level view can also do, moreover, is to encourage others to exchange ideas at a similar high level and trade ostensible options for action that have far more uncertainty and complexity in them than first considerations allow.

This paper discusses some instances of how such forms of high level analysis and discussion disguise the complex reality of understanding the finer grain of public service provision and delivery and the sheer localised slog of effecting any changes.

One of these is the ever present temptation for people to analyse the array of public services in a Scotland-wide form; the second to assume the long established is sacrosanct and only recent innovation is to be challenged; and the third is the tendency for people to assume that a reorganisation is the efficiency-enhancing and low-cost answer in such circumstances.

1 Howat, W [Chair] and others [2006, published 2007] Choices for a purpose; Report of the budget `review group.

2 They preferred the use of the word 'headroom' to cuts or reductions

The fallacy of aggregation

We live in a country whose population is very inconveniently distributed for the easy provision and financing of public services in the form and to the extent we often assume they should be. Within Scotland we have the three smallest councils in Britain (Orkney, Shetland and Eilean Siar); the largest and smallest councils with housing responsibilities (Glasgow and Orkney); and the smallest police force outside the City of London (in Dumfries and Galloway). One council (Highland) represents 33% of the land mass of Scotland. It is also important to appreciate the marked sparsity of population in Scotland when compared with England. The most sparsely populated English council area is Eden with 34 people per square kilometre; 8 of Scotland's councils are below that density. Glasgow, the most densely populated council area has under half the population density of Inner London. This range of differences between councils is of course one of the reasons that we talk of *local* government. The recognition that such differences exist, are important, and necessarily need to be accommodated makes sweeping Scotland-wide budgetary decisions hard to model and implement.

Such contrasts make it virtually impossible to compare and contrast councils in any incontrovertible manner[3] . Stirling council, for example, has at times been compared to 10 other councils in Scotland. Although the Accounts Commission for Scotland attempts to create means and criteria for comparison between councils this often proves difficult to sustain[4].

With such difficulty in comparison it is surprising to find various observers attempting to argue the case that, in effect, 'if all councils could do as well as X council then we could save £Y in expenditure'. It is disappointing that we can even find this approach taken by well equipped and expert analysts.

In a report published by Reform Scotland[5] the authors attempt to argue just this kind of case in relation to various public services, notably education. They observe that spending per pupil varies from one council to another and that:

> "...just holding spending per pupil constant, and letting spending follow Scottish demographic trends would save around £492M per annum." (p44)

To look at one measure of the variation between councils suggests how hard to achieve such an approach of consolidation and greater uniformity might be, particularly in school education which is already one of the most homogenous of council services in Scotland. One of the greatest challenges that face councils is the position of schools that operate under capacity with few pupils enrolled in a school building designed for many more. The reasons for this are complex but in rural areas are typically related to remote locations and sparse populations; in urban areas too closely adjacent schools, depopulation, or alleged poor performance and/or unpopularity with parents (incidentally not the same thing). The variation between councils is substantial. If we take a modest measure of acceptable pupil capacity and say that a school around 60% full is acceptably utilised, then Argyll, Highland and Orkney all had more than 40% of their primary schools running below this level in 2008-2009. It is of course no coincidence that these are all rural councils, with all the community pressures that we would expect to see arguing for the local school to be kept open.

[3] Local government Financial Statistics, Annual.
[4] Accounts Commission for Scotland /Audit Scotland [2010]. An overview of local government in Scotland 2009
[5] MacKay, D and Bell D (2006) The Political Economy of Devolution. Reform Scotland

The current government legislated to provide additional protection for such schools against closure but even that has quickly run into difficulty[6]. A wholesale closure of schools with extremely low occupancy rates – under 40% - would, on 2008-09 figures lead to the closure of 233 primary schools: 42 in Highland; 28 in Argyll and Bute; 34 in Glasgow; and 15 in Aberdeenshire. Only 5 councils would escape such a cull.[7]

At the other end of the age range, one underlying constant topic of discussion related to the budgetary resources available to the government is Free Personal and Nursing Care (FPNC). This is always hailed as a landmark policy which it is argued may not be 'sustainable'[8] in light of demographic change. This policy is also significantly influenced by variable and long term demographic change between different councils. The long term aspect of this is important if we look as far ahead as the Chief Economic Adviser to the Scottish Government has recently done[9] where he has asserted that "a period of sustained adjustment lasting up to 12 to 15 years" is in prospect.

Such a long term perspective extends our horizon to 2025 approximately and the Registrar General for Scotland[10] does give population forecasts by age range for all council areas for the years 2023 and 2028. The variation on percentage change for over 75s between council areas is sharp and highly pertinent to this discussion[11].

Projected Percentage Change in over 75s in population by selected councils – today to 2023	
Glasgow	4
West Dunbartonshire	24
Orkney	74
Aberdeenshire	76
West Lothian	89
Scotland	*45*

Clearly the potential for a budget shifting impact of continuing some form of FPNC will impact to a greater extent on some councils than on others.

The difference between council areas is reflected clearly in patterns of expenditure on those services which are heterogeneous to a greater extent than is education, the most broadly uniform service. An illustration of the relative difference of service expenditure per capita between different councils and different (population-wide) services can be seen by comparing two contrasting services provided by 4 mid range councils of different degrees of urbanity/rurality in the year 2008-2009.

6 The Herald (2010) 'Law that set out to protect fragile hinterland branded worthless' 28th July.
7 Accounts Commission for Scotland, 2010
8 East Renfrewshire Council (2010) submission to the IBR Glasgow Herald [2010] Parent s looks at legal bid to halt school closure. 7th August
9 Chief Economic Adviser (July, 2010) Outlook for Scottish Government Expenditure – emergency Budget Update.
10 General Register Office for Scotland (GROS), 2008. Population projections for Scottish Areas
11 Such projections of course reflect current patterns of spatial differences in life expectancy with the two councils with lowest growth projections at the foot of the table for both male and female life expectancy.(Mackie, 2010)

Council	Spend per capita on Roads & Transportation	Spend per capita on culture and related services
Aberdeenshire	1137	83
Fife	959	130
North Lanarkshire	831	127
West Lothian	956	95

The differences of demography, the different levels of service composition and the variations between councils all contribute to the difficulty of effecting reductions in expenditure based on a high level overview of services in the country as whole.

Reverse engineering or reversing progress?

In the period of turmoil that followed the onset of the banking crisis and UK government responses to it, public discussion and media reporting were laden with apocalyptic forecasts and projections of the impact on Scottish public services. We were warned[12] by 'experts' that the Scottish government would be forced to reverse almost all of the policy and programme developments introduced in the period from 1999.

Some of these expert predictions were always dubious; the claim that bridge tolls would *need* to be reinstated appeared to take little account of the capital reinstatement costs of physical infrastructure and the revenue costs of collection. Unsurprisingly this particular proposal has not been mentioned much in recent months.

Although such marginal suggestions have disappeared from public discussion, the current climate of discussion appears to be heavily influenced by assumptions that the starting point of any major programme review takes 1999 as Year 0.

The proposals discussed in the Report of the IBR where it discusses the costs and benefits of Universality (see the essay in this publication by Bell) represent a form of policy choices based on 'reverse deincrementalism'.

In taking this perspective, the IBR[13] is driven to discuss the merits (and demerits) of some major universal changes introduced by various administrations: concessionary travel; FPNC; removal of prescription charges; free eye examinations; free school meals and free HE tuition for full-time students.

It is also noticeable that the detailed discussion of universality and the cost of such services is confined to a sub set of universally provided 'free at the point of use' services; and, indeed this was noticed by various of those who submitted evidence to the IBR. Papers from Age Scotland; BMA Scotland; Universities Scotland; and the Scottish Disability Inclusion Forum & Inclusion Scotland appear, in different ways, to question the opportunity cost of focusing on some aspects of universal public service provision rather than others. The last named bodies were to the point:

> "...why is it proper to charge for services which enable a disabled adult to live an independent life...but improper to charge for museums and art galleries....improper to provide subsidised taxi fares?"

[12] Macleod. A (2009) 'Scotland facing 'budget cuts of billions'' The Times. 26th April
[13] Independent Budget Review (2010) Scottish Government P98.

What this specific observation does is to open up for debate the entire array of services that are currently (and often historically) provided at no user charge, and which often sit alongside similarly organised services for which charges are just taken for granted. In many local authorities the same council department (or quasi department as in Glasgow Life) operates:

- Sports centres - Where most of us pay a charge;
- Galleries – Where most of can enter for nothing but pay for special events;
- Libraries – Where we use most facilities for no charge but pay for some.

Are free libraries more socially desirable than free bus travel for older people? If we are to charge for Higher Education then why not all post compulsory education? Such questions and contrasts are more extensive than we often at first assume.

I do not answers, but clearly our current set of assumptions about the position of 'free' public services are actually circumscribed by legacy and many unstated assumptions.

Does reorganisation ever come cheap?

A similar high level of discussion often surfaces about the notionally appealing outcome of a reorganisation of local government in Scotland which it is argued will achieve greater coherence, economies of scale and expertise and lower cost. It therefore appeals at several levels and to different people in different ways.

Tom McCabe MSP, a former Minister responsible for local government, was one who was moved to being a convert before he left office and whose views hardened afterwards:

> "It's as good as impossible to justify 32 education directors and the huge tier of professionals below that. You could say the same about finance and social work."[14]

A similar sentiment is frequently found in The Scotsman columns of Bill Jamieson, and the editorials of both the major daily papers in Scotland.

There may be a case for reorganising local government in Scotland (essentially reducing the number of councils and making most of those that remain much bigger) but it is not clear that it can be based on verifiable potential cost savings.

The last reorganisation of local government over the period of 1995-1996 reduced the number of councils from 65 to 32, partially through a process of combination of Regions and Districts to one council – for example in Fife - and partially through the disaggregation of councils such as Lothian to the boundaries of the four district councils. Clearly there was no longer a need for 65 Chief Executives but only 32 – a saving. However 12 Directors of Education, Social Work, Highways etc. were replaced by 32. Despite claims by the then government that such changes would save money (and also be otherwise desirable) there is little evidence to support this savings claim. Indeed the eventual acceptance by government of very modest potential savings through reorganisation was reflected in their financial assumptions for the reorganisation year – £40M, or 0.75% of total local government budgeted expenditure (Rating Review).

[14] The Herald(2009) 14th January

There are many ways in which we can assess possible evidence of cost saving; none of them conclusive and unequivocal.
For the council tax-paying resident, over the period of time immediately preceding the 1996 reorganisation and the few years following, the Scotland-wide Band D council tax continued to increase at a fair pace, with rises of 10% and 13%.

In the 5-year period commencing 1993/4 the % increase in Scotland-wide overall local government expenditure was as follows:

1993-94	0.8%
1994-95	3.2%
1995-96	3.5%
1996-97	4.8 %
1997-98	3%

And bear in mind that this change was presented as achieving savings, not just reduced increases.

Even if we took the most heroic of assumptions achieved within ruthlessly executed commercial takeovers, and assumed that in central and support service costs (the famed 'back office') savings of about 15%, are achievable, the total potential savings might amount to somewhere in the order of £140M. In public service mergers[15] the savings achieved appear to not exceed 5%. That might seem a lot of money but such savings are rarely cost-free and would amount to less than is needed to sustain the current provision of concessionary travel on an annual basis.

It's in the programmes…

Central to any consideration of how we cut public expenditure in Scotland is an adaptation of the message that allegedly helped get Bill Clinton elected: 'It's the economy, stupid'. The high level aggregation of country-wide programme costs; the sweeping summation of blocks of money and the appeal to apparently popular organisational solutions can be a starting point – but only that. All such proposals eventuate in decisions about allocating or denying services to communities, families and individuals in localities throughout the country. This is start of the discussion about which services might be allocated or denied; at what level of provision; and at what price to the individuals concerned. The final decision on which money is spent, or not spent, on which people will often continue to be made by the 'street level bureaucrat'.

Richard Kerley

[15] Fulop, N; et al (2002) British Medical Journal, 325:226. Process and impact of mergers of NHS trusts: multicentre case study and management cost analysis

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Sweet are the uses of adversity

David Hume

"Sweet are the uses of adversity,
Which, like the toad, ugly and venomous,
Wears yet a precious jewel in his head"

In these lines, Shakespeare captured a sense of the opportunity contained at the heart of the most difficult and adverse circumstances - a metaphor which is of profound relevance to the public sector in Scotland today.

In more recent times, Rahm Emanuel, President Barack Obama's Chief of Staff may have put it more succinctly, albeit less poetically, when he said "you never want a serious crisis to go to waste."

It is clear that the conditions facing public sector organisations, and other bodies dependent on public sector funding, are indeed 'ugly and venomous', and that the crisis is serious.

The Scottish Government's Chief Economic Adviser, Dr Andrew Goudie, is positing that the Scottish Government's budget could fall by £4.3 billion by 2014/15, and that, assuming a slow return to levels approximating current spend, a cumulative total of £42 billion expenditure could be foregone in real terms in the period up to 2025/26.

Specifically with regard to capital investment, Dr Goudie sees that area of spending sustain a proportionately greater cut, with spending falling by £1.6 billion (40.1%) in real terms between 2009/10 and 2015/16.

The key task for all of us with an interest in the delivery of public services in Scotland therefore must be to craft and design the "sweet" ends towards which these adverse forces will impel us.

Scotland's Independent Budget Review

Scotland's Independent Budget Review Panel met between February and July in 2010. The Review was given scope to consider all expenditure over which Scottish Government has control. Specifically, the Review panel was asked to consider:

- The implications of the reductions in public spending for current patterns of spend;
- The implications of reduced spending for the long term sustainability of public spending; and
- The means for delivering public services in the context of reduced public spending.

In their five month's deliberations, the Review Panel brought forward a number of recommendations, which with particular regard to local authorities, included:

- The need for a presumption against the ring-fenced protection of current spending in any given area of the public service;
- The discontinuation of the Council Tax freeze;
- The generation of efficiency savings of 2 – 3 %;
- Concerted action to generate new income streams;

- Strict controls on public sector pay, and a reduction in headcount;
- The need to review all free or subsidised universal public services;
- The need for clarity in capital spending priorities;
- Putting Scottish Water into a new model of ownership and control, short of privatisation, which would attract private investment; and
- Consideration of the introduction of road user charging.

The review Panel also called for more creative thinking and innovation in financing, and the design and delivery of public services.

Reinventing Government in Challenging Times

There have been many attempts in the past to review or reinvent public services in the face of adverse conditions and threats. In 1992 one such testament was published, at a time when the authors believed that "our governments are in deep trouble." David Osborne and Ted Gaebler claim they published 'Reinventing Government' specifically "for those who are troubled by that reality."

'Reinventing Government' generated a widespread interest in the early nineties. It was endorsed by President Clinton who recommended that it "should be read by every elected official in America." Even today, it offers some penetrating insights into the issues which need to be tackled in the medium and long term, and in doing so provides a thought provoking complement to the report of the Independent Budget Review Panel.

In considering the fundamental need to reduce waste and constrain the size of the public sector, Osborne and Gaebler are clear in their criticism of traditional methods and approaches: "Our governments are like fat people who must lose weight. They need to eat less and exercise more; instead when money is tight they cut off a few fingers and toes."

Rather, they argue for a more sophisticated understanding of organisations and management. "Waste in government does not come tied up in neat packages. It is marbled through our bureaucracies. It is embedded in the very way we do business. It is employees on idle, working at half speed – or barely working at all. It is people working hard at tasks that aren't worth doing, following regulations that should never have been written, filling out forms that should never have been printed." And inevitably therefore such a view calls for a very different approach to change and improvement.

'Reinventing Government' set out ten principles of good governance which effectively presaged many of today's actions and aspirations for better governance. The principles are:

1. **Catalytic government**: steering rather than rowing, focusing on leading whilst freeing up options on who actually delivers public services.

2. **Community owned government**: empowering rather than serving, with governments opening up opportunities for real participatory democracy in delivering public services.

3. **Competitive government**: injecting competition into service delivery to revitalise public institutions.

4. **Mission-driven government**: transforming rule–driven organisations, utilising trust and accountability rather than inspection and scrutiny.

5. **Results-oriented government**: funding outcomes, not inputs

6. **Customer-driven government**: meeting the needs of the customer, not the bureaucracy.

7. **Enterprising government**: seeking more sophisticated ways to earn, rather than spend, and to achieve a change in the culture in how it regards enterprise.

8. **Anticipatory government**: prevention rather than cure – always cheaper and ultimately more effective.

9. **Decentralised government**: from hierarchical control to participation and teamwork.

10. **Market-oriented government**: leveraging change through the market, and empowering service users and customers.

Challenges for Local Government

In overall terms therefore, the outlook is very challenging. On the supply side, sharp and sustained decreases in public sector funding will require downsizing in what public services can deliver if current costs and operations pertain, even without taking into account increasing demand for services as a result of demographic and other need factors.

The Independent Budget Review Panel has given pointers towards actions required in the immediate and short term, but plainly regard must also be paid to actions in the medium and longer term which will reduce costs and waste, and which will free up scope for extending participation and engagement to communities, to the market, to employees and to customers in the provision of public services.

It is suggested therefore that there are **five key challenges** for the public sector, and local authorities in particular, to address to ensure that resources are maximised and targeted in the delivery of essential services to customers and services users.

1. **The Productivity Challenge**
   Despite public sector organisations having adopted new, progressive approaches to business change and improvement over recent years, including a new focus on customers and outcomes, on non-traditional business models, structures and processes, outsourcing and shared services, performance management and Best Value, the one critical area for business improvement which has remained virtually untouched has been the definition and measurement of productivity.

   The sector's failure to adopt an active approach to measuring productivity has left business change and wage negotiations essentially and fatally unbalanced, and unable therefore to deliver the service improvements and cost reductions which might be expected in any competitive salary and wage negotiation process. This has led to such negotiations being a one-dimensional process, the only possible outcome of which is ever-increasing labour costs.

The reasons commonly given for this situation relate to the perceived inherent difficulties in measuring productivity in a public service context, and the inappropriateness of using output and input measures for complex service orientated activities (Hodgkinson, 1999). Both these factors arise from the view that public services are diverse, and operate over many dimensions in respect of quanity, quality, performance, and client and customer groups. In addition, many public service outputs are not easily expressed in equivalent market value terms.

However it is clear from the work of Hodgkinson (1999) and others that measures can be constructed and used. Hodgkinson cites the example of Liverpool City Council which has negotiated wage increases in the City Works business unit where the award of wage increases were dependent on concomitant reductions being achieved in road and building maintenance costs, and performance levels equating to those in agreed private sector comparators.

2. The Democratic Challenge: Engaging and Empowering Communities

Traditionally, public services in the UK have taken a very direct approach to service delivery. As public spending is becoming more and more constrained, particularly in terms of local authority services, it is evident that some communities are pressing to be given the freedom to take responsibility themselves for the provision and management of local services and facilities. This can range from the raising of funds for school buildings and extensions, to the maintenance of parks and other public open space, to taking responsibility for the management of large public facilities.

The new UK Government is seeking to extend this local engagement through the development of its 'Big Society' and other policy initiatives. It is essential that local authorities keep pace with such changes underway at community and UK Government levels. It will be essential that local authority structures and processes change to accommodate and nurture local community initiatives. It will be essential that the culture of working with local communities is one of respect and support, and that the requirements of working with communities in this way is quite radically different – particularly for staff in professional areas previously unused to working with community representatives.

3. The Partnership Challenge

Local authorities and other public, private and voluntary organisations work in partnership across Scotland on the basis of agreed common objectives, and more recently defined and brought together in Single Outcome Agreements. At the same time, local authorities have been innovative in creating new models of delivery involving arms-length companies, joint ventures, and outsourcing.

Where this experience has been less successful however has been in the establishment of:

- Shared service solutions which minimise the costs of administration and management and maintain service standards which meet local service needs;
- Pooled resources and shared decision-making;
- Streamlined auditing and performance scrutiny;
- New forms of governance and accountability to oversee and drive the development of effective partnership and shared effort;

- New consolidated management arrangements to provide single management and support structures across a number of local authority areas or across a number of public sector organisations.

The challenge for all public agencies is to **standardise** procedures as far as possible, **simplify** processes to reduce costs and assist universal application across Scotland, and **share** resources, facilities, management and support arrangements to ensure that delivery to customers and communities is protected as far as possible.

4. The Challenge of Place

Public sector organisations have traditionally provided their services and committed resources to local communities through single-agency delivery channels and mechanisms, and separately managed budgets and facilities. This approach has been reinforced by institutional structures and requirements for accountability and scrutiny. Where services were able to cooperate and work together in meeting customer and community needs, this was welcomed as additional, but exceptional value.

An alternative view and approach is being taken in England through the development of 'Total Place'. Total Place takes a holistic approach to public services in seeking to provide better services at less cost, and to avoid wasteful overlap and duplication between organisations. It was launched in 2009 as a key recommendation of the then Government's Operational Efficiency Programme.

The starting point for Total Place work is in the totality of public sector spending committed in defined local areas. Having established this common resource base, consideration can then be given to the integrated utilisation of resources to meet local priorities, and also the redesign of services with the informed engagement of local communities.

Therefore by means of local leadership and collaborative working, the aim is to design and deliver services which meet people's needs, improve outcomes and deliver better value for money. HM Treasury (2010) describe Total Place as providing:

- **New freedoms from central performance and financial controls** – further reductions in ring-fencing, indicators and burdens for places that agree to deliver improved outcomes and additional savings;
- **New freedoms to collaborate** – support for local partnerships to use pooled individual budgets, working together on capital asset and investment plans, and for joint working between local authorities and other agencies
- **New freedoms for places to invest in prevention** – including new funding arrangements to develop interagency collaborations in early intervention and prevention
- **New freedoms to drive growth** – including devolution to local areas to drive growth and inclusion through the recovery, and new flexibility for places to shape spending on skills

It is essential that the potential and possibilities of more effective public sector resourcing and service delivery is unlocked in Scotland.
It is essential that Total Place approaches are used to challenge and transform the way that public services are managed and delivered.

5. **The Investment Challenge**
   Investment in capital infrastructure and facilities by local authorities and other public bodies over many years has improved the quality of life in our local communities, supported the development of more modern forms of service delivery, and contributed to economic growth and prosperity. In recent times, areas all over Scotland have seen the engagement of private finance in the provision of these facilities.

   The outlook given by the Scottish Government's Chief Economic Adviser (2010) is indeed bleak and worrying therefore: Scottish Government capital expenditure is likely to fall by over 40% in real terms between 2009/10 and 2015/16.

   Increasing service demands and a growing backlog of investment requirements in maintenance and replacement, to say nothing of the need for investment in regeneration and development, will intensify pressure on scarce capital resources over this period.

   The challenge for local authorities then will be to identify and exploit viable and affordable new funding streams for these purposes. In the past the sector has been quick to employ new opportunities for investment in much needed assets and facilities – in the use for example of covenant schemes and private finance. The City of Edinburgh is to be congratulated in this regard, in seeking to exploit new sources of capital investment for regeneration in the face of dwindling private sector investment in this area. The Council is looking to utilise Tax Increment Financing which captures anticipated incremental tax revenues to pay for enabling infrastructure, to fuel economic growth and investment in a regeneration waterfront development project.

   Commentators argue that although there are risks involved with this funding as with many other options, the benefits to local areas are clear, particularly in conditions of high cost private financing and no central government guarantees or underwriting. What is required, however they agree if new sources of investment and funding are to be opened up, is a radical change to attitudes to risk in the public sector, and the need for much closer partnership and mutual understanding between the private and public sectors in order to fill the gap, and get results.

So, how sweet can the uses of adversity actually be?

It is evident that a great and profound period of change is upon the public sector, and local authorities in particular. The forecast reductions in public spending will require substantial reshaping and redesigning of services, business processes, and organisational structures. These imperatives will not be satisfied by traditional approaches to trimming and reducing annual budgets. We would be doing a disservice to our customers and communities if we relied upon traditional, simplistic approaches to cutting budgets.

The challenge is rather for us to **reinvent government and governance** drawing on principles such as those articulated by Osborne and Gaebler almost twenty years ago, and making operational the recommendations of the Independent Budget Review Panel.

Within the context of central government action to reduce public spending in the coming years, it is essential that public bodies are also given the time, freedom and scope to innovate in becoming the smaller, lower cost, resilient and responsive empowering organisations which are required.

Within aspects of the UK Government's programme, there are signs that this scope may be open to public bodies. The Big Society, Total Place and the search for alternative sources of finance still require significant work to refine and implement the right solutions for modern times. But it is absolutely clear that the future for public services must be characterised by being driven by the recognition that great power and initiative can be released from communities and partners, and that government will benefit from being more enterprising and committed to early intervention and prevention.

In 1991 the Governor of California, Pete Wilson, proclaimed in his inaugural address "We will not suffer the future. We will shape it." That should be our philosophy in making sweet uses of the adverse times ahead.

David Hume, Chief Executive, Scottish Borders Council
(written in a personal capacity)

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Wholesale Transformation of Public Services in Scotland – A Roadmap for Higher Value and Sustainable Citizen Services

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Contributions From:

IBM paper on Digital Britain
IBM - Delivering performance through continuous transformation - from the Institute of Business Value.

Introduction

As the public sector in Scotland grapples with the change required to meet the needs of expanding demand on core public services, at a time of unprecedented squeeze on available investment to deliver those services, this paper seeks to draw parallels from the private sector, in particular from IBM, on how the implementation of a longer term programme of transformation can move an organisation to excel in a re-defined environment.

Numerous programmes of research and recommendations are now available to the public sector, including studies such as the Independent Budget Review, the McClelland review of public sector procurement, pathfinder studies carried out on behalf of City of Edinburgh Council and Glasgow City Council, and various consultations on shared services carried out by the Scottish Government and partners over the previous 5-10 years.

Indeed, one could argue that in terms of available customer data, the Scottish Public Sector is in an envious position with the data that it holds and the research which has been carried out. The data from these programmes does however sit in isolated silos, is not shared across bodies and has not been subject to any great degree of analytics.
Such detail, were it available to a private sector company on its own customer base, would allow an unprecedented level of realignment of services, delivery methods and measures of customer satisfaction. A culture of performance measured against customer needs and demands would then naturally flow.

As the only constant in the public sector has been change over many years, public bodies have become adept and agile at delivering efficiency savings against issued targets. Indeed, a three percent per year saving by doing things "better" has been consistently delivered by many local authorities, health boards, non-departmental public bodies (NDPB's) and agencies. This initiative has however missed the opportunity for longer term, sustainable transformation and has instead focussed on short term expedience.

The challenge now is not to create "more for less", but to identify real transformational change in terms of what services are delivered, how they are delivered, where they are delivered and who they are delivered by. In effect to create a new model for "Smarter Government".

The paper strongly suggests that wholesale transformation across the public sector is the only viable option for the long term future. Short term efficiency gains will be peripheral, unsustainable and, in the long term ineffectual. Instead the Scottish Government needs to view a wholesale transformational approach- looking at everything that the sector does, how it does it and why it does it - as the only viable way forward and then needs to drive that change through to secure the required outcomes.

In this respect the story of IBM Corporation itself offers an excellent reference on how comprehensive and continuous transformation can be achieved. From this reference clear lessons can be drawn which are equally applicable to the Scottish Public Sector. The two over-riding principles that will drive that transformation are strong, committed leadership, that clearly lays down the strategy and the roadmap for delivery, along with robust performance management to ensure that strategy is being delivered by all stakeholders.

The following sections cover the definition of Smarter Government, Inhibitors to Smarter Government, the IBM transformation story, lessons that can be applied from that transformation story to accelerate the delivery of smarter government in Scotland and a series of recommendations to deliver.

What is a 'Smarter Government'?

Just as IBM, like other private enterprises, had to rediscover its mission and business model by returning to a focus on core values, changing what they do, doing it more effectively and innovating for growth, so governments around the world are finding success by redefining their structures, policies and delivery methods around the citizens that they serve.

At the most fundamental level, smarter government means making operations and services truly citizen-centric. Leading governments are integrating their service delivery, establishing offices that support multiple services and placing the most needed transactions onto the most appropriate delivery channels.

Smarter government means collaborating across departments and with communities — to become more transparent and accountable, to manage resources more effectively, and to give citizens access to information about decisions that affect their lives.

IBM believes that key indicators of the achievement of Smarter Government in Scotland will include:

- A Scottish Public Sector that is lean and comparable in size to the best exemplars across the world, measured either by GDP or population size
- the ability of citizens to do business with government utilising new channels to receive the services that they require
- True collaboration between the public sector, the private sector and the third sector to deliver citizen focussed services – from the most appropriate delivery partner

This service delivery will be underpinned by a common set of support functions, processes and technologies that will allow standardisation and sharing of infrastructure, systems and processes and will therefore reduce the cost of delivery of these services.

Historic Limitations

Given that change has been on the agenda for some time and that there have been limited pockets of success, it is evident that there are significant barriers to making it happen. These include:

- The complexity of the government landscape, both from an organisational and a systems point of view. The whole of the UK is hindered by its maturity as a service provider and as a user of technology. The evolution of government policy and service delivery is the subject of much academic research but few citizens understand who delivers their services: central, local or third sector. The technologies used to deliver the major services (e.g. welfare benefits) are rooted in the designs of the seventies and eighties, making them difficult to integrate and change and burdening government with substantial investment programmes simply to maintain the systems and keep up with legislative and other mandatory change requirements. Developing countries have less organisational and technological baggage to leave behind.

- Security and privacy have leapt up the agenda as possible barriers to change. Joining up government operations and use of citizens' data across many different applications, not just the purpose for which it was first collected is highly emotive and challenging in the UK. Progress made in other countries has, to some degree, relied on less angst about these subjects together with strong central direction and widespread recognition of the potential benefits for citizens and government alike.

- Limitations on management and leadership capacity: From a public services point of view requires considerable leadership, focus and, potentially, investment. History suggests that even relatively modest initiatives suffer from the challenges of maintaining existing service delivery while trying to invent and implement new models.

- Cultural differences between the public sector and private sector often mean that different bodies can be seen to be pulling in different directions. As an example, local authorities are often competing with each other for stature, respect and to attract investment and people.

- Political and real concerns about creating a "digital divide": making public services available to those that need them is a fundamental tenet that cannot be ignored. As a consequence, public services will always need to be "multi-channel". This should not be seen as an obstacle to e-channels; rather it emphasises the importance for public services of moving away from the established 'one size fits all' philosophy to one where services are targeted at individuals through the most appropriate channels. There is also clear evidence that the more useful you make an e-channel, the more people will use it, freeing up resources to service other channels. The commitment to Universal Service is a critical signal that government recognises this issue and is prepared to act to mitigate its impact.

- Aligning public procurement: public procurement could be encouraged to take account of the factors that are most relevant to successfully delivering e-services, in particular: insight, innovation, experience and ability to deliver. Often these critical factors are evaluated in the long shadow of other factors focusing on 'inputs' (in particular cost).

To overcome some of these barriers, lessons can be drawn from the transformation of IBM itself, and the following section summarises why IBM had the imperative to transform, how strong leadership enabled that transformation and how it is now once again a global leader and can share the lessons learned with other organisations.

IBM Transformation Journey

When it comes to business transformation IBM is itself an excellent reference. From a near-death experience for the corporation in the early nineties, it has returned to industry leadership and then continued its ongoing reinvention to become a showcase example of a globally integrated enterprise built for success in the 21st century.

Specifically, IBM recorded the world's largest corporate loss in 1990 of some US$8billion. From that precipice the transformational journey now has positioned the company to deliver record revenues, profits, leadership in the number of patents registered and continual investment in R&D to lead in innovation.

The IBM transformation journey provides one roadmap that can be applied by organisations, in both the public and private sectors, to deliver similar transformation.

At the time, choices were made that would radically change the corporation and what is stood for. One of the choices was to break up the giant corporation into its component parts. This was rejected in favour of integrating and re-aligning the business – not through centralisation of all decision making, but through the adoption of common values, common management systems and standardised processes and technology tools. This integrated approach to support systems then allows local managers and executives to take local decisions that meet client needs, all within a framework that applies globally.

IBM's Four Strategic Goals

IBM achieved success by executing towards four strategic goals:

i) Capture Higher Value
Migrating to more attractive customer segments as well as higher-value products and service offerings. By divesting commoditised products and services (PC's, storage, components etc) to business services that align with the customers own strategic imperatives.

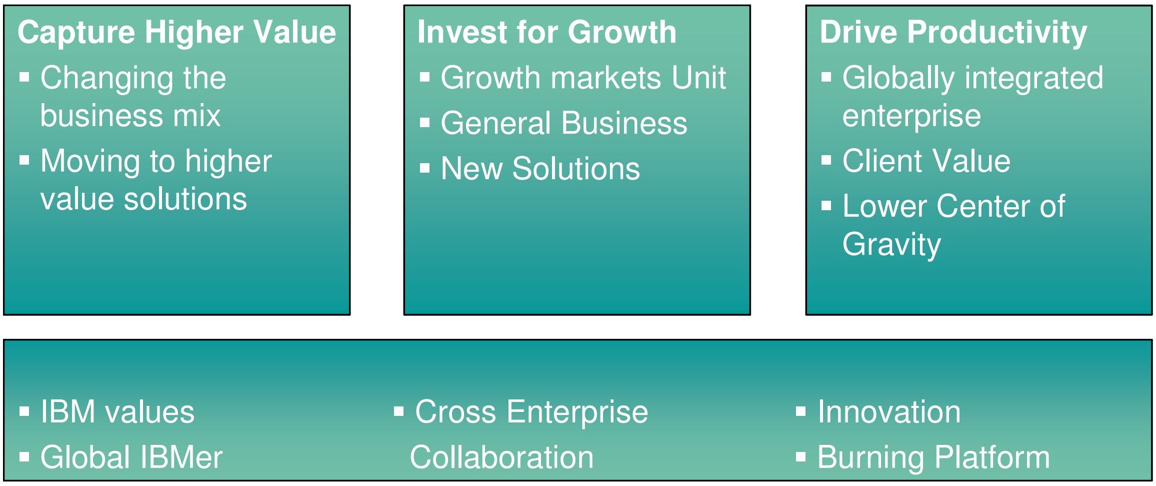
ii) Invest for Growth
Taking advantage of the global presence to benefit from global growth as well as investing in new market offerings. This meant increasing investment in markets such as China, India, Brazil and Russia and integrating markets in Europe into smaller, more aligned market units.

iii) Shift the operating model to drive productivity
Improving operating performance by globally integrating, while pushing decisions further down into the organisation. For example, having a single management system globally, with standardised processes and tools, whilst leaving day-to-day decision making at a local level within global parameters.

iv) Apply shared values and performance management
Driving change throughout the organisation based on a common set of values and an aligned performance management system. Aligning rewards and performance so that measures are consistent and robust.

IBM continues to execute against these strategic objectives because it has flexibility built into its operating model – the flexibility that allows it to shift resources and deploy investments in unique ways to take advantage of selected opportunities.

The figure below illustrates these goals.



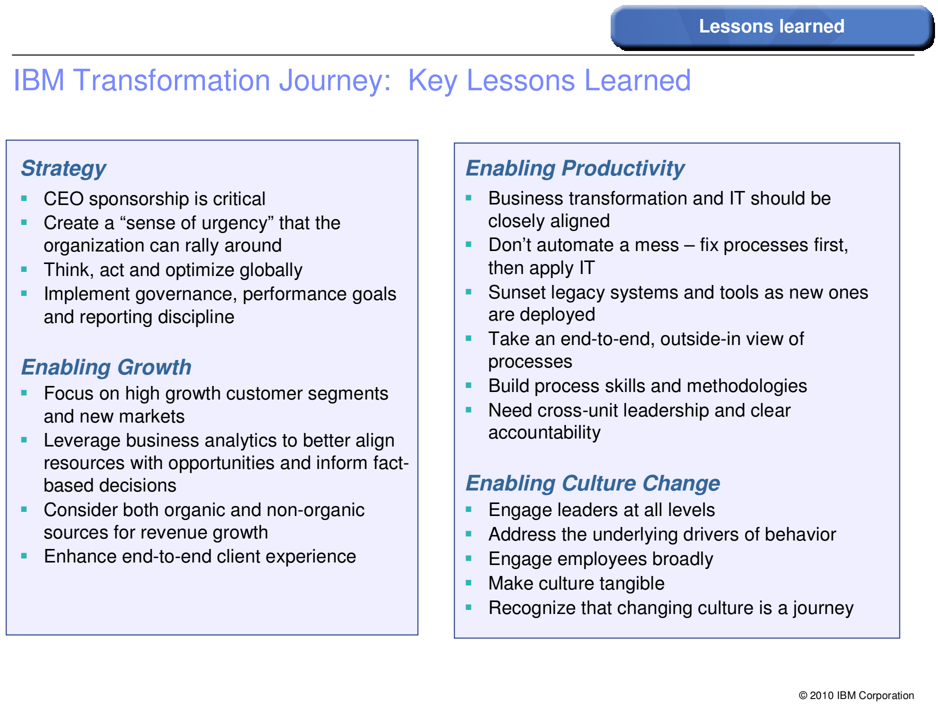
Within the context of existing strategy, IBM has been expanding both our offerings and addressable markets. We are already a leader in smart technologies, products and services to help our clients transform their existing IT infrastructures — from Dynamic Infrastructure to Cloud and more —The smart technologies we are bringing to clients we are also using internally to help enable our ongoing transformation.

Enabled by the transformation of the world's infrastructure, almost anything can now be digitally aware and, as a result, optimised. As examples consider how organisations – both private and public – are rethinking their systems and applying technology in ways that change how the world works:

- Stockholm's smart traffic system has resulted in 20 percent less traffic, a 12% drop in emissions and a reported 40,000 additional daily users of public transport. Smart traffic systems are strengthening the competitive positions of cities such as London, Brisbane, Singapore and many more planned.
- Intelligent oil field technologies can increase both pump performance and well productivity – in a business where less than half the available reserves are extracted
- Smart food systems – such as those used in Norway to trace fish – can use RFID technology to trace meat and poultry through the supply chain to supermarket shelves.

During an economic downturn, organisations often respond by cutting investment in transformational initiatives for future growth. However, IBM believes that continuing to invest in new discoveries has been a core element of delivering performance despite economic turmoil.

Learning Points



Some of the lessons from IBM's transformation journey can equally be applied to the required transformation of the Scottish Public Sector in the following way:

i) Strategy

The public sector cannot choose in which markets it operates and from which markets it withdraws. There are of course statutory duties that are the raison d'etre for a public sector.

A smarter government chooses those services that cannot be delivered elsewhere as the core of their business. Everything else can then be put into the pot to consider the most appropriate delivery organisation, model and channel.

One alternative to consider is a comprehensive shift in the nature of the public sector organisation. To change from "all things to all men" to being a commissioning body responsible for policy and specification, whilst delivery of front line services is contracted to lower cost bodies, private or third sector.

Such a dramatic shift will require strong leadership from the centre – without taking away control from existing bodies – to drive the strategy through. Compared to the current situation, this will mean that the centre needs to mandate policy and not look for selective buy-in across the country.

ii) Enabling Growth

As has very consistently and widely reported since the UK general election, "there is no money".

However, any form of radical transformation will require investment up front. This investment can come from the private sector in return for a longer term partnership contract that allows real savings to be made and invested to carry out the transformation.

This needs to be beyond traditional outsourcing and needs to look at real strategic partnerships where there is a contracted saving, a real sharing of risk and strong leadership that allows the partner to execute against a savings plan.

As in the example of Southwest One, reference attached, the savings that can be achieved in back office alone represent 20 to 40 percent of current costs through the application of best practice, process re-engineering and shared services.

iii) Drive Productivity

Here the parallel with IBM's own transformation story is the strongest. As IBM reduced the number of back office functions duplicated around the world the Scottish Public sector should look to consolidate – through directives from central government rather than the so far unsuccessful attempt at voluntary co-operation – many back office functions. For example:

Procurement reform – which is well under way - should be accelerated and mandated rather than it presenting potential frameworks for optional use across the sector. Strategic procurement at Southwest One for example delivering savings of more circa £200M over 10 years on a combined annual spend of more than £500m.

Scotland does not need the hundreds of data centres which proliferate across the sector. Rather than the image of the "shed in the M8 corridor", a partner should be sought to operate a secure, virtualised, heavily utilised IT infrastructure which delivers services via a private Scottish Public Sector Cloud. New developments in technologies such as virtualised enterprise servers will allow fewer centres, virtualised and shared infrastructure and easier systems management by far fewer staff.

HR, Payroll, Finance – these can easily be consolidated to cut out duplication – if partner organisations are prepared to let go of in house control and agree to a standardised, virtual solution jointly owned across the sector and delivered as a service

Innovation and research and development can increase to bring in more work from outside Scotland, and outside public sector, once these services are transformed and recognised as centres of excellence. As an example, IBM in Greenock has transformed itself from a manufacturing plant to a global centre of excellence in four specific service areas and continues, after 60 years, to re-invent itself and remain as one of the core delivery centres for IBM.

iv) Underpinning this with Values and driving the cultural change

To deliver a transformation of this nature will require:

- strong and dedicated leadership, at executive and political level,
- a level of certainty and continuity – therefore agreement on the strategy and the values that will underpin that strategy from across the political stakeholder
- buy in from all stakeholders to support the continuous transformation journey
- a recognition that whilst it may not seem palatable to move some functions to other geographies, investment in innovation can lead to growth in those retained areas for which Scotland decides it wants to be famous.

- As an example many local authorities in the south east of England have a very different challenge for recruiting and retaining key staff to deliver services such as revenues and benefits. If Scotland were to become the UK Centre of Excellence for such a service, then this could be delivered via Cloud technologies to client authorities in the South East.

Recommendations - Why Smarter Government makes sense:

As IBM has survived and thrived from near collapse, the public sector now faces a similar "perfect storm" in terms of the need to cut back on spending, look again at the services delivered and review the delivery channels.

Critical Success Factors

IBM's experience of delivering transformation for ourselves and for our clients indicates that there are a number of key things that we must get right. These include:

- Understand your customers: use primary market research to understand customer needs/expectations and segments. Appoint champions within Departments/Agencies for key customer groups.

- Know where to start: Set channel strategy – use customer insight to define which services to which customer segments through which channels. Be prepared to differentiate services instead of the default 'one size fits all' (e.g. to target non-compliant citizens but make transacting easier for compliant citizens). Pick the service (or group of services, or customer group, etc) that will create a critical mass for the proposed e-channel(s) and make their delivery important at the most senior level.

- Don't build for every eventuality: Apply the 80/20 rule: build for 80% of the customer circumstances and ignore the minority of exceptions that create disproportionate complexity and cost. Target services and educate customers to minimise the likelihood of exceptions occurring. Handle exceptions through appropriate existing off-line channels.

- Fix the basics: e-enabling inefficient processes will only realise a fraction of the potential benefits. Push Departments/Agencies to deliver real efficiency savings from operational processes (measured by transaction time/cost etc). Set targets linked to customer expectations from the private sector rather than public sector historical performance. Use 'lean' to drive short term performance improvement, embed a continuous improvement mindset, and help Departments/Agencies re-skill/ redeploy/ release surplus staff.

- The right leadership: The challenges are as much cultural, political and organisational as they are to do with technology. They require a different kind of leadership – entrepreneurial skills are as important as operational/political skills.

- Make it matter: Establish ownership of end to end services (rather than functional silos) and incentivise performance improvement. Reward cross-Department/Agency collaboration. Target policy and security functions with enabling (rather than policing) e-services.

- Behave like the private sector: Think 'product development' and use marketing and incentives to drive take up of e-services. Focus on core services and outsource non-core activities, e.g. those expected to decline as take-up increases. Recognise that running services in real time over extended hours (possibly 24x7) requires a different approach to operational management.

- Partner with industry: Take advantage of practical industry experience by engaging business owners with ICT delivery partners as early as possible (after feasibility or requirements is too late) to maximise innovation and ensure joint ownership of outcomes. Look for partnering models that reflect shared objectives (e.g. drawn from the business case, such as take up and implementation costs).

- Prepare the ICT: Complex brown field IT landscape and fragmented data prevalent in the Public Sector require a long term, stable ICT strategy and the governance and investment to make it happen. Fix the immediate local barriers to e-enabling priority services (e.g. batch system availability, security, data access and data quality).

- Drive provision of enabling services centrally: Drive data standards, focus on building confidence in security, fix authentication. Bite the bullet on enabling data sharing across departments. Initiatives like Tell Us Once and consolidation of websites into DirectGov and Business Link are the right way to go – encourage/mandate their use by Departments and Agencies.

Define the Roadmap

- Identify the high value potential services: use criteria including transaction volumes, complexity, target customer groups, legislative impacts, requirement for physical tokens and authentication to build a cross-government 'heat map' identifying those services that have the most potential to be moved online.

- Make it matter: appoint owners for each of these high potential services, support them with necessary funding and set clear delivery targets focused on outcomes (for example, a target take up percentage by a specific date). Establish incentives (and penalties) to drive delivery.

- Begin by fixing the basics: for each service, use lean principles to drive short term performance improvements and ensure that services are fit for purpose before new channels are implemented. Bring business and technical insight to bear alongside operational resources to challenge established ways of working and create a vision for the future online service. In addition to reducing the cost of delivering today's services, a key benefit of this approach is the potential to reduce the cost of implementing new channels as services are simplified.

- Apply the 80/20 rule: build for '80%' of the anticipated circumstances and ignore the minority of exceptions that create disproportionate complexity and cost. Target services and educate customers to minimise the likelihood of exceptions occurring and, when they do, to direct customers towards appropriate existing off-line channels.

- Encourage Citizens to Connect with Smarter government programmes: smarter government needs greater involvement of citizens to enable design to be more citizen-centric and aligned with their real needs. Citizens need to be both more demanding and more willing to get involved in the design process.

- Encourage Citizens to Engage in the data sharing debate: examples exist of citizens granting permission for their data to be used (e.g. Crossroads Bank in Belgium), to remove some of the burden when doing business with government. In Scotland and the UK this burden exists (think of all the documents you used to need to take to the Post Office before electronic vehicle licensing), but is paper form and is seen to be less threatening. If agreement could be reached on how authorisation processes for data use can be given, e.g. the citizen giving blanket access, the citizen giving access on request, or the citizen giving no access, then Smarter Digital Scotland could be a step closer.

Conclusion

This document is intended to drive discussion and action around transformational change in the public sector in Scotland – as stated in this paper it is IBM's belief that the roadmap and strategies undertaken in their own transformation are relevant and can be applied to the public sector to support sustainable delivery of high valued citizen services.

Kal Osmani

Challenging the Culture

Eddie Frizzell

Two recent outpatient experiences at the Edinburgh Eye Infirmary set me thinking about culture. Not the Festival; nor the culture in which keeping me waiting 55 minutes beyond appointment time just to be screened clearly did not matter. Rather, the culture implicit in the answer to the question as to why, before I could see a doctor, I had to provide all the same data and have the same antiquated vision test as 10 days before, i.e.: it was "procedure" and would have applied even if I had been there only 24 hours earlier.

Also the culture that means, when a regular check-up there confirms her optician's diagnosis that a diabetic lady of nearly 90 needs a cataract operation, there is no possibility of arrangements being set in hand or of making an appointment there and then. Instead she must be sent back to her nursing home to make another appointment with her optician, so he can make another assessment and write to her GP, who is then required to refer her back to the Eye Infirmary. Round in a circle: another "procedure", presumably not reserved for elderly ladies.

This was a worry. I had understood that the new "management" culture in the NHS was clearing away convoluted procedures and ancient rituals en route to a less hide-bound, nimbler, patient-centred service. If new brooms had not swept the Eye Infirmary, were they busy elsewhere in the NHS or in other parts of the public sector? If not, what were the chances of a satisfactory response to what the Auditor General had called, in anticipation of the upcoming expenditure cuts, the "urgent need to improve the efficiency and productivity of Scotland's public services."[1] Had the culture still not changed despite 30 years of strategies, initiatives, restructurings and efficiency reviews?

The UK public sector reform agenda

Taken as a whole, culture change is what the reforms kicked off in 1982 by the Thatcher Government's Financial Management Initiative (FMI)[2], were supposed to achieve. The key elements would be recognised by managers in the private sector, as it was to the example of successful businesses that Ministers looked for inspiration. In central government there was to be a new culture in which civil servants would take personal responsibility for financial management and know what the money was buying. In the late 1980s the FMI was followed by the "Next Steps" initiative[3] which created Executive Agencies directly accountable to Ministers under Chief Executives with clear targets, a thirst for continuous improvement, and pay linked to performance. Recruitment of experienced people from outside the public sector was to bring fresh thinking, better cost control, and new ways of doing business.

Later, investment in ICT supported improvements in financial and performance reporting. Compulsory Competitive Tendering (CCT) in local government, and in the 1990s market testing and contracting out more generally, and the PFI[4], added an edge.

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1 Scotland's public finances: Preparing for the future. Audit Scotland November 2009
2 Efficiency and effectiveness in the Civil Service. October 1982 (Cmnd 8616)
3 Improving Management in Government: the Next Steps. Sir Robin Ibbs, February 1988
4 Private Finance Initiative

The Citizens Charter[5] required public servants to wear name badges, and Chartermark awards were available to bodies whose customer services met national standards. Throughout the public sector, this "New Public Management" (NPM) – as its academic observers dubbed it – was supposed to bring a shift from organising services round the convenience of the "producer" to focusing on the needs of the "customer", and at the same time create more economic, efficient and effective public services.

The New Labour Government of 1997 largely accepted the Conservatives' changes, though CCT was replaced by a requirement on local government to achieve "best value", and the Citizen's Charter was overtaken by Service First. In 1999 New Labour published its own reform proposals with an emphasis on "joined up government", online access to services, and encouraging innovation.[6] Public Service Agreements (PSAs) - or contracts - between the Treasury and Departments covering what would be delivered for the money spent were introduced in England. Targets multiplied, but latterly recognition of their limitations saw Whitehall policy documents place increasing emphasis on empowerment, frontline staff and engagement with service users as the key to innovation and improvement. [7] [8] [9]

Devolved Scotland

In May 1999 public sector reform in Scotland became the responsibility of the devolved Scottish administration. Like the UK Government in 1997, the Labour/Liberal Democrat coalition absorbed the changes of the previous 20 years. As in England, "best value" replaced CCT in local government, and in due course was extended throughout the public sector. The UK Government's attachment to top-down targets was matched in Scotland, and after the 2003 Scottish Parliament Elections scaled new heights in the coalition's Partnership Agreement, which contained over 450 commitments and targets.

There was talk of reform, but little action. A promised "bonfire of the quangos" in 2001 fizzled out and the priority became to ensure that every penny flowing to Scotland from Westminster through the Barnett formula was spent. While the Blair Government kept up pressure for reform in England, Scottish Ministers' main concern was to clamp down on underspending to avoid accusations of incompetence from their political opponents or over-provision from the Treasury. However, in the run-up to the 2004 Spending Review alarm bells began to ring within St Andrews House as to the sustainability of the spending commitments that were being made, and Scottish Ministers set public sector efficiency saving targets equivalent to 1.5% a year. This was a signal to Westminster that the Scottish administration was as committed to efficiency as the UK Government, which received a report by Sir Peter Gershon[10] on how to deliver savings of £20 billion promised in the 2004 Budget.

Unlike the Gershon proposals, which envisaged a net reduction of over 70,000 civil service posts by 2008, Scotland's efficiency plans were accompanied by assurances from Ministers that there would be no impact on public sector jobs.

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[5] *5 The Citizen's Charter: Raising the Standard. July 1991 (Cmnd 1599)*
[6] *Modernising Government. March 1999*
[7] *Excellence and Fairness: Achieving world class public services. Cabinet Office, August 2008*
[8] *Working together: Public Services on Your Side. HM Government March, 2009*
[9] *Engagement and Aspiration: Reconnecting Policy Making with Front Line Professionals. A Sunningdale Institute Report for the Cabinet Office, March 2009*
[10] *Releasing resources to the front line: Independent Review of Public Sector Efficiency. Sir Peter Gershon, CBE, July 2004*

In fact, far from falling, devolved public sector employment in Scotland then grew by some 3% to over half a million by 2008, at which level it has since remained.[11] Despite that, and although the targets were not founded on reliable baseline cost data, the required efficiency savings were by December 2006 reported as on course to being achieved.[12]

In 2006, after much deliberation, Scottish Ministers published their own thoughts on public sector reform.[13] These raised now familiar themes of personalised public services and customer choice, empowerment and innovation, but for discussion, not action, and consideration of what might be done was interrupted by the May 2007 Scottish Parliament Elections.

Following the Elections, the new Scottish Government announced that "high quality, continually improving, and efficient public services responsive to local people's needs" would be one of its 15 National Outcomes. The number of targets was reduced, but the required efficiency savings were increased to 2% a year. Again there were to be no job losses during the Spending Review period (to March 2011) and local authorities were permitted to keep their savings and recycle them to frontline services. Efficiency savings aside, the SNP Government's approach to public service reform has been narrowly focused on reducing the number of public bodies and on procurement. It has also been antipathetic to private sector involvement in service delivery, with open hostility to PFI. One achievement to date is the partial unwinding of the most successful reform of the past 30 years by the absorption of 6 Executive Agencies back into the central bureaucracy.

Has the culture of the public sector changed?

There is no doubt that the way in which many services are now delivered would be unrecognisable to previous generations. ICT has enhanced access to information and services, and Scots have benefited from improvements in national services provided by UK bodies such as the DVLA, the Identity and Passport Service, HMRC and the DWP. In Scotland, Executive Agency status provided a stimulus for culture change programmes in, for example, the Scottish Prison Service, Historic Scotland and, after a sticky start, the Students Awards Agency. Of other public bodies, Scottish Water has led the field, achieving real unit cost reductions and service improvements. A paper for the Scottish Policy Innovation Forum (SPIF) concluded that if Scotland's public service overall were to deliver Scottish Water-equivalent productivity improvements, the savings would be £2.25 billion.[14]

There are national standards for community engagement, and in local government and elsewhere ICT is being used to consult and engage with service users. Freedom of Information (FOI) legislation has increased transparency and has sharpened accountability. In the NHS new research-based treatments have improved the survivability of some serious illnesses, and developments in technology have changed the way in which surgery is carried out.

Though Scotland's life expectancy remains lower than in England, and apparently intractable problems associated with many Scots' lifestyles continue to impact on health, the Scottish Government's website reports progress on hospital waiting times, access to GPs, and a range of other HEAT[15] targets and initiatives.

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[11] *Public Sector Employment in Scotland (Quarterly series). The Scottish Government/National Statistics*
[12] *The Efficient Government Initiative: A progress Report. Audit Scotland, December 2006*
[13] *Transforming Public Services. Scottish Executive, June 2006*
[14] *Improving productivity in Scotland's public services. Jo Armstrong, SPIF February 2008*
[15] *Health Improvement, Efficiency, Access, Treatment*

Although the political drive for reform in Scotland has since Devolution been weaker than in England, the UK-wide reforms of the 1980s and 1990s have had an impact on the Scottish public sector. Performance measures and targets and customer engagement are part of the standard vocabulary of public service managers, though whether the language is symptomatic of culture change as opposed to lip-service is not yet proven. There are enough examples of unreformed opening hours, hospital routines, bureaucratic processes, attitudes and behaviours which suggest that a shift from the producer focused culture to one with the customer at the centre has not been universally achieved. Also, well publicised findings of public sector waste and extravagance bear out auditors' concerns about financial management and the availability of the robust information on the cost, efficiency and productivity of services which is needed to allow the public sector to measure its performance and identify areas for improvement[16].

Though local authorities are busy planning ahead, and some have been leading thinking on new approaches to provision, there has been slow progress on shared services. While shared services are not a panacea, it is encouraging that eight Councils are taking forward workstreams following up Sir John Arbuthnott's report[17] for the Clyde Valley local authorities. Some of the work relates to service delivery. This is good news as his report notes that back offices, the obvious target area for shared services, account for only 15% of local government expenditure, and that the main gains are likely to be in operational areas. However, there are 32 Councils in Scotland and even among eight, it will require very strong leadership to break down the geographical rivalries and silo cultures which impede progress.

In information sharing too, there is room for improvement, as inquiries into child protection failures have repeatedly shown. ICT may be changing the interface between providers and users but it is not universally supporting joint working. Scotland's crowded landscape of public bodies is served by an equally crowded landscape of computer systems which do not interact. This inhibits efficiency, nowhere more than in the NHS, where despite a substantial Government expenditure on an e-health Strategy, progress with electronic patient records and data capture has been woefully slow.

Can further change be achieved?

Much remains to be done to make Scotland's public services fit for the future, and there is little time to do it. Nevertheless, the foundations are there and effective leaders will build on them. The public sector is diverse and complex. If progress has been less than had been hoped for, this may partly be due to lack of appreciation at political level that culture change is less likely to come from dictacts, top-down targets and one-size-fits-all central initiatives, than from trusting leaders and managers to articulate a vision, communicate with staff, and work to win their hearts and minds.

Leaders and managers will do best if empowered to take the difficult decisions, and if they have reliable, up-to-date information that will inform the rigorous prioritisation which will be needed. Such prioritisation means that engagement with the public will be more, not less, important than up to now. Understanding which service users are the most vulnerable and have the greatest needs will be essential, so that scarce resources can be targeted effectively. Good communication will be crucial – hearing what users have to say about priorities and service standards, and, in the other direction, being open and honest with them about what the options are, and what contribution they themselves might make to ensure services are maintained.

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[16] *Improving public sector efficiency: Auditor General for Scotland and the Accounts Commission. February 2010*

[17] *Clyde Valley Review. Sir John Arbuthnott, Nov 2009*

As the Society of Local Authority Chief Executives (SOLACE) has noted, managing public expectations about levels of service will be fundamental to addressing the challenge of reduced funding[18].

Prioritisation will also require better information linking costs to outcomes in a way that enables a robust assessment of value for money to be made. If they have not already done so, senior managers should now be reviewing their requirements: asking, for example, what financial information is needed and how quickly it can be obtained; whether optimal use is being made of ICT. Also, whether HR policies and systems, for example for managing poor performance and sick absence, are fit for purpose; and how reward and remuneration might be used to encourage innovation and new working practices. Corporate systems need to be facilitators of change. Too often they are not.

Involving frontline staff will also be important. Their knowledge and experience need to be harnessed if accepted wisdom is to be effectively challenged. Frontline staff are often better placed than managers to know where the inhibitors to efficiency are to be found, and are capable of generating the innovative ideas which will be required if transformational change is to be achieved. Encouragement and support are, however, essential: a recent survey found that only 39% of UK civil servants thought it was safe to challenge the way things were done in their Departments.[19] In the Scottish Government the figure was 42%.[20]

Partnership working and collaboration also need to work better. The Accounts Commission found that at local level community planning needed to become more effective at incorporating priorities into individual partner organisations' plans and activities.[21] Progressive managers at both local and national level will address this, and also look to exploit the potential contribution the voluntary and private sectors can make to maintaining services; but it implies a greater willingness to take risks than has been the cultural norm. This will require great courage: risk taking and the dilution of autonomy and personal control implied in true partnership working sit uncomfortably with the preferred Scottish approach to accountability, which is to find an individual to blame when things go wrong.

Changing mindsets

But culture change and a step-change in public sector productivity will only soften, not offset, the effects of the expected expenditure reductions. Nor can they be achieved quickly, as three decades of trying have shown.

Though the details remain to be confirmed, the likely scale and duration of the cuts have been laid out by the Scottish Government's Chief Economic Adviser (CEA)[22] and in the report of the Independent Review Panel (IRP)[23] commissioned by Ministers to advise on the options. It is clear that significant pain will be unavoidable, particularly in the short to medium term, with service reductions, public sector job losses and pay freezes in prospect.

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[18] *The Future of Public Services in Scotland. SOLACE, February 2010*
[19] *The Civil Service People Survey. Cabinet Office, 2009*
[20] *Employee Survey 2009. The Scottish Government, 2010*
[21] *Community planning: an initial review. Accounts Commission, June 2006*
[22] *Outlook for Scottish Government Expenditure: Emergency Budget Update. The Scottish Government, July 2010*
[23] *Independent Budget Review. July 2010*

It is also clear that a long-term adjustment will be required. The CEA's conclusion that it could be the mid-2020s before 2009-10 peak-year levels of expenditure are replicated in real terms raises two important questions: first, whether it is desirable that Scotland should return to a position where public spending accounts for half of GDP and a quarter of all jobs; and second, whether Scots will be prepared to consider what their expectations of the State should be, as the Chairman of the IRP has suggested, and in so doing take the opportunity of moving to a world in which people, "do more for themselves and each other, and look less to the State as provider of first resort".[24]

A "redefinition of the relationship with the State" would mean a big culture shift which will not easily be achieved. The expectation that "the Government" or "the Council" should do something about almost everything has become deeply ingrained in the collective Scottish mind. If only we had a Minister – for tourism, for West Lothian, for small businesses – or a "czar" for drugs, for obesity, for alcohol – and a chunk of taxpayers' money to spend, then according to a prevailing mindset every problem would be solved. This mindset goes largely unchallenged by a political class whose livelihoods depend on it and who understand that a Government's standing in Scotland is mainly defined by how much money it is willing to spend.

Yet, questions arise over what good that does. Work by the Centre for Public Policy for Regions (CPPR)[25] at Glasgow University suggests, for example, no causal link between recent higher spending and better outcomes in school education or health. Serious health and social problems remain. Inequality, poverty, drug taking, excessive alcohol consumption, violence, poor skills, high unemployment and lack of ambition remain dominant features of life in many communities, despite substantially higher levels of spending per head on health, education, housing and social services than in England. The needs such problems expose is a justification advanced in Scotland for higher per capita spending than in other parts of the UK, and a caring State obviously has an obligation to alleviate deprivation and help the most vulnerable. But in Scotland the belief - reflected in such policies as free personal care, free prescriptions, free eye tests, free bus travel for the elderly and free university education - that the State will provide irrespective of means has extended to many who can well afford to pay.

A silver lining to the gathering storm clouds is that there is now an opening for debate on the future of universal free provision, what service users should be expected to pay for themselves, and what should be the responsibility of the taxpayer. There is also the possibility of proper debate about the desirable size of the public sector that has for years been closed down by reference to Scandinavian examples of the "success" of high tax/high public spending economies.

Such debate, long overdue, would provide the opportunity for the political class to lead culture change by reminding people that it is their own commitment and hard work that will secure their future, not their political institutions; that creating wealth is a worthwhile and respectable endeavour; that economic growth needs a competitive private sector driven by enterprising individuals unburdened by the apparatus of the State; and that there is no such thing as a free lunch.

If a consensus is emerging on what will be essential in coming months, it is that it will be political leadership. This has been scarce since 1999, but was shown in the repeal of "Section 28" and in the ban on smoking in public places.

[24] *After the downturn – managing a significant and sustained adjustment to public sector funding. CIPFA/SOLACE, December 2009*
[25] *Scottish Government Budget Options, Briefing Series 3: Spending on Health. CPPR, June 2010*

It has been shown in the Scottish Government's proposals for alternatives to short prison sentences and alcohol. Scottish Ministers now have an opportunity to show further leadership, above all by being honest with the public: honest about the choices they face; about the consequences of protecting sacred cows and flagship policies; and about the need for public sector jobs to be lost. The opposition parties can show leadership too: by resisting the temptation to put all the blame on the Scottish Government for the Budget reductions ahead; by not pretending that they could make the pain go away; and by being willing to question long held beliefs in Scottish public life – among them that free university education is a right, that higher spending per head than elsewhere in the UK is simply our due, and that private sector involvement in public services must be a bad thing.

Political leadership will also involve being honest about tax. There may be pressure to use either existing powers to raise £1 billion or so by adding 3p in the pound to basic income tax, or any future tax-raising powers, to mitigate the effects of spending cuts in the longer term. If so, proponents must be up front about the implications. If calculations by the Calman Commission[26] of the yield of its own proposals are a guide, raising £3.7 billion – the projected real terms "loss" of spending by 2014-15 compared with the current year - would require an increase in income tax of over 7p on the basic and higher rates. As regards Council tax, an increase of 50% (or of 25% in both Council tax and business rates) would be needed to compensate for a potential loss to local authorities of around £1 billion in central government grants over the same time period. Should that loss be as high as £2 billion, as some fear, Council tax might have to double. There are of course under Calman other taxes which could be raised, but income tax is the largest yielding tax in Scotland and might be expected to carry the biggest burden - a burden so heavy and potentially damaging to enterprise that even the most committed big spenders in the Parliament and Councils would surely recoil from it.

And so?

And so the hard times are coming. The savings will have to be made, and there is no get-out-of-jail-free card. Unemployment will rise. Services will suffer. There will be fewer teachers, classroom assistants, nurses, home helps, policemen and university students. There will be fewer grants to business, and less frequent refuse collections. There will be more people in prison, more potholes in the roads, more charges for services, and at some stage more tax too. There will be fewer civil servants but the same number of politicians, and among those we may yet find the leadership we need. The "new politics" which Devolution has not delivered may still come. Necessity may drive the culture change we require: in our public bodies as employees realise that their jobs depend on it, and in Scotland at large as the importance of private enterprise is recognised and a smaller public sector frees up the space it needs to flourish.

If, as a consequence, Scotland's rate of early stage entrepreneurial activity were to shift from being among the lowest[27] in 20 developed countries to being among the highest, that would be the most desirable culture change of all - and by far the most important. Let us hope that it happens.

Professor Eddie Frizzell, Queen Margaret University Edinburgh

[26] *Serving Scotland Better: Scotland and the United Kingdom in the 21st Century. Commission on Scottish Devolution, June 2009, page 104, para 3.175*

[27] *Global Enterprise Monitor. University of Strathclyde, June 2010*

Devolution: Tax and Other Revenue Raising

John Aldridge

Under the devolution settlement, the Scottish Parliament has the right to vary the basic rate of income tax by up to 3p in the £, by means of the Scottish Variable Rate, or SVR. This power has never been exercised by administrations of whatever political complexion for several reasons. First, until now, the resources coming to Scotland by means of the block grant adjusted each year by the Barnett formula have been substantial. There has therefore been no real pressure to raise more cash through taxation peculiar to Scotland. Second, the cost to HM Revenue and Customs of calculating and collecting a different variable rate of tax in Scotland would have to be met, at least on introduction, from the Scottish Government's budget. Since those costs would be significant, any prospective benefit from a marginal change to the basic rate in Scotland would be outweighed by the cost. Third, especially in a time of relative financial plenty, it is easier to stick with the status quo.

Nevertheless, the prospect of substantial cuts to the Scottish Government's Budget over the next few years changes the environment. Any new taxation powers will not be granted to Scotland before 2015 at the earliest, so they will not be able to be used to help cope with the financial crisis. But a case could be made for using the SVR, say, to protect a particular service against cuts, with the tax revenue being hypothecated. The practicality of this would depend on the state of readiness of Her Majesty's Revenue and Customs (HMRC) to implement a different rate of tax north of the Border.

But this paper concentrates on the prospects in the rather longer term, although the discussion of user charges in particular could have more immediate impact.

Both the Calman Commission in respect of Scotland and the Holtham Commission in respect of Wales have considered what further tax raising powers might be introduced in the devolved administrations to increase autonomy and accountability. The centrepiece of the Calman Commission's recommendations was the proposal that for Scotland the UK Government would set a rate of income tax substantially lower than that for the rest of the UK, and the Scottish Parliament would decide each year whether to set the income tax rate at the same level as in the rest of the UK, at a higher level or at a lower level. Calman also recommended that responsibility for setting a number of other relatively minor taxes should be devolved to Scotland.

The Holtham Commission went somewhat further. Whereas Calman recommended against devolving the responsibility for setting Corporation Tax (because of the risk of economic distortion within the UK, and because of the limitations imposed by the need to abide by EU rules prohibiting state aids), Holtham considered a mechanism which would allow devolution of some control over corporation tax levels by ensuring that the consequences of any decision were borne exclusively by the devolved administration concerned.

So this paper discusses:

- what would be the likely effect in revenue terms if the Scottish Parliament were to vote in favour of using any of the proposed tax raising powers, assuming they are granted
- how using different tax varying powers might interrelate with each other and with existing revenue raising
- what alternative sources of revenue raising there might be for the devolved administration in Scotland.

In discussing the second of these issues, it will pose some questions around the constraints on any administration making use of taxation powers in such a way as to diverge from the UK, and on the consequences of any change to the Barnett formula. Finally it will speculate on what the position might be in 15 years time.

Effect of using tax raising powers

On the basis of Treasury estimates, the Calman Commission reported that making use of the SVR the Scottish Parliament would raise (or lose) about £380million for each 1p by which it varied the standard rate of income tax up or down. The Commission's recommendation that the Scottish Parliament's income tax varying powers should extend to the higher rate as well would increase that to about £500million. The reports by Dr Andrew Goudie, Chief Economist to the Scottish Government, on the Outlook for Public Expenditure in Scotland in the light of the March and June 2010 UK Budgets ("the Goudie Reports") show that, given certain assumptions, public expenditure by the Scottish Government is likely to decline in real terms until about 2015, before starting to increase again, not returning to 2010-11 levels until the mid 2020s. But the wider economy is expected to start growing again well before then. Nevertheless, given the likely performance of the economy, and in particular the prospect of a fairly lengthy period of recovery before previous levels of activity are regained, the Commission's estimate of the amount that would be generated by a change to Scottish tax rates is likely to remain broadly relevant for 2015, the date that the current UK Government has set for the implementation of the tax powers.

The other taxes proposed by Calman for devolution to Scotland would raise relatively small amounts, perhaps around £600million all told in 2008-09; and therefore clearly, unless very large changes were made to the rates at which they are levied, any adjustment would have a very small impact on the resources available to the Scottish Parliament (although they could have a significant impact on behaviour in the areas of public life to which they relate).

In practice, given that the existing SVR powers have not been used, is there any reason to suppose that the Scottish Parliament would actually choose to set tax rates for Scotland diverging from those in the rest of the UK? And if so, how much of a divergence might be expected? The requirement for the Scottish Parliament to set a Scottish tax rate each year makes it easier to contemplate divergence, and in particular, the fact that HMRC will therefore have to have the mechanisms in place to calculate and implement a divergent rate removes one of the obstacles currently militating against using the SVR. On the other hand, it would be very difficult to diverge too far from the UK rate without requiring substantial changes in policy which would need to be defended against a probably sceptical public; and diverging only marginally would have limited effect in resource terms. Even a small change in the income tax rate could, however, have an effect on the attractiveness or otherwise of Scotland as a place to live and work.

So adjusting the rate of any of the taxes devolved to Scotland would be unlikely to affect very greatly the resources available to the Scottish Parliament. But there is a more radical option which it is worth considering. The Scottish Parliament is expected to be given the power to create new taxes with the agreement of the UK Parliament. Perhaps the most obvious possibility would be the introduction of some kind of tourist, or tourist bed tax. Such taxes are quite common elsewhere, and there would be less risk of adverse consequences from a divergence in taxation practice between Scotland and the rest of the UK in this area (although the tourist industry would no doubt object to the concept).

That, or other new taxes could therefore provide the Scottish Parliament with scope to raise significant amounts of extra resources (a £1 a night tourist bed tax might raise some £70million a year).

Interrelationships

The Calman Commission's remit in relation to taxation was primarily to increase the financial accountability of the Scottish Parliament. In balancing that aim with others – such as maintaining the economic and social union of the UK – the Commission concluded that only a limited range of taxation powers should be devolved. As a result there is little scope within the proposed taxation powers for the Scottish Parliament to offset a tax increase in one area with a tax decrease elsewhere. As indicated earlier, wholly to offset a 1 penny decrease in income tax in Scotland would require roughly a doubling of all the smaller taxes recommended by Calman for devolution – aggregates levy, stamp duty land tax, landfill tax, and air passenger duty.

However, it is possible to consider further possible interrelationships. Apart from income tax a very visible tax to Scottish citizens is the council tax. The proposed new taxation powers would enable the Scottish Parliament to adjust the balance between income tax and the council tax and the non domestic rates (or conceivably a new property tax or taxes introduced using the Parliament's proposed power to create new taxes). That could, for example, enable the Parliament to stipulate that an element of the Scottish Income Tax was earmarked for local government spending, thus achieving some of the aim of a local income tax.

Speculating further in the light of the Holtham Commission's recommendations, if some control over corporation tax rates were to be devolved (as long as EU state aid rules were complied with), it might be possible for the Scottish Parliament to complement a change in the rate of corporation tax with a new tax levied on business or a consequent change in non-domestic rates.

In all of this the greatest "known unknown" is what effect on behaviour any change in Scottish taxes might have. Would an increase in income tax above the UK level lead to a flight from Scotland even if there were a clear benefit in better quality services? Conversely, would a decrease in Scottish income tax lead to an influx of people from elsewhere in the UK, and if so what kind of people (for example, entrepreneurs or retired people)? Similarly, if business taxes are changed, will that lead to additional economic activity, or will traditional Scottish caution (as shown by the smaller number of business start ups in Scotland, and the correspondingly lower level of company bankruptcies) work against such a change?

Theory would suggest that there would be an effect, but its scale must be questionable. It is worth considering the introduction of free personal care in Scotland. Although not exactly equivalent to a tax change, when the policy was introduced in Scotland there was much speculation that many older people would migrate from elsewhere in the UK to take advantage of the more favourable personal care regime. In practice there was little such movement. That may be a matter of geography as much as anything, since the border country between Scotland and England is not heavily populated.

There appears to have been more of an effect, for example, on the Wales/England border (which is more densely populated) when the Welsh Assembly Government abolished prescription charges.

Taxation changes and the Barnett formula

As is widely known, the Barnett formula determines changes to the Scottish Block Grant at each UK spending review by applying to the Scottish baseline a population based share of changes to comparable English (or English and Welsh) spending programmes. If the formula were to be left unchanged, the introduction of the proposed tax raising powers in Scotland would cause few difficulties. The formula and block arrangements would continue to be applied to the part of the Scottish Parliament's resources which was not funded by its own taxation.

However, a consensus appears to have developed that this simple formula should be replaced by a more complex needs based formula. This view was reflected in the Calman and Holtham Commissions' reports and in the report of the House of Lords Select Committee on the Barnett Formula. Depending on how that formula is defined, there could be serious implications for the use by the Scottish Parliament of the proposed powers.

If needs are defined in terms of the underlying need for spending on public services (for example, morbidity rates determine the element relating to health spending needs), and if the Scottish Parliament were to direct resources successfully to reducing those rates in Scotland faster than elsewhere in the UK, the Scottish Block would suffer. This suggests that there would be a perverse incentive not to improve the health of the Scottish people in order to protect the budget. Similarly, if needs are determined in a more broad brush way (as the Holtham Commission proposes for example) or by reference to a general indicator of economic health such as relative GDP, similar perverse incentives could arise.

Other revenue raising options

An element of the Scottish Parliament's powers in relation to revenue that is often ignored is their ability to introduce, increase or decrease user charges. Since devolution, the tendency of the Parliament and the various administrations has been to reduce or abolish charges for services provided for the people of Scotland. Free personal care has already been mentioned. But other developments have included the progressive reduction of prescription charges with a view to their abolition; the introduction of free eye and dental checks; the abolition of tolls on estuarial road crossings; free bus travel for over 60s.

User charges are never popular, and in considering them – especially if means testing is part of the package – it is important to avoid bringing about a situation where better off members of society have no, or only a very limited, interest in supporting public services since they do not benefit from their previously free provision. But with that proviso, there is substantial scope for reintroducing, or introducing new charges. Indeed in some cases user charges may well serve to restrain demand for services, which could help to control costs further during periods when public resources are constrained.

Although there would be understandable reluctance on the part of the Parliament to reverse the trend since devolution, it would be relatively easy to slow down or reverse the move towards free prescriptions. Such a move would be virtually cost free as well, since at present a charge is still being made. It would also be fairly straightforward to reintroduce charges for eye tests and dental check-ups, although there would be some changes required to the underlying bureaucracy. More controversially within the NHS, charges could be considered for "hotel services" during hospital stays or for visits to the GP, but such developments could be seen as fundamentally changing the nature of the NHS as it has come to be understood.

In transport, road use charges could be introduced. There would be set up costs, and they would almost certainly face substantial opposition by car owners and road transport operators. But the potential for raising revenue from this source is great. In Scotland, the only experience of tolling in recent times has been on estuarial crossings (and one or two privately owned thoroughfares).But in continental Europe it is common for drivers to be charged for using motorways; and despite the failed attempt to introduce a town centre congestion charge in Edinburgh, that approach is also becoming more widely used elsewhere.

Scotland (with the rest of the UK) is unusual in European terms in providing universal free access to national galleries and museums. Again there would be costs associated with introducing a charge, but receipts could be significant, although probably at the cost of lower usage of the facilities. In Higher Education the question of tuition fees could be reopened.

Listing these options (and the list is not comprehensive) does not imply that any of them could be implemented without facing some – and in some cases very vociferous – opposition. Neither does it imply that charges could be introduced without changing, possibly in a damaging way, the nature of the public services concerned. But it is designed to show the substantial scope that exists for the Scottish Parliament to raise revenue even without making use of specific tax raising powers.

Scotland and revenue raising 2025

On the assumption that the current plans are implemented and the Scottish Parliament can start using new taxation powers from 2015, what might the position be ten years later?

The granting of the new taxation powers will have caused a major debate in Scotland. On the one hand, many will argue that there is no point in having the powers and, in particular, being required to set a level of income tax for Scotland each year, unless those powers are used to benefit Scotland's people and/or economy. Furthermore, the Goudie Reports indicate that 2015 should see the re-emergence of real terms growth in the Scottish Budget after 4 years of substantial real terms cuts. It might well be argued that the new taxation powers should be used to accelerate the growth of the economy, or to move more quickly to restore Scottish public spending levels to their previous highs. On the other hand, business will point to the additional costs to both Government and the private sector of administering a varied rate of tax or taxes north and south of the Border.

Therefore, it seems likely that for the first few years, despite much debate, the income tax rates will remain the same in Scotland as in the rest of the UK. But by 2025 there will have been some change, perhaps an increase to protect spending on a service such as personal care of older people, or perhaps a decrease implementing a manifesto pledge in the 2019 Scottish election. In any case it seems likely that the level of tax will be a central feature of the 2019 and later elections.

But inevitably there will be frustration that the Scottish Parliament has such limited taxation powers. Having shown that it makes use of its new powers responsibly there will be strong pressure to devolve further taxation powers, not simply to allow for variation in taxation levels across the UK (and there will remain fears about a "race to the bottom" with corporation tax), but to allow the Scottish Parliament to offset changes in different taxes more effectively.

The Scottish Parliament will have become more comfortable with its new powers, and the Treasury and HM Revenue and Customs will have had their fears about the extra cost and the potential damage to the UK economy of allowing variable tax rates in different parts of the UK largely put to rest. As a result, consideration will be being given seriously to the introduction of new taxes in Scotland, the revenue from which might be hypothecated for specific projects or policies.

Scotland in 2025 will probably continue to favour policies which support rather more public spending per head than in England, and the divergence in policies will have been facilitated by the Scottish Parliament's freedom to raise more of its own revenue.

But perhaps the biggest change resulting from the new powers has been the opening up of Treasury decision making. The requirement to share thinking with the Scottish administration in advance of decisions on new taxes (because of the need to take into account the impact on the Scottish tax rates) has led to wider debate across the UK about taxes and their implications.

Conclusion

The prospect of new taxation powers for the Scottish Parliament undoubtedly offers opportunities for policy variation as well as increasing its accountability. But while the Parliament will be responsible for raising substantial sums through its taxation powers, in practice the scope for increasing or decreasing the total resources available for public spending in Scotland will be smaller, since, at least in the first years following the granting of the powers, any adjustments are likely to be marginal.

Perhaps the most interesting prospect is for new taxes to be developed in Scotland, resulting in imaginative thinking about options, and potentially new sources of revenue which do not impact adversely on existing revenue streams.

But one thing is certain. Granting new substantial tax powers to the Scottish Parliament, and requiring a decision to be taken on tax levels in Scotland each year will change – for the better - permanently the relationship between the Whitehall Treasury and the nations and regions of the UK.

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