Inverclyde council

AGENDA ITEM NO. 17

Report To:	**Policy & Resources Committee**	**Date:**	**15th November 2011**
Report By:	**Chief Financial Officer**	**Report No:**	**FIN/92/11/AP/CM**
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Subject:	**Scotland's Public Finances – Addressing the Challenges**		

1.0 PURPOSE

1.1 The purpose of this report is to highlight the key issues and risks identified in the Audit Scotland Report, Scotland's Public Finances – Addressing the Challenges. In addition an assessment of how the Council is placed in respect of the main matters raised is provided for Committee consideration.

2.0 SUMMARY

2.1 In August 2011 Audit Scotland produced a report Scotland's Public Finances – Addressing the Challenges. This report gave an overview of the financial environment in the public sector in Scotland and outlined what public bodies should be doing to address the challenges.

2.2 It is Council practice to present such reports to the Parent Committee for consideration and this report intends to fulfil that remit.

2.3 The report highlights three keys messages as follows:

- All parts of the Public Sector have less to spend in 2011/12 than in 2010/11. There is a risk that whilst most public bodies have been able to agree a balanced budget for 2011/12 that the savings needed may not be realised during the year.

- Pay restraint and reducing workforce levels are the most common approaches being taken by Public Bodies to reduce costs. As most bodies have already reduced staffing levels through recruitment freezes and voluntary early release schemes, good workforce planning is necessary to ensure that the right people with the right skills are available to delivery effective services in the future.

- The need to reduce costs provides Public Bodies with an opportunity to reform and streamline Public Service delivery and in doing so focus on long term financial sustainability. This requires a clear understanding of the organisations costs allied to a process which aligns budgets to priorities and the outcomes to be achieved.

2.4 Section 6 & 7 of the report provides the Corporate Management Team's assessment of how the Council is placed in respect of each of these messages and identifies future work required.

2.5 Based on the Corporate Management Team's assessment the Council is in a relatively strong position in respect of the financial challenges which lie ahead. However in common with the vast majority of the Public Sector more work is required on understanding the relationship between activity levels and costs plus clearly demonstrating that Council budgets are allocated against it's strategic outcomes.

3.0 RECOMMENDATIONS

3.1 It is recommended that the Committee note the Audit Scotland Report, Scotland's Public Finances – Addressing the Challenges.

3.2 That the Committee endorse the Corporate Management Team's assessment of those areas which require further work and agree that Officers should continue to progress the development of these via the Organisational Improvement Plan Groups.

Alan Puckrin
Chief Financial Officer

4.0 BACKGROUND

4.1 It is recommended practice that all Audit Scotland Reports are presented to the Parent Service Committee for consideration.

4.2 Appendix 1 is a full copy of the Audit Scotland Report, Scotland's Public Finances – Addressing the Challenges which was issued in mid August 2011.

4.3 This report highlights the main issues and risks highlighted within the report and thereafter gives the Corporate Management Team's assessment of where the Council currently stands in respect of the main issues and risks.

5.0 MAIN MATTERS HIGHLIGHTED IN THE AUDIT SCOTLAND REPORT

5.1 The key messages within the report are as follows:

- That all parts of the Public Sector have less money to spend in 2011/12 than they had in 2010/11 and whilst the vast majority of organisations have been able to agree a balance budget for 2011/12 there is a risk that the savings needed will not be achieved during the year.

- Pay restraint and reducing workforce levels have been the most common approaches that have been taken to reduce costs in the short term. This has been achieved via recruitment freezes and voluntary early release schemes. Good workforce planning is therefore necessary to ensure that the right people with the right skills are available to deliver effective services in the future.

- The need to reduce the costs provides an opportunity to reform and streamline public services and at the same time focus on long term financial sustainability. This requires a clear understanding of the organisations costs including the relationship between different activity levels and costs and a clear budget process for allocating resources to strategic priorities and outcomes.

5.2 Page 7 of the report highlights the key risks and issues and refers thereafter to 26 specific questions which appeared at the back of the report.

5.3 The Corporate Management Team has considered the key risks and issues on page 7 and its assessment of the Council's current position is in the following section.

6.0 CORPORATE MANAGEMENT TEAM ASSESSMENT OF THE COUNCIL'S CURRENT POSITION

6.1 The Council has an embedded medium term Financial Strategy covering an eight year period. This Strategy is reviewed on a six monthly basis and reported to the Full Council for approval and takes into account latest developments at a UK, Scottish and Local level and has proven an effective financial planning tool.

6.2 In identifying the future challenges and building in the Council's key strategic financial commitments such as the School Estate, Asset Management Plan and Riverside Inverclyde then this allows the Council to plan in advance and take longer term decisions both in terms of investment and savings delivery.

6.3 The Financial Strategy is treated as a "live document" and not simply a document which is produced to tick a box. The format and use which is made of the Financial Strategy by the Council has been recognised by the Council's External Auditors.

6.4 The Financial Strategy has therefore greatly contributed to the delivery of the Council's two year revenue budget cycle and four year capital programme. Setting a firm two year budget allows the Council time to manage both workforce and service delivery matters in a better way than the more traditional annual budget process. It must be stressed however that in order for all the above to be truly effective then medium term certainty of funding from the Scottish Government is required which in turn requires medium term certainty funding from the UK Government.

6.5 In setting the Council's two year budget Members receive detailed proposals in respect of both investment/budget pressures and also savings. Within these proposals Officers highlight both the policy and service implications of the proposals plus the workforce issues and as such the Corporate Management Team believes the Council is able to demonstrate budget decisions match Council policy priorities.

6.6 In the Audit Scotland report a concern is raised that organisations whilst agreeing a balanced budget for 2011/12 may not be able to deliver the savings needed within year. The latest round of budget monitoring reports shows that almost 100% of the agreed workstream savings for 2011/12 have already been delivered whilst overall the General Fund is projecting a surplus of £850,000. This clearly demonstrates that within Inverclyde Council the savings agreed as part of 2011/12 budget were realistic and deliverable. The Corporate Management Team however do recognise that it is important that savings are kept under regular review and as such will be reviewing the deliverability of all the 2012/13 workstream savings as part of the updating of the 2012/13 Revenue Budget.

6.7 In terms of reforming public services the Committee will be aware that there are a number of exercises ongoing in respect of potential shared services. The Council recognises that given its relative scale and the future public sector financial climate then it would be appropriate for the Council to at least consider the possibility of sharing certain services where there is a financial case and/or improved resilience. In addition to this Council services are looking at possible arrangements with other public sector providers whereby the Council can provide services and generate extra income.

7.0 AREAS IDENTIFIED BY THE CORPORATE MANAGEMENT TEAM FOR FUTURE DEVELOPMENTS

7.1 Workforce Development has been an area which has been highlighted by the Council's External Auditors on a number of occasions. It is recognised by the Corporate Management Team that this becomes even more important at a time of reducing financial resources and hence the need to manage with fewer employees. Progress in this area is monitored via the Organisational Improvement Plan Workforce Planning Group which will review the reports recommendations and take appropriate action.

7.2 Understanding the relationship between activity levels and costs and demonstrating whether the Council is achieving value for money in the delivery of its services is another area where the Corporate Management Team recognises that more work is required. Corporate Planning Guidance requires the demonstration of competitiveness to be included in each Directorate Plan however this can only really be achieved through the generation of robust information which can then be benchmarked with peers. There is an outstanding action in the Finance Capacity Development Plan relating to providing improved cost information and the Corporate Management Team recommends that this matter be remitted to the Resources Group within the Organisational Improvement Plan for further progress.

7.3 Across the Public Sector there is a drive to develop the “golden thread” linking strategic outcomes amongst Community Planning Partners to individual organisations resource allocation. A significant amount of time and resource is being spent at a national level in developing this and latest indications are that there is still a way to go in this regard. However the Corporate Management Team do believe that the Council should engage in this work and as such relevant Officers will continue to monitor developments whilst at a local level work can commence with Community Planning Partners.

7.4 The Corporate Management Team would however highlight that developing some of these proposals to the optimum level would require extra resources at a managerial and professional level at a time of significant financial challenges. Therefore care needs to be taken to ensure that delivering against the developments highlighted in section 7 is affordable and will deliver real tangible benefits for the Council.

8.0 CONCLUSIONS

8.1 The Audit Scotland Report, Scotland’s Public Finances – Addressing the Challenges is a useful overview of the issues and risks which face the public sector in Scotland in the medium term.

8.2 The main issues and resultant issues and risks highlighted in page 7 have been reviewed by the Corporate Management Team who provided an overview of where the Council currently sits in respect of the matters raised.

8.3 Overall the Corporate Management Team assessment is that with the Council’s two year budget process, eight year Financial Strategy and Corporate/Directorate planning process the Council is in a relatively strong position to face the challenges. The CMT does recognise that more work is required in being able to demonstrate the Council’s approach to Workforce Planning, delivery of value for money and allocating resources to strategic outcomes.

Appendix 1

Scotland's public finances

Addressing the challenges

AUDIT SCOTLAND

Prepared for the Auditor General for Scotland and the Accounts Commission
August 2011

Auditor General for Scotland

The Auditor General for Scotland is the Parliament's watchdog for helping to ensure propriety and value for money in the spending of public funds.

He is responsible for investigating whether public spending bodies achieve the best possible value for money and adhere to the highest standards of financial management.

He is independent and not subject to the control of any member of the Scottish Government or the Parliament.

The Auditor General is responsible for securing the audit of the Scottish Government and most other public sector bodies except local authorities and fire and police boards.

The following bodies fall within the remit of the Auditor General:

- directorates of the Scottish Government
- government agencies, eg the Scottish Prison Service, Historic Scotland
- NHS bodies
- further education colleges
- Scottish Water
- NDPBs and others, eg Scottish Enterprise.

The Accounts Commission

The Accounts Commission is a statutory, independent body which, through the audit process, requests local authorities in Scotland to achieve the highest standards of financial stewardship and the economic, efficient and effective use of their resources. The Commission has four main responsibilities:

- securing the external audit, including the audit of Best Value and Community Planning
- following up issues of concern identified through the audit, to ensure satisfactory resolutions
- carrying out national performance studies to improve economy, efficiency and effectiveness in local government
- issuing an annual direction to local authorities which sets out the range of performance information they are required to publish.

The Commission secures the audit of 32 councils and 45 joint boards and committees (including police and fire and rescue services).

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

Contents

Summary

The scale of budget cuts brings immediate challenges for the Scottish public sector to reduce expenditure but also to ensure long-term sustainable public services.

Introduction

1. The financial challenges facing the Scottish public sector are well documented. In October 2010, the UK government outlined spending reductions in almost every area of the public sector over the next four years. As Scotland receives most of its funding from the UK government, the reductions will have a significant impact on the amount of money available to the public sector in Scotland. The Scottish Government estimated in October 2010 that its budget for day-to-day spending and running costs will fall by £3.3 billion in real terms (11 per cent) from £29.2 billion in 2010/11 to £25.9 billion in 2014/15. The overall decrease is most pronounced in 2011/12 as the budget falls by £1.7 billion in real terms (six per cent) to £27.5 billion.

2. The scale of budget cuts brings immediate challenges for the Scottish public sector to reduce expenditure but also to ensure long-term sustainable public services. The purpose of this report is to provide an overview of how public bodies are beginning to respond to the challenge. However, it is clear that public bodies will not be able to deliver the savings and reforms needed overnight. This report provides a snapshot of progress as at January–April 2011 and we plan to publish further reports over the next few years looking in more detail at how public bodies are managing with reduced budgets.

3. This is not the first time we have reported on such issues. In November 2009, we published *Scotland's public finances: preparing for the future* which provided an overview of the financial environment in Scotland at that time and looked at the challenges facing the public sector.[1] At the time of our last report, the scale of budget reductions was not yet clear. However, we underlined how vital it was for the Scottish Government and other public bodies to manage the risks effectively to ensure the delivery of high-quality, sustainable public services, now and in the future. We also posed some key questions for the Scottish Government, the Scottish Parliament and the wider public sector to consider when planning the delivery of public services in a time of severe budget constraints.

4. Similarly, the challenges facing the public sector have been outlined in a number of our reports. For example, *Financial overview of the NHS in Scotland 2009/10* and *An overview of local government in Scotland 2010*, published in December 2010 and January 2011 respectively, commented on the financial challenges facing the NHS and local government and highlighted some of the key issues which need to be addressed, including:

- Strong leadership to drive the necessary changes forward and good governance arrangements.
- Better information on cost, activity, quality and productivity of services delivered.
- Good information about service users' current and future needs to enable decision-makers to make informed decisions about priorities.
- Consideration of alternative ways of providing services including working with other parts of the public sector, the private sector and the third sector, and consideration of how service changes may impact on different groups.
- Effective engagement with local communities to obtain views and support for proposed changes to service delivery.
- Accurate workforce planning to ensure staff resources are in the right place to deliver priority services.

Responding to reduced budgets

5. In February 2010, the Scottish Government commissioned an independent review of public expenditure in Scotland to inform the 2011/12 budget process. The Independent Budget Review Panel (the panel), published its report in July 2010 making a number of observations about the options for delivering public services within a constrained public spending environment:

- All possible avenues should be pursued to sustain borrowing and capital investment as this can create jobs and drive economic growth.
- The rationale for protecting major blocks of expenditure, particularly in the context of integrated services and early intervention programmes, is unclear and could place an additional burden on non-protected areas to make savings.
- A reduction in public sector employment appears inevitable although this could be mitigated against by measures including pay restraint, recruitment controls and revised working arrangements.
- The McClelland Review of purchasing, the Crerar Review of scrutiny and regulation and the Arbuthnott Review of shared services in the Clyde Valley area suggest there is scope to make further public sector efficiency savings but the funding gap currently faced is unlikely to be bridged by efficiency savings alone.
- A debate is required about whether those who can afford to pay for universal services such as concessionary travel, prescription charges, free personal and nursing care and tuition fees might be invited to do so.

1 *Scotland's public finances: preparing for the future*, Audit Scotland, November 2009.

- For a small country, Scotland has many public bodies including 32 local authorities, 23 NHS bodies, eight police forces, 20 universities and over 100 other public bodies. The number of public bodies needs to be considered as an integral part of a strategic review of the future delivery of public services.
- The financial challenges are likely to persist beyond the UK government's current Spending Review period 2011/12 to 2014/15. This makes it imperative to establish a more strategic longer-term perspective based on the transformation of the organisation and delivery of public services in Scotland to meet future needs.
- Taking immediate action is important. Public sector managers expect strong leadership from the Scottish Government and the Scottish Parliament in terms of early identification of key priorities. They are also looking for an outcomes-based, rather than an input-based, approach to tackling the challenges ahead.[2]

6. In addition to these observations, the panel made a number of recommendations. The Scottish Government has responded to some of the panel's recommendations in the 2011/12 budget and in wider government initiatives (Exhibit 1). In particular, in June 2011, the Commission on the Future Delivery of Public Services, established by the

Exhibit 1
The Scottish Government's response to the Independent Budget Review Panel's key recommendations
Some of the panel's recommendations were taken into account in the Scottish Government's 2011/12 budget.

Key panel recommendations	Scottish Government response
Undertake comparative prioritisation in the allocation of resources rather than ring-fencing certain areas of the public sector so that they were protected from budget cuts.	The Scottish Government outlined a cash terms increase to the NHS budget for 2011/12 following a similar decision by the UK government. This was the only area of the public sector to receive a cash terms increase.
The current council tax freeze should be removed.	The Scottish Government has kept the council tax freeze in place for 2011/12 and has plans to extend this over the next spending review period.
Build assumed efficiency savings into budgets as a means of reducing future budget allocations and ensure that future targets are not less than two per cent.	Efficiency savings are treated as a contribution to the overall budget reduction in 2011/12 where an average target of three per cent efficiency savings was set. The Scottish Government stated the efficiency target for 2012/13 to 2014/15 would be two per cent each year.
Reduce further the number of public bodies and consider the remaining scope for merging different scrutiny bodies as part of the Simplification Programme.	The Scottish Government already has plans to reduce the number of public bodies in Scotland by 25 per cent in 2011 against a baseline of 199. As at April 2011, there were 147 public bodies in Scotland.
Mainstreaming the role of the private and voluntary sectors as collaborative partners in the delivery of public services.	No central policy on this. Each individual public body is responsible for the level of engagement with other sectors in the delivery of services.
Reduce the public sector pay bill through pay freezes and reductions in public sector employment.	The Scottish Government and the NHS have implemented a pay freeze for most staff in 2011/12. Local government has implemented a two-year pay freeze for staff to 2012/13. Many public bodies are reducing the workforce by implementing recruitment freezes and voluntary early severance or retirement schemes.
Review the case for free or subsidised universal services such as national concessionary travel, free personal and nursing care and free prescription charges.	The Scottish Government has reaffirmed its commitment to free universal services and provided for these in the 2011/12 budget.
Change the status of Scottish Water to allow the release of capital funds for other projects, while enabling the attraction of private investment.	The Scottish Government plans to retain Scottish Water's public status.

Source: Audit Scotland from Independent Budget Review Panel

2 *Independent Budget Review: The Report of Scotland's Independent Budget Review Panel*, July 2010.

Scottish Government in November 2010, found that a number of broad priorities are required for long-term public service reform.[3] Priorities include building public services around people and communities; prioritising preventative spending measures; maximising all available resources including those from the public, private and third sectors; and reforming public services based on outcomes, improved performance and cost reduction. The Scottish Government has welcomed the findings of the report and has established a Cabinet subcommittee to take forward plans for public service reform.

7. At the same time, a number of other initiatives are being taken forward, which are intended to change the shape of the public sector landscape leading to reduced expenditure or providing the potential to increase government revenue. For example, the Scotland Bill, currently going through the legislative process in the UK Parliament, proposes providing greater powers to the Scottish Parliament to set an income tax for Scottish taxpayers. If enacted, this will abolish the terms of the Scotland Act 1998 where the power to vary income tax is confined to a maximum of three per cent more or less than the UK basic rate of income tax. The Bill also proposes providing the Scottish Parliament with powers to set taxes on transactions involving interests in land and disposals to landfill, and giving Scottish ministers new borrowing powers to fund capital projects.

8. This is a time of great uncertainty. Public bodies currently face a range of cost pressures which are likely to continue for a number of years (Exhibit 2). But their ability to address these pressures may be hindered because, apart from only indicative figures published by the Scottish Government, public bodies lack a clear view of their budgets beyond 2011/12. The Scottish Spending Review, to be conducted by the new Scottish Government and to report in September 2011, provides an opportunity to provide public bodies with greater certainty about future years' budgets which will assist in longer-term planning.

Exhibit 2

Cost pressures currently facing the public sector

The public sector currently faces a range of cost pressures which are likely to continue into the future.

Category of cost pressure	Examples of cost pressures
Demand	The consequences of an ageing population which is likely to increase demand for health and social care services.
Financial	The continuing need to deliver efficiency savings, higher than expected inflation rates and reduced income from asset sales.
Workforce	Rising staff and pension costs. Reduced workforce to meet increased demand.
Investment	The need to invest in new roads, railways, schools and hospitals to support existing services and economic growth. Also, the long-term revenue commitments arising from using private finance to fund investment.
Maintaining assets	Significant costs for backlog maintenance and repair to the public sector estate.
Environmental	Rising energy and fuel costs, emission reduction targets.

Source: Audit Scotland

About this report

9. The report provides an overview of the financial environment facing the public sector in Scotland and the cost pressures currently faced. It outlines what the public sector is doing to respond to current and future budget reductions, and highlights a number of key risks and issues that the public sector needs to manage in responding to the challenges. Most of the fieldwork for the audit was carried out between January and April 2011, at a time when public bodies were still finalising their 2011/12 budgets. The report is organised into three parts:

- In Part 1 we consider the current financial environment and review the main changes to the Scottish Government's 2011/12 budget compared to 2010/11.
- In Part 2 we review the main cost pressures facing the public sector.
- In Part 3 we focus on how the public sector is planning to reduce their costs and make savings and is based on information obtained from a sample of 47 public sector bodies covering local authorities, health and central government.

All budget figures in the report, unless stated, are quoted in real terms (at 2010/11 prices) using the GDP deflator applied at the time of the UK Spending Review (October 2010) and draft Scottish budget (November 2010). HM Treasury has since published revised figures for the GDP deflator, which show an increase in the inflation rate for 2011/12. We comment on the effect of this in paragraph 40. Appendix 1 provides further information on our

3 *Commission on the future delivery of public services*, Christie Commission, June 2011.

methodology. Appendix 2 provides a list of bodies included in our sample. Appendix 3 provides details of our project advisory group.

Key messages

- The budget reductions affect revenue and capital expenditure differently with the capital budget taking the largest cut in percentage terms. Traditional public spending on capital projects such as new hospitals, roads and prisons will reduce by £1.2 billion (36 per cent) to £2.1 billion in 2014/15. This compares to an eight per cent reduction in revenue spending which will fall by £2.1 billion to £23.8 billion over the same period.

- All parts of the public sector have less to spend in 2011/12 than in 2010/11, although the level of budget reduction varies significantly among spending areas. Scottish Government funding to the health and local government sectors has reduced by 0.3 per cent and five per cent respectively, while central government funding has reduced by 12 per cent. Most bodies surveyed have been able to agree a balanced budget for 2011/12. However, there is a risk that savings needed may not be realised during the year. There is also a risk that unforeseen pressures will emerge during the year, which may reduce further the ability to generate savings.

- Public bodies are finding it difficult to plan beyond 2011/12, as they do not have a clear view of their budgets beyond 2011/12. The Scottish Government plans to publish detailed spending plans for years 2012/13 to 2014/15 in September 2011, which should establish a framework that bodies can use to make decisions about future spending plans.

- Public bodies currently face increasing demand and cost pressures for their services and this is likely to continue in the future. An ageing population, the effects of the recent recession and the heightened expectations of the public, all increase the demand for public services. These, together with cost pressures such as maintenance backlogs and existing financial commitments such as annual payments for revenue-financed capital projects, place an additional burden on the capacity of public bodies to provide efficient and quality services at a time when budgets are reducing.

- The need to reduce costs provides public bodies with an opportunity to reform and streamline public service delivery. However, in doing so, bodies must focus on long-term financial sustainability. This requires a clear understanding of the organisation's costs, including how different activity levels affect costs, and a clear methodology for setting budgets based on priorities and the outcomes to be achieved. Strong leadership and governance are vital if actions are to be successful.

- Pay restraint and reducing workforce levels are the most common approaches being taken by public bodies to reduce costs over the next few years. Many bodies have already reduced staff levels through recruitment freezes or voluntary early release schemes and further reductions are planned. Good workforce planning is necessary to ensure that the right people and skills are available to deliver effective public services in the future.

- Public bodies are considering how they can work better together as a way to reduce costs. While a number of initiatives are being planned to increase working together, sharing resources and involving voluntary and private organisations, progress to date has been limited. It is likely to be a number of years before cost savings are realised.

Key issues and risks

10. There are few people working in the Scottish public sector today who have previously experienced similar levels of budget reductions as those currently faced. The need to reduce expenditure while maintaining service standards as far as possible is a major test for managers, non-executive directors and elected members, that requires strong and effective leadership and management. There are a number of associated risks and public sector managers are responsible for identifying, monitoring and managing these.

11. The table opposite outlines some of the key risks and issues that public bodies need to consider and manage. Many of these risks are not new to the public sector but the likelihood of their occurrence has increased as public bodies seek to implement changes. Appendix 4 provides a more detailed list of key questions for public sector managers, non-executives and elected members to consider. External audit also has a role to play in monitoring and reporting on how public bodies are responding to the risks and issues faced and in supporting continuous improvement by helping to disseminate examples of good and innovative practice.

Key risks

Potential issues and risks for public sector leaders and elected members

Potential issues and risks		Report reference	Checklist reference
Reforming public services	**Difficulties in measuring and assessing performance** created by unclear aims and objectives. **Focusing on dealing with current problems rather than longer-term issues** as a result of short-termism in decision-making. **Lack of commitment or constructive challenge to reform measures** caused by weak leadership or poor coordination between staff and other stakeholders. This can also result in **poor communication** between different parties. **Benefits of action may not be received for a considerable amount of time** as a result of uncertainty over time and cost commitments deterring bodies from taking effective action. **Insufficient scrutiny and monitoring of risk, finances and performance** created by poor governance and accountability arrangements. **Difficulties in resolving differences or areas of conflict** may also arise from this. **Weakened governance and accountability arrangements** as a result of poor planning and implementation of reforms.	Paragraphs 83 to 105	Questions 1 to 8
Workforce reductions	**Reduced leadership skills and professional competence** as a result of losing staff with essential skills and corporate knowledge. **Reduced quantity and quality of service delivery** created by staff shortages in key service areas caused by unmanaged workforce reductions. **Lower staff morale and increased sickness** as a result of increased workload and lower reward packages; and the negative impact on remaining staff created by workforce reductions. **Delayed benefits** as a consequence of having to re-train or re-deploy staff. **Failure to motivate remaining staff to innovate, change and do more** as a result of changes to reward packages.	Paragraphs 73 to 82	Questions 9 to 13
Financial sustainability	**Failure to deliver outcomes or budget reductions** as a result of unclear priority budget-setting. **Saving plans not being delivered** due to a lack of a risk and evidence-based cost-reduction strategy. It may also result in inefficiencies remaining within the system. **Spending commitments may exceed budgets** due to over-optimistic savings plans or unforeseen cost pressures. **Over-committing on levels of borrowing** to finance current plans at the expense of future plans when repayments are required.	Paragraphs 65 to 72	Questions 14 to 20
Leadership and governance	**Poor decision-making, unclear priorities or lack of direction and ownership** as a result of weak leadership. **Lack of accountability, scrutiny and challenge** as a consequence of poor governance arrangements. **Lack of transparency and openness** as a consequence of unclear decision-making processes and poor governance arrangements.	Paragraphs 106 to 110	Questions 21 to 26

Part 1. The current financial climate

The Scottish budget will reduce significantly over the four years to 2014/15, with capital budgets facing the largest reductions.

Key messages

- The budget reductions affect revenue and capital expenditure differently with the capital budget taking the largest cut in percentage terms. Traditional public spending on capital projects such as new hospitals, roads and prisons will reduce by £1.2 billion (36 per cent) to £2.1 billion in 2014/15. This compares to an eight per cent reduction in revenue spending which will fall by £2.1 billion to £23.8 billion over the same period.
- All parts of the public sector have less to spend in 2011/12 than in 2010/11, although the level of budget reduction varies significantly among spending areas. Scottish Government funding to the health and local government sectors has reduced by 0.3 per cent and five per cent respectively, while central government funding has reduced by 12 per cent. The most significant reduction in Scottish Government funding relates to further and higher education, which has fallen by £245 million (14 per cent) to £1.5 billion in 2011/12.
- Public bodies are finding it difficult to plan beyond 2011/12, as they do not have a clear view of their budgets beyond 2011/12. The Scottish Government plans to publish detailed spending plans for years 2012/13 to 2014/15 in September 2011, which should establish a framework that bodies can use to make decisions about future spending plans.

Scottish public spending will reduce significantly over the next four years

The UK budget will reduce by three per cent in real terms to 2014/15

12. In October 2010, the UK government published the results of its Spending Review setting out the UK's public spending plans for the four years to 2014/15.[4] It confirmed that the total UK budget will reduce by £23 billion (three per cent) to £674 billion in 2014/15.[5]

13. The scale of the budget reductions are, however, not uniform across all areas of spend:

- The UK government decided to protect spending in two areas: health and international aid. Consequently, other UK spending areas, including the devolved administrations, will experience higher budget reductions, averaging 14 per cent over the four years to 2014/15.
- The total Departmental Expenditure Limit (DEL) budget – that is day-to-day spending and running costs, which can be planned with more certainty over a number of years – will reduce by £41 billion (ten per cent) to £354 billion in 2014/15.
- Capital budgets will be particularly hard hit. The overall capital DEL budget will reduce by £15 billion (29 per cent) to £37 billion in 2014/15.
- The total Annually Managed Expenditure (AME) budget – that is expenditure in areas such as social security benefits and pensions, which are predominantly demand led and therefore more difficult to predict over the long term – will increase by £18 billion (six per cent) to £320 billion in 2014/15.

The Scottish budget will reduce significantly over the four years to 2014/15, with capital budgets facing the largest reductions

14. As the Scottish Government receives most of its funding from the UK government, it will bear a share of the UK budget cuts. According to the Scottish Government, the total Scottish DEL budget, for which it has discretion over how it is spent, will reduce by £3.3 billion (11 per cent) to £25.9 billion in 2014/15 (Exhibit 3, overleaf).[6] This contrasts starkly with the first ten years of devolution when the Scottish DEL budget increased by an average of over five per cent a year from £19.1 billion in 2000/01 to £29.7 billion in 2009/10. The extent of the reductions varies in the two main components of the DEL budget:

- The revenue DEL budget will fall by £2.1 billion (eight per cent) to £23.8 billion in 2014/15. The most significant reduction will occur in the current year, 2011/12 – the budget has reduced by £1.0 billion to £24.9 billion (four per cent).
- The capital DEL budget is expected to reduce by £1.2 billion (36 per cent) to £2.1 billion in 2014/15. Again, the most pronounced reduction will occur in 2011/12 as the capital budget has fallen by £0.8 billion to £2.5 billion (24 per cent).[7]

15. The Scottish AME budget which covers demand-led expenditure, for example, mainly on NHS and teachers' pensions, remained at £5.5 billion between 2010/11 and 2011/12. However, the Scottish Government is only responsible for administering the AME budget and has no discretion over how it is spent. The Scottish Government is responsible for providing estimates of AME spending but this requires separate HM Treasury approval.

4 *Spending Review 2010*, HM Treasury, October 2010.
5 All budget figures in the report are quoted in real terms unless otherwise stated.
6 There are slight differences between the figures reported for 2010/11 by the Scottish Government and those reported by HM Treasury as part of the 2010 Spending Review. This is due to an agreement with HM Treasury that the Scottish Government could defer £332 million of planned UK budget reductions in 2010/11 to 2011/12. In addition, the Scottish Government also incurred expenditure in 2010/11 which had been carried forward from previous years under End Year Flexibility arrangements.
7 This excludes £100 million capital transferred from 2010/11 to 2011/12 as proposed in the draft Scottish Budget 2011/12. The DEL budget for 2011/12 totals £27.5 billion when the transfer is included. See Exhibit 5 on page 11.

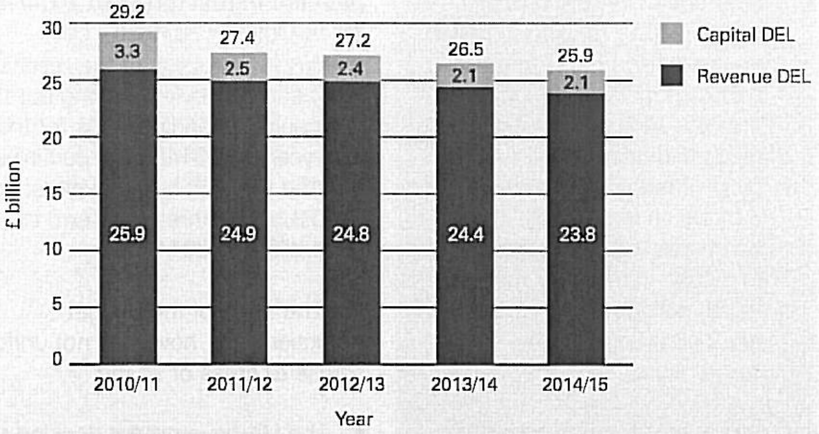
No estimates have been made for the Scottish AME budget beyond 2011/12.

16. Overall, the Scottish public sector is facing significant budget cuts and these are in line with previous worst case scenarios forecast by independent commentators. In our 2009 report, *Scotland's public finances: preparing for the future*, we highlighted analysis by the Centre for Public Policy for Regions (CPPR).[8] This looked at three possible budget scenarios, ranging from a five per cent real-term reduction in the DEL budget over the three-year period 2011/12 to 2013/14 (best case) to an 11 per cent real-term reduction over the same period (worst case). It is now clear that the scale of the budget reductions facing Scotland over the next few years is close to the CPPR's worst case scenario (Exhibit 4).

Exhibit 3

The Scottish Government's revenue and capital budgets 2010/11 to 2014/15

Public spending will fall significantly over the four years to 2014/15 with capital spending facing the largest percentage reductions.



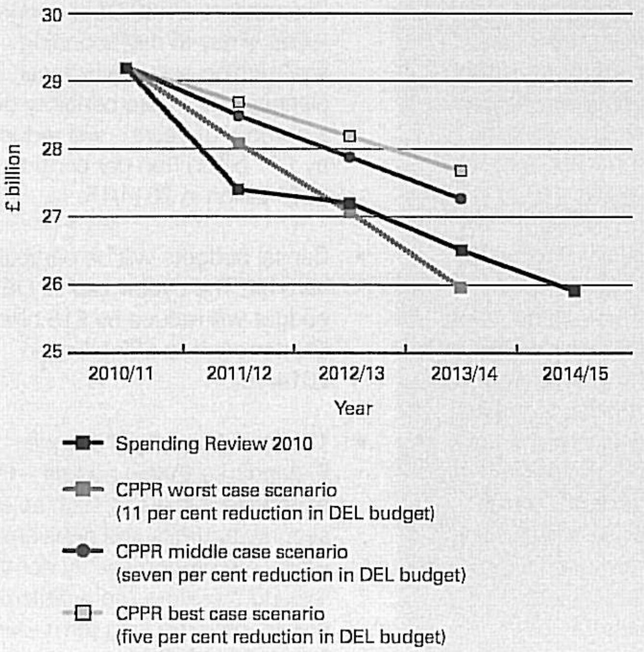
Notes: 1. All figures are at 2010/11 prices.
2. Figures exclude £100 million of capital transferred from 2010/11 to 2011/12 as proposed in the draft Scottish Budget 2011/12. The budget for 2011/12 totals £27.5 billion when the transfer is included. See Exhibit 5.

Source: *Comprehensive Spending Review*, Scottish Government news release, October 2010

Exhibit 4

Scottish DEL budget reductions compared to CPPR projections, 2010/11 to 2014/15

The budget reductions facing Scotland are closest to the CPPR's worst case scenario projections.



Source: Audit Scotland adapted from CPPR

Budget constraints are likely to continue beyond the current spending review period

17. The Scottish Government has estimated that it may take until 2024/25 before spending levels return to 2010/11 levels.[9] These estimates depend largely on the outlook for the UK economy as a whole and the length of time it takes to recover from the recent recession. They also depend on UK government policy on reducing national debt levels. The magnitude of these reductions is likely to significantly affect the ability of public bodies to maintain and deliver services and meet required targets over the next spending review period and beyond.

All parts of the public sector have less to spend in 2011/12

18. In February 2011, the Scottish Parliament approved the Scottish budget for 2011/12.[10] The 2011/12 Scottish budget includes DEL

8 *Briefing Note*, Centre for Public Policy for Regions, April 2009.
9 *Outlook for Scottish Government expenditure*, Office of the Chief Economic Adviser, Scottish Government, July 2010.
10 Budget figures for both 2010/11 and 2011/12 are taken from *Scotland's Spending Plans and Draft Budget 2011/12* published by the Scottish Government in November 2010. The total budget for 2011/12, approved by the Scottish Parliament in February 2011 is £250 million higher than in the draft budget document. This is largely attributable to technical accounting amendments as a result of the introduction of International Financial Reporting Standards and the requirement of the Public Finance Accountability (Scotland) Act 2000 to present budgets of non-departmental public bodies to the Scottish Parliament on a cash basis only. These changes have a neutral effect on spending power. A table outlining the reconciliation is included in the *Budget (Scotland) Bill Supporting Document*, Scottish Government, January 2011.

expenditure of £28 billion (83 per cent) and AME expenditure of £5.6 billion (17 per cent), of which £3.2 billion relates to teachers' and NHS pension costs and £2.2 billion is for non-domestic rates income distributed to councils (all cash terms).

19. Overall, the 2011/12 Scottish DEL budget is £1.7 billion less in real terms (six per cent) compared to the 2010/11 budget. All Scottish Government portfolios incurred real-terms reductions in their DEL budgets in 2011/12, with the largest percentage reduction in the Justice portfolio (£191 million, 13 per cent). The Health and wellbeing and Local government portfolios are the only areas within the Scottish Administration to have real-term reductions of less than ten per cent (Exhibit 5).

20. The Scottish Government has only published detailed budget plans for the first year, 2011/12, of the spending review period. Bodies, therefore, lack a clear view of their budgets beyond this period, which may have limited the amount of detailed planning undertaken to address the financial challenges. The Scottish Government plans to publish detailed spending plans for 2012/13 to 2014/15 as part of a Scottish Spending Review in September 2011.

21. Exhibit 6 (page 13) provides a more detailed analysis of the changes to portfolio DEL budgets between 2010/11 and 2011/12. This indicates that there are some significant differences in how the budget reductions will affect different areas of the public sector in Scotland.

Exhibit 5

Changes in DEL budgets 2010/11 to 2011/12 by Scottish Government portfolio

All Scottish Government portfolios have less to spend in real terms in 2011/12, with the largest percentage reduction occurring in the Justice portfolio.

Portfolio	Budget			Change between the 2010/11 budget and 2011/12 budget restated to 2010/11 prices	
	2010/11	2011/12	2011/12 restated to 2010/11 prices		
	(£m)	(£m)	(£m)	(£m)	(%)
DEL budget					
Finance and sustainable growth	2,474	2,219	2,178	-296	-12
Health and wellbeing	11,652	11,748	11,529	-123	-1
Local government	9,586	9,047	8,878	-708	-7
Education and lifelong learning	2,715	2,481	2,435	-280	-10
Justice	1,435	1,268	1,244	-191	-13
Rural affairs and the environment	514	468	459	-55	-11
Office of the First Minister	280	255	250	-30	-11
Administration	262	236	232	-30	-11
Crown Office and Procurator Fiscal	118	108	106	-12	-10
Directly funded bodies outwith Scottish Administration	190	178	175	-15	-8
Total DEL budget	29,226	28,008	27,486	-1,740	-6
AME	5,513	5,612	5,507	-6	0
Total budget	34,739	33,620	32,993	-1,746	-5

Note: The 2011/12 budget figures are restated to 2010/11 prices by applying an inflation factor of 1.9 per cent. This is the same inflation factor applied at the publication of the draft Scottish Budget in November 2010 although the level of inflation has increased since then. See paragraph 40 for details on the impact of higher inflation on budgets.

Source: *Scotland's Spending Plans and Draft Budget 2011-12*, Scottish Government, November 2010

The health sector's DEL budget has reduced by 0.3 per cent in real terms in 2011/12

22. The Health and wellbeing portfolio DEL budget, covering health, housing and regeneration, has decreased by £123 million (one per cent) to £11.5 billion in 2011/12. Of this, the health DEL budget has reduced by £32 million in real terms (0.3 per cent) to £11.1 billion in 2011/12. The budget reduction is, however, confined to special health boards, which have received an average real-terms reduction of three per cent in their 2011/12 budgets. Territorial NHS boards have received an average real-terms increase of 1.3 per cent in the budget received from the Scottish Government, with increases ranging from 0.8 to 2.3 per cent in individual boards.[11]

23. Most of the increase in funding to territorial NHS boards is associated with the £70 million Change Fund. The Change Fund has been established to enable health and social care partners to implement local plans to make better use of their combined resources for older people's services. It will provide bridging finance to facilitate shifts in the balance of care from institutional to primary and community settings, and should also influence decisions taken on spend on older people's care. A further £57 million of the increase is compensation paid in respect of the full abolition of prescription charges. This money has been allocated on the basis of each board's loss of income and does not represent an increase in overall spending on the NHS.

Scottish Government funding to local government has reduced by five per cent in real terms in 2011/12

24. The Scottish Government's total funding of local government comprises general grants and non-domestic rates income paid from the Local government portfolio and specific grants, such as the police grant, funded from other portfolios. The Scottish Government's funding to local government, including non-domestic rates income, which is treated as AME due to HM Treasury reporting requirements, has decreased by £654 million in real terms (five per cent) to £11.3 billion in 2011/12. All councils received a real-terms reduction in both their revenue and capital allocations with revenue budgets reducing by two to six per cent. Capital reductions are more severe, ranging from 11 to 25 per cent.[12]

25. Scottish Government funding accounts for around two-thirds of local government income.[13] It is the responsibility of individual councils to allocate this funding, as well as locally-raised finance through council tax or borrowing, in order to meet both local needs and national priorities. As part of the funding allocation, all 32 councils agreed to a package of measures including maintaining the pupil-teacher ratio for early primary school years; maintaining police numbers at current levels; agreeing a council tax freeze for the fourth successive year; and remaining committed to the delivery of the current Single Outcome Agreements.

Central government bodies' DEL budget has decreased by 12 per cent in real terms in 2011/12

26. Central government's (including the Scottish Government, its agencies, non-departmental public bodies and bodies directly funded from the Scottish budget such as the Scottish Parliamentary Corporate Body) DEL budget has decreased by £992 million in real terms (12 per cent) to £7.2 billion in 2011/12. Areas of significant budget reductions include:

- Transport programmes (net budget reduction of £85 million or five per cent in real terms).
- The withdrawal of support for Scottish Water borrowing (budget of £150 million in 2010/11).
- Housing and regeneration (net budget reduction of £101 million or 21 per cent in real terms).
- The Scottish Prison Service (overall revenue and capital budget reduced by £111 million or 24 per cent in real terms).

27. The biggest budget reduction has occurred in the higher and further education sector where overall revenue and capital budgets fell by £245 million (14 per cent) to £1.5 billion in 2011/12. Revenue funding for higher and further education institutions has fallen by eight per cent to £1.4 billion in 2011/12. The capital budget has decreased by 57 per cent to £89 million in 2011/12.

28. The UK government's decision to remove the cap on tuition fees in England and Wales may also result in increased financial pressures for Scottish universities and colleges. A recent joint report by the Scottish Government and Universities Scotland estimated that the UK government's decision to remove the cap on tuition fees in England and Wales may result in a funding gap of between £97 million and £263 million by 2014/15 between Scottish and other UK universities.[14] In June 2011, as part of proposed measures to reduce the gap, the Scottish Government announced that Scottish universities would be allowed to charge fees for students from the rest of the UK from 2012/13 onwards. However, the Scottish Government is committed to a policy of no tuition fees for Scottish students and has tasked the higher and further education sector with achieving budget reductions through greater efficiency and collaborative working while at the same time maintaining the number of college and university student places.

11 Calculations based on Scottish Government initial revenue funding allocations to NHS boards. Taken from Scottish Government news release dated 11 February 2011.
12 Individual councils' allocations taken from *Local Government Finance Circulars 9/2010* and *4/2011*, Scottish Government.
13 *An overview of local government in Scotland 2010*, Audit Scotland, January 2011. In 2009/10, Scottish Government funding for local government was £11.8 billion, representing 66 per cent of total local government income (£17.9 billion).
14 *Report of the Scottish Government – Universities Scotland technical working group on higher education*, Scottish Government, February 2011.

Exhibit 6

Scottish Government DEL budget changes 2010/11 to 2011/12

All portfolios have less to spend in 2011/12 than in 2010/11, although the level of budget reductions varies significantly among spending areas.

Portfolio	Main areas of spending	2010/11 budget (cash) £m	2011/12 budget (cash) £m	2011/12 budget (real) £m	Difference between 2010/11 (actual) and 2011/12 (real) £m	%	Comments
Finance and sustainable growth	Transport	1,855	1,804	1,770	-85	-5%	Existing transport projects are expected to take priority over new projects in 2011/12, while spending will be reduced on maintaining motorways and trunk roads. Spending on the Forth Replacement Crossing will increase from £30 million to around £196 million (real terms) in 2011/12 as design, procurement and development plans continue to progress.
	Enterprise, energy and tourism	450	423	416	-34	-8%	Further efficiencies expected from Scottish Enterprise and Highlands and Islands Enterprise while priority is given to supporting the transition to a low carbon economy and other key sectors critical to long-term economic development.
	Other	169	-8	-8	-177	-105%	Support for Scottish Water borrowing withdrawn in 2011/12. Budgets for other areas in 2011/12 amount to £80 million. However, income received from Scottish Water voted loans (£88 million) means that the overall net figure is negative (-£8 million).
	Portfolio total	**2,474**	**2,219**	**2,178**	**-296**	**-12%**	
Health and wellbeing	Health	11,082	11,260	11,050	-32	-0.3%	Territorial NHS boards will receive an average real-term increase of 1.3 per cent in their 2011/12 revenue budget allocations from the Scottish Government. Special health boards will receive an average three per cent reduction in their revenue budget allocations. The overall health capital budget reduced by 17 per cent in 2011/12. This is based on initial allocations published by the Scottish Government in February 2011.
	Housing and regeneration	488	394	387	-101	-21%	Most of the budget reduction relates to a reduction in the Affordable Housing Investment Programme used to support the construction of new homes for rent and low-cost home ownership.
	Other	82	94	92	10	12%	The budget increase relates to sport, in particular, funding towards the operational costs of Glasgow 2014 Commonwealth Games.
	Portfolio total	**11,652**	**11,748**	**11,529**	**-123**	**-1%**	
Local government	Block grant	9,586	9,047	8,878	-708	-7%	This relates to general revenue and capital grants only. Revenue allocations have been subject to budget reductions of between two and six per cent in individual councils while capital allocations have reduced by between 11 and 25 per cent.
	Portfolio total	**9,586**	**9,047**	**8,878**	**-708**	**-7%**	
Education and lifelong learning	Higher and further education	1,786	1,570	1,541	-245	-14%	Revenue funding for FE colleges will reduce by seven per cent in real terms to £535 million in 2011/12 while revenue funding for higher education institutions will reduce by eight per cent in real terms to £909 million. The combined capital funding for FE colleges and higher education institutes will reduce by 57 per cent in real terms to £89 million.

	Student awards	428	414	406	-22	-5%	Expenditure on student fees, grants and bursaries is expected to fall by £20 million in real terms.
	Other	501	497	488	-13	-3%	Budget increases in the schools and learning areas will be offset by reductions in areas such as Skills Development Scotland which will see its 2011/12 funding reduce by £24 million to £178 million, a real-terms decrease of 12 per cent.
	Portfolio total	**2,715**	**2,481**	**2,435**	**-280**	**-10%**	
Justice	Scottish Prison Service	470	366	359	-111	-24%	The reduction is largely confined to the Scottish Prison Service's capital budget which has fallen by £90 million in 2011/12 to £47 million, a real-terms reduction of 66 per cent. This reflects the Scottish Government's decision to review the timing of future investment in the prisons estate.
	Legal Aid	168	154	151	-17	-10%	Efficiency savings expected from changes to court procedures.
	Police central government	237	210	206	-31	-13%	Includes police support services such as the Scottish Police Services Authority. Funding for front-line policing is delivered through the police grant included within the local government allocation.
	Other	560	538	528	-32	-6%	This largely relates to spending on police and fire pensions as well as funding the Scottish Courts Service.
	Portfolio total	**1,435**	**1,268**	**1,244**	**-191**	**-13%**	
Rural affairs and the environment	EU support and related services	156	138	136	-20	-13%	This includes the Single Farm Payment Scheme as well as rural and business development support. A further £542 million is being spent in this area in 2011/12 using EU funding.
	Environmental and rural services	196	186	183	-13	-7%	There will be general funding reductions in 2011/12 to bodies such as Scottish Natural Heritage, the two national parks, and the Scottish Environment Protection Agency.
	Other	162	144	140	-22	-14%	Includes reductions in expenditure on marine and fisheries and unspecified research programmes in 2011/12.
	Portfolio total	**514**	**468**	**459**	**-55**	**-11%**	
Office of the First Minister	Culture and Gaelic	194	175	172	-22	-11%	Reductions in funding to bodies such as Creative Scotland and the National Galleries for Scotland are expected to be managed through increased efficiencies.
	Other	86	80	78	-8	-9%	Expenditure mainly relates to Historic Scotland.
	Portfolio total	**280**	**255**	**250**	**-30**	**-11%**	
Administration	Scottish Government staff costs	167	152	149	-18	-11%	The Scottish Government is aiming to reduce staff costs through a pay freeze for all staff except some lower paid staff and by implementing a voluntary early severance scheme. It also plans to reduce the cost of the Senior Civil Service by ten per cent by the end of 2011/12 and by 25 per cent by 2014/15 compared to 2010/11 levels.
	Other	95	84	83	-12	-13%	This budget covers accommodation, training and overhead costs.
	Portfolio total	**262**	**236**	**232**	**-30**	**-11%**	

Source: *Scotland's Spending Plans and Draft Budget 2011-12*, Scottish Government, November 2010

Part 2. Cost pressures in the public sector

Public bodies face a number of significant cost pressures that will make it difficult to reduce costs while maintaining service standards.

Key messages

- Demand for public services is increasing and this is likely to continue in the future. An ageing population, the effects of the recent recession and the heightened expectations of the public all increase the demand for public services. This places an additional burden on the capacity of public bodies to provide efficient and quality services at a time when budgets are already stretched and reducing.
- Public bodies face a number of significant cost pressures including increasing backlog maintenance and repair costs and rising energy costs. These, together with existing financial commitments such as annual payments for revenue-financed capital projects and rising pension costs, will make it difficult for public bodies to reduce costs while maintaining service standards.

29. This part of the report reviews some of the cost pressures currently facing public sector managers at a time when budgets are reducing. We have highlighted many of these pressures in recent years in a number of reports. The main cost pressures, which are not mutually exclusive, can be categorised into six key areas:

- Demand pressures – such as the consequences of an ageing population, which are likely to increase demand for health and social care services.
- Financial pressures – such as reduced budgets and the continuing need to deliver efficiency savings.
- Workforce pressures – such as rising pay and pension costs.
- Investment pressures – such as the affordability of new capital projects.
- Maintaining asset pressures – such as addressing the rising cost of backlog maintenance and repair.
- Environmental pressures – such as the implementation of EU and Scottish Parliament legislation to reduce carbon emissions.

The demand for public services is increasing

30. Many public services are demand led and public bodies have limited or no control over this demand. For example, access to universal public services such as free personal and nursing care and concessionary travel is open to all eligible people and demand can only be influenced through changes in government policy. However, more control can be exercised in other areas such as access to further and higher education, where demand can be controlled through the number of student places that universities and colleges make available.

Changes to Scotland's population profile will increase the demand for public services

31. There will be a significant change in the demographic profile of Scotland's population over the next 25 years, which will increase demand for public services in many areas. Projections show that over the period 2008 to 2033 the number of people aged 60 and over will rise by 50 per cent from 1.17 million to 1.75 million, with the number of people aged 75 and over set to almost double. The number of people aged 16 to 59 will decrease by six per cent from 3.09 million to 2.89 million (Exhibit 7).[15]

32. As a result of these demographic changes, the ratio of older people to those of working age is expected to increase from the current 31 older people per 100 workers to 40 older people per 100 workers by 2033. Having relatively fewer people of working age to support older people has a number of consequences including:

- Fewer people to deliver public services and care for others.
- Fewer people to contribute to pensions putting strain on pension funds.
- Fewer people paying national insurance and tax, reducing tax revenues.
- Larger proportion of working people's income needed for pensions and national insurance which reduces their disposable income.
- A greater proportion of future tax revenues generated from the working population will be required to pay for older people's health and social care needs and pensions.

33. Demand for health and social care services is particularly high among older people, particularly those aged 75 and over. An increasing older population is likely to lead to more people living longer with health problems such as diabetes and chronic obstructive pulmonary disorder requiring ongoing care.[16] At the same time, the public's expectations of services delivered by the NHS have risen. For example, it may be difficult to maintain recent improvements in waiting times for treatment when there is significantly higher demand for these services.

The demand and cost of free services continues to rise

34. The Scottish Government remains committed to a number of universal public services such as free prescription charges, free eye tests, concessionary travel and free

15 *Projected Population of Scotland (2008 based)*, General Register Office for Scotland, October 2009.
16 *Financial overview of the NHS in Scotland 2009/10*, Audit Scotland, December 2010.

personal and nursing care where the costs are increasing. These services are demand led, making it difficult to estimate their future costs. However, given the expected rise in the number of older people in Scotland, the likelihood is that, unless changes are made to areas such as eligibility criteria, demand for these services will increase costs.

35. In 2010/11, the combined cost of free personal and nursing care, free prescriptions, free eye tests and the national concessionary travel scheme cost around £870 million and the costs are rising. The Scottish Government has yet to take forward the Independent Budget Review Panel's recommendation that all universal services should be reviewed to see if they should be maintained in their current form, focusing on changes in eligibility criteria, the introduction of charges and to ensure that those who need these services most are not disadvantaged.[17] Our report on the national concessionary travel scheme stated that the scheme cost £199 million in 2009/10 and that costs are expected to rise.[18] We projected that, based on current levels of concessionary journeys and a range of fare increases, the uncapped costs of the scheme could reach between £216 million and £537 million by 2025.[19]

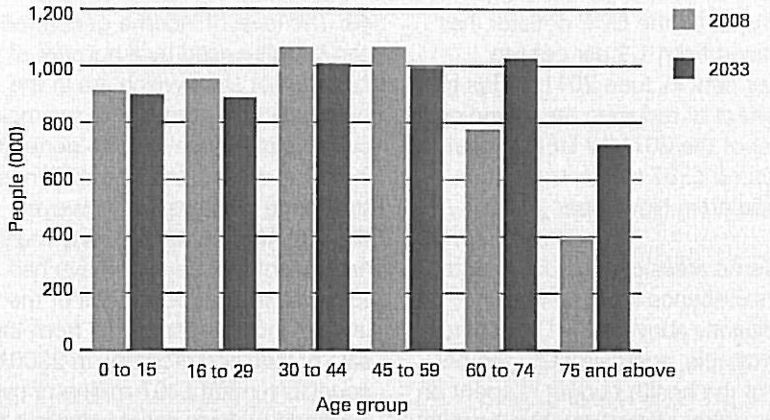
Demand for further and higher education places is rising

36. The recent recession has been particularly difficult for young people. In June 2011, over a quarter of claims for jobseeker's allowance came from people in the 18-24 age group – approximately 40,000 out of 140,000 claims.[20] Within this age group, the number of young people classed as economically inactive rose from 23 to 26 per cent between 2006 and 2010. This is due, in part, to an increase in the number of students. The total number of students studying in Scotland reached 288,000 in 2009/10, around 8,000 more than in 2008/09.

Exhibit 7

Projected changes in the age structure of Scotland's population 2008 to 2033

By 2033, Scotland will have significantly more older people, particularly in the 75 and over age group.



Source: *Projected Population of Scotland (2008 based)*, General Register Office for Scotland, October 2009

Assumed efficiency savings, inflation and less income add to the financial pressures faced

Public bodies may find it difficult to continue to deliver efficiency savings

37. Public bodies have been required to achieve annual targets of two per cent efficiency savings since 2004 and have reported over £4 billion in efficiency savings to the end of 2009/10.[21]

38. In February 2010, Audit Scotland concluded that, due to significant weaknesses in the information available and inconsistencies in reporting, it was unable to provide assurances on the level of efficiency savings reported as part of the 2008 to 2011 Efficient Government Programme.[22] Many public bodies were using existing processes and systems to measure efficiency savings that, for the most part, were not designed for the purpose. As a result, there is a risk that reported efficiency savings may actually be cuts in services due to a lack of clarity on the volume or quality of services provided.

39. The Scottish Government's 2011/12 budget assumes that public bodies will deliver three per cent efficiency savings. It is likely that public bodies will also be expected to achieve a further two per cent efficiency savings annually between 2012/13 and 2014/15. Given efficiency targets have been in place for seven years now, there is a risk that further efficiency savings may be harder to find without making fundamental changes to the way public services are organised and delivered.

Higher than expected inflation will reduce the spending power of future budgets

40. The level of inflation has a direct bearing on the spending power of future budgets because, if the inflation rate is higher than forecast,

17 *Independent Budget Review: The Report of Scotland's Independent Budget Review Panel*, July 2010.
18 *National concessionary travel*, Audit Scotland, October 2010.
19 Our projections are based on recent trends in average adult single fares and inflation and on Transport Scotland's estimate of a five per cent increase in adult single fares each year. The range of projections are based on increases in fares of between 0% and 6.25%.
20 *Labour market statistics: Scotland*, Office for National Statistics, July 2011.
21 *Efficient Government Efficiency Outturn Reports*, Scottish Government, November 2009 and October 2010.
22 *Improving public sector efficiency*, Audit Scotland, February 2010.

public bodies will have less money in real terms to spend on goods and services. Since the Scottish Government outlined its spending plans for 2011/12 in November 2010, the level of predicted inflation, as measured by the GDP deflator, has increased from 1.9 per cent to 2.9 per cent in June 2011.[23] This has the effect of reducing the spending power of the 2011/12 DEL budget by around £267 million more than anticipated in November 2010.

41. Some areas of the public sector may experience inflation that is significantly above the GDP deflator. For example, approximately ten per cent of the health budget is spent on drugs, either administered in hospital or issued through GP prescriptions. In June 2010, some NHS bodies forecast that expenditure on hospital drugs would rise by between four and 11 per cent between 2009/10 and 2010/11, while the cost of GP prescribing was expected to rise by between four and eight per cent.[24] This is significantly higher than the most recent GDP deflator estimates of inflation of between 2.5 and 2.9 per cent a year over the next four years, and could put health budgets under considerable pressure.

Other public sector income may be less than forecast

42. The Scottish budget includes assumptions about non-government income which, although relatively small at around £420 million in 2011/12, is used to support spending across a number of areas. The Scottish Government also assumes that other public bodies, such as local authorities, will also generate income, which it considers when deciding how much funding to allocate. For example, in 2009/10, councils generated £2.3 billion income from user charges and fees for services such as car parking, rent, waste collection, licensing, planning, leisure facilities and day care arrangements.

43. The level of income generated can be influenced by a number of factors, not all of which are in the public sector's control. For example, councils often use income generated from the sale of land and buildings to finance new assets. However, the downturn in the property market has meant that councils have had to revise their expectations of the level of income generated from the sale of land and property. In 2006/07, councils funded £497 million of capital expenditure from asset sales but this fell to £234 million in 2009/10; and a further fall to £147 million in 2010/11 was estimated. This places additional pressures on already reducing budgets.[25]

44. At the same time, it may be difficult for public bodies to increase income from other sources to fill the gap caused by budget reductions. While some increase in charges may be possible, this needs to be managed carefully to ensure it does not adversely affect demand for the service, particularly if there are well-established social reasons for providing the service, for example respite care.

Workforce costs may continue to rise without further action

Staff costs may continue to rise, despite a pay freeze

45. In 2010/11, the devolved public sector in Scotland employed around 493,000 staff, at a cost of £15.2 billion (Exhibit 8). This represents almost 60 per cent of the Scottish revenue DEL budget. As part of the 2011/12 Scottish budget announcement, the Scottish Government introduced a one-year pay freeze for most staff working in the Scottish Government, its agencies and non-departmental public bodies. This follows a similar policy introduced by the UK government. It has also been adopted by the NHS in Scotland.

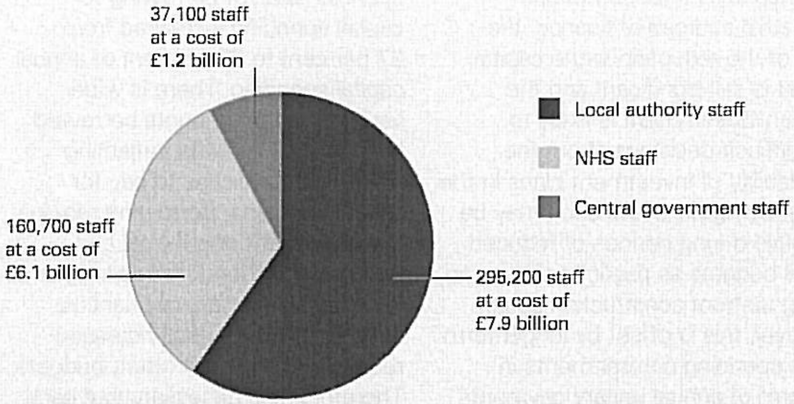
46. However, pay costs will continue to rise unless staff numbers are reduced. The pay freeze policy only applies to annual cost of living rises but not increases between pay scale points.[26] In addition, staff earning less than £21,000 will receive a minimum pay increase of £250. All public sector bodies under the policy are also required to implement the Scottish Living Wage, currently set at a minimum of £7.15 an hour. The Independent Budget Review Panel found that if the same pay freeze was applied across the whole of the Scottish public sector, total staff costs would still increase by £180 million in 2011/12 and £340 million (cumulative) in 2012/13. However, the pay freeze is likely to have saved the public sector £240 million in 2011/12 and £560 million (cumulative) in 2012/13.

23 The Gross Domestic Product deflator (GDP deflator) represents the change in prices of all goods and services produced within the UK rather than being a representative 'basket' of goods used to determine other measures of price changes such as the Retail Prices Index (RPI) and the Consumer Prices Index (CPI).
24 NHS bodies' submissions to the Health and Sport Committee as part of the Committee's inquiry into NHS boards' revenue allocations, June 2010.
25 *An overview of local government in Scotland 2010*, Audit Scotland, January 2011.
26 Most public bodies operate a pay structure based on each grade below a certain level having a series of pay scale points. Assuming satisfactory performance, staff who are not on the maximum pay for their grade will normally continue to receive a pay increase equivalent to one pay scale point. Cost of living payments are amounts needed to sustain a certain level of living, covering basic expenses such as housing, food and clothing.

Exhibit 8

Scottish public sector staff numbers and costs 2010/11

The public sector in Scotland employed around 493,000 staff at a cost of £15.2 billion in 2010/11.



Source: *Public Sector Employment in Scotland*, Scottish Government, March 2011 and *Independent Budget Review*, July 2010.

47. Local authority employers, including fire and the police, are responsible for setting their own pay levels and structures, independent of the Scottish Government. In August 2010, a two-year pay freeze covering 2011/12 and 2012/13 was implemented for local government staff. It is similar to the central government sector; in most cases pay scale increments will still be paid and lower paid staff will receive a cost of living award. There is no agreement to pay lower paid staff an additional payment or to introduce the Scottish Living Wage, though councils can choose to do so according to local circumstances. In April 2011, the main teachers' union in Scotland, the Educational Institute of Scotland, voted to accept new pay and conditions terms, which included a two-year pay freeze.

48. The pay freeze is designed to act as a constraint on public sector costs. However, pre-existing pay agreements within the public sector, the need to respond to other employment regulations, as well as the implementation of central government policies mean it will be difficult to contain staff costs completely. For example:

- previous Audit Scotland reports have highlighted the costs and complexity of a number of NHS pay agreements including the NHS consultants' contract, the General Medical Services contract and the use of locums in the NHS. NHS bodies are also reporting challenges in meeting the costs associated with the European Working Time Directive

- all councils have single status agreements in place although a number of equal pay claims have still to be resolved. Up to the end of March 2010, the cost of meeting equal pay claims across councils was around £420 million. However, a large number of cases remain at tribunal and councils estimate that outstanding claims may cost a further £180 million[27]

- the Scottish Government's policy to recruit and retain 1,000 additional police officers places pressure on the ability of police forces to reduce staff costs. Under current legislation, police officers cannot be made compulsorily redundant. This means that any reductions in staff numbers are likely to be concentrated on civilian staff employed in support functions such as human resources and finance, as well as in contact centres and analysts. This poses additional risks to the police in terms of maintaining support to front-line services.

Public pension schemes have significant long-term cost pressures

49. We recently reported that public sector employers' pension contributions have increased by 19 per cent in real terms over the last five years to £2.2 billion in 2009/10.[28] Significant cost pressures have built up in all six of the main public sector pension schemes in Scotland mainly as a result of people living longer. A number of pension reforms, such as increases in retirement ages and in employees' contribution rates for some schemes, were implemented between 2006 and 2009 to help deal with rising costs. However, many of the reforms only affect new members of schemes, or are being phased in gradually.

50. Pension changes announced in the 2010 UK Spending Review are intended to ease cost pressures, although by how much will not become apparent until later in 2011 or 2012 when actuarial valuations are completed. Changes include the move from the Retail Price Index to the Consumer Prices Index for uprating public sector occupational pensions and an increase of around three per cent of pay in employees' contributions.

51. Similarly, in March 2011, the Independent Public Services Pensions Commission (the commission) published a review of public sector

27 *An overview of local government in Scotland 2010*, Audit Scotland, January 2011.
28 *The cost of public sector pensions in Scotland*, Audit Scotland, February 2011.

pension schemes, which made a number of recommendations designed to reduce the cost of UK public sector pensions. These included introducing pensions based on an employee's average working life rather than final salary, and an increase in the retirement age. The UK government announced it would accept the commission's recommendations as a basis for a consultation and plans to outline its proposals in autumn 2011. Therefore it is too early to determine how these changes will impact on Scotland. Overall, pension contributions will remain a significant cost for public sector employers for the foreseeable future.

Spending plans on new capital assets will increase pressure on future budgets

52. The Scottish Government has emphasised capital investment as being a key strand to generating economic growth and recovery through its Government Economic Strategy and subsequent Economic Recovery Plans in recent years.[29] With the Scottish capital budget set to fall by £1.2 billion (36 per cent) between 2010/11 and 2014/15, the Scottish Government faces difficult decisions about its investment programme. The Scottish Government has around 182 major capital projects planned or currently in progress, with a combined estimated value of £13–£15 billion, phased over a number of years. The Scottish Government is unlikely to be able to fund all of these projects through its capital budget and therefore reaffirmed its commitment to use private finance using the Non-Profit Distributing (NPD) method to fund £2.5 billion worth of capital projects. Some of the projects to be funded through NPD include the Scottish Schools for the Future programme (£800 million), the Royal Hospital for Sick Children/Department of Neurosciences in Edinburgh (£148 million) and Borders Railway (£230–£290 million).

53. Despite its intention to use alternative sources of finance, the scale of the reduction in the capital budget is still significant and the Scottish Government is likely to face difficult decisions about the affordability of investment plans in the future. Using private finance may be attractive during periods of reduced capital budgets as public bodies avoid paying up-front construction costs. However, this is offset by longer-term public spending commitments in the form of annual unitary payments to the private sector provider to cover up-front construction costs, lifecycle maintenance and facilities management.

54. In 2010/11, annual unitary payments across the public sector in Scotland were £838 million, with £439 million of this relating to local government projects. This is equivalent to around three per cent of the Scottish Government's revenue budget. By 2024/25, annual unitary payments for projects completed and currently in progress, will peak at over £1.1 billion in cash terms. The increase in these annual commitments will reduce the level of funding available to spend on services and activities in the future.

55. In January 2011, Audit Scotland recommended that the Scottish Government should set out an overarching capital investment strategy to help identify the long-term needs and constraints and to provide key information to help Scottish ministers decide on priorities within the capital programme.[30] Such a strategy should include an assessment of the private finance options available to it.

56. In recent years, councils have been borrowing more to fund capital expenditure resulting in total borrowing of £9.4 billion in 2009/10.[31] Between 2004/05 and 2009/10, councils' level of borrowing for capital spending increased from 27 per cent to 63 per cent of annual capital spending. There is wide variation in the amounts borrowed by individual councils, reflecting different approaches to pay for capital spending. Borrowing requires the repayment of principal and interest, and therefore has long-term implications for council finances, in particular, the affect increased repayments have on future budgets. Therefore, it is necessary that each council assesses the long-term financial sustainability of borrowing to ensure that plans are affordable and in accordance with professional good practice.[32]

The level of backlog maintenance and repair continues to rise

57. A number of Audit Scotland reports have highlighted that there is an urgent need to address the increasing level of maintenance and repair backlog in the public sector estate. For example, the cost of eliminating all defects in Scotland's roads is estimated to cost at least £2.25 billion. In our February 2011 report, *Maintaining Scotland's roads*, we reported that road construction inflation, at around eight per cent a year, was considerably higher than general price inflation over the last five years. This meant that the purchasing power of the money available for road maintenance had fallen. Given that the price of oil has a significant bearing on road construction costs, it is reasonable to suggest that road construction inflation will continue to exceed general price inflation over the next few years.

29 *The Government Economic Strategy*, Scottish Government, November 2007 and *The Scottish Economic Recovery Plan*, Scottish Government, February 2011.
30 *Management of the Scottish Government's capital investment programme*, Audit Scotland, January 2011.
31 *An overview of local government in Scotland 2010*, Audit Scotland, January 2011.
32 Councils are required to adhere to a professional code developed by the Chartered Institute of Public Finance and Accountancy in determining borrowing levels relating to their capital investment programme.

58. The cost of removing backlog maintenance in council-owned property assets is around £1.4 billion, with £376 million of this described as urgently required.[33] Almost a third of the NHS estate needs major upgrading, with over £500 million required to address all outstanding estate maintenance issues over the coming years.[34] Most councils and NHS bodies have investment plans in place to address the maintenance backlog in their property assets. However, significant reductions in the capital budget mean that it is unclear how long it will take to implement these plans in full.

Environmental pressures have significant cost implications for public bodies

Energy and fuel costs will rise over the next ten years

59. In December 2010, an Audit Scotland report found that there has been little change in public bodies' energy use in recent years but spending has increased. Between 2006/07 and 2008/09, public sector spending on energy increased by 21 per cent in real terms to £322 million.[35] Electricity and gas prices rose by an average of 28 and 30 per cent respectively over these three years and, although there was a fall in 2009/10, energy prices are forecast to rise again over the next ten years. Energy costs will therefore be a significant financial pressure. While this raises the importance of introducing energy efficiency measures, declining budgets may mean it will be difficult for public bodies to undertake significant spend-to-save investment in this area.

60. Many public bodies face ongoing cost pressures created by increasing fuel costs. Since 2001, fuel costs have risen by 52 per cent to an average of 120 pence per litre during 2010.[36] The UK Department of Energy and Climate Change estimates that fuel costs will continue to rise over the next ten years by as much as 35 per cent to an average of 162 pence per litre in 2020.[37] Other than limiting the amount of vehicle usage, which may affect services, it may be difficult for public bodies to significantly reduce their spending on fuel.

Emission reduction targets are challenging

61. The Scottish Parliament has set ambitious targets to reduce emissions.[38] Scotland aims to reduce annual emissions with the result that emissions will be 42 per cent lower in 2020 and 80 per cent lower in 2050 compared to 1990 levels. The intermediate 2020 target is more challenging than those set for the UK as a whole and for the European Union, which aim to reduce emissions by 34 per cent and 20 per cent respectively by the same date.

62. The Scottish Government considers there is a significant economic advantage in Scotland being a leader in establishing an economy based on lower greenhouse gas emissions. The most recent estimate of the costs of meeting these targets over the next decade is around £8 billion.[39] If Scotland's targets are to be achieved, these costs will have to be met during a period of declining budgets and increasing demand for public services. Audit Scotland will publish a report on reducing greenhouse gases later in 2011.

33 *Asset management in local government*, Audit Scotland, May 2009. Only 23 councils were able to report the size of their backlog.
34 *Asset management in the NHS in Scotland*, Audit Scotland, January 2009. Based on information supplied by 16 NHS bodies.
35 *Improving energy efficiency – a follow up report*, Audit Scotland, December 2010.
36 *Quarterly Energy Prices*, Department of Energy and Climate Change, June 2011.
37 *Energy and emissions projections*, Department of Energy and Climate Change, June 2010.
38 Climate Change (Scotland) Act 2009 asp 12.
39 *Independent Budget Review: The Report of Scotland's Independent Budget Review Panel*, July 2010.

Part 3. Addressing the challenges

Good workforce planning is necessary to ensure that the right people and skills are available to deliver effective public services in the future.

Key messages

- Public bodies will need to make substantial in-year savings if balanced budgets are to be achieved in 2011/12. Most bodies surveyed have been able to agree a balanced budget for 2011/12 but there is a risk that required savings may not be realised. There is also a risk that unforeseen pressures will emerge during the year, which may reduce further the ability to generate savings.
- The need to reduce costs provides public bodies with an opportunity to reform and streamline public service delivery. However, in doing so, bodies must focus on long-term financial sustainability. This requires a clear understanding of the organisation's costs, including how different activity levels affect costs, and a clear methodology for setting budgets based on priorities and the outcomes to be achieved. Strong leadership and governance are vital if actions are to be successful.
- Pay restraint and reducing workforce levels are the most common approaches being taken by public bodies to reduce costs over the next few years. Many bodies have already reduced staff levels through recruitment freezes or voluntary early release schemes and further reductions are planned. Good workforce planning is necessary to ensure that the right people and skills are available to deliver effective public services in the future.
- Public bodies are considering how they can work better together as a way to reduce costs. While a number of initiatives are being planned to increase working together, sharing resources and involving voluntary and private organisations, progress to date has been limited. It is likely to be a number of years before cost savings are realised.

63. This part of the report provides an overview of how public bodies are planning to address the financial challenges outlined in Parts 1 and 2, and some of the key issues and risks that public bodies must address. How public bodies are managing with reduced budgets will continue to be a key area for audit focus over the next few years.

64. Our analysis is based on summary information received from a sample of 47 public bodies from across the public sector, with a combined expenditure of £17.7 billion. The information was provided between January and April 2011, at a time when public bodies were still finalising their 2011/12 budgets. We supplemented this with more detailed information from a sub-set of 24 bodies in our sample in April 2011, which included 12 local authorities, seven NHS boards and five central government bodies. The list of bodies in our sample is included in Appendix 2.

Public bodies need to focus on achieving long-term financial sustainability

65. Public bodies face a period of declining budgets covering several years. To meet this challenge, public bodies need to look beyond the short term and think more radically about how to take cost out of the business in the longer term. Cutting spending effectively requires public bodies to take a strategic approach to assessing the impact of spending reductions on the quality and quantity of services that can be delivered for the money available. At the same time, they need to avoid reducing service quality and quantity in priority areas. Public bodies need to present balanced budgets, which involves generating in-year savings. Savings decisions must also focus on achieving long-term financial sustainability while taking account of the organisation's aims and objectives and the outcomes to be delivered. This requires reducing costs based on:

- a clear understanding of the organisation's costs including the distribution and profile of costs, and how costs differ with changes in activity
- a clear methodology for setting budgets based on the priority of services to be delivered.

Public bodies need to develop a better understanding of their costs

66. Previous Audit Scotland reports have indicated that public bodies often do not have a clear understanding of their cost drivers. For example, *Improving public sector efficiency* found that public bodies were generally aware of the total costs of their services and budgets are monitored regularly. However, there were variations across the public sector and within public bodies on understanding unit costs and monitoring how costs differ with changes in activity. Out of a sample of 15 bodies, it was found that all had baseline information on costs but lacked unit cost information to help them measure improvements in productivity.

A priority-based approach to budget setting can help determine where expenditure should be reduced

67. There are a number of established approaches to budget setting. The simplest method involves an incremental approach whereby the previous year's budget is adjusted for inflation and other known factors such as increasing demand for services. This approach assumes the current pattern of spending is broadly right and that activities will continue on the same basis. An incremental approach can work when financial resources are stable and change is gradual and planned. However, it does not help prioritise spend or reduce costs in times of financial restraint. Nor does it provide incentives to promote better ways of working or new ideas.

68. A priority-based budgeting approach focuses on the delivery of priority outcomes and allocates money to those services or areas which make the greatest contribution to delivering these outcomes. The process requires an effective understanding of which services contribute most and least to the organisation's priorities. This approach means services or activities which contribute least to outcomes may be reduced or withdrawn. A priority-based budgeting approach therefore helps managers, board members, non-executive directors and elected members take decisions about where spending cuts can be made against a clear background of the consequences of these cuts.

69. While priority-based budgeting may take place in an informal way, our survey indicated that few public bodies have so far undertaken a structured approach to budget setting in this way. An example of a public body that has recently gone through this process is Aberdeen City Council. The council introduced a priority-based approach to budget setting in 2010 to help address a potential budget shortfall of £120 million over the four years to 2014/15 (Case study 1).

Case study 1

Priority-based budgeting in Aberdeen City Council

Aberdeen City Council (ACC) developed a priority-based approach to its budget setting in 2010 to determine future service commitments and costs over the four years to 2014/15. The approach, based on scenario planning, was designed to address a potential budget shortfall of £120 million over this period, which was largely due to an estimated 19 per cent increase in the cost of providing services at a time when budgets are reducing.

A five-stage process was adopted which involved:

- Developing an understanding of the significant areas of spend and forecasting the cost and demand pressures which may arise over time.
- Mapping costs to ACC's strategic priority outcomes and identifying areas of spend where the contribution to priority outcomes was marginal and where decisions were therefore required about future spending.
- Developing options for action in respect of each area based around: improving efficiency; transforming how the service was delivered; and stopping or reducing the service provided.
- Testing the feasibility and benefits of each option throughout the process.
- Agreeing a package of efficiency and transformation options and a prioritised list of stop or reduce options to take forward.

Around 200 services were reviewed as part of this process and over 750 options identified. Using this approach, ACC has identified potential savings of around £127 million over the next five years from:

- improved efficiencies
- transforming how the service is to be delivered
- stopping or reducing service delivery.

Source: *Priority Based Budgeting: Final Draft Report*, Aberdeen City Council, October 2010

Public bodies need to make substantial in-year savings if balanced budgets are to be achieved in 2011/12

70. Analysis of 24 public bodies indicated that, at the beginning of April 2011, 22 of them have been able to agree a balanced budget for 2011/12.[40] Although this represents only a small proportion of all public bodies, two bodies within the sample reported funding shortfalls totalling £11 million.[41] While we have not assessed the robustness of these budgets, or the extent to which they will allow agreed targets and outcomes to be achieved, it is clear that their delivery is dependent on public bodies' ability to generate substantial savings in a number of areas within the year. Balanced budgets may also be at risk if the cost pressures outlined in Part 2 of this report are greater than expected or if any other unforeseen cost pressures emerge.

71. Public bodies' ability to balance their budgets is also made more difficult by a number of external factors which could limit the potential to plan for and make savings. For example, over 70 per cent of public bodies in our survey reported that legislation and the requirement to deliver all statutory functions restricted their scope to make significant savings. Public bodies also referred to other factors that reduced their flexibility to make savings, including commitments to no compulsory redundancies in the central government and health sectors.

72. Overall, public bodies face a number of challenges and risks to achieving financial sustainability while continuing to deliver priority services and outcomes. Some of these risks are highlighted in the table opposite.

40 The 24 bodies are outlined in Appendix 2.
41 At the time of our audit the Scottish Police Services Authority and Historic Scotland had not been able to present a balanced budget for 2011/12.

Key risks
Financial sustainability

Key risks to achieving financial sustainability	Potential reasons why the risk may occur
Higher costs compared to other public bodies for providing similar services. Actual costs are higher than expected due to increases in activity.	Lack of information about the costs of services provided and how costs are affected by changes in activity. Previously unidentified cost pressures.
Budget reductions concentrated on service areas of higher priority. Failure to deliver priority outcomes. Inefficiencies remain within the system.	Lack of a clear methodology for setting budgets based on an analysis of the outcomes to be delivered. Lack of a risk and evidence-based cost-reduction strategy. Lack of staff and senior management ownership of savings plans.
Savings plans not delivered resulting in costs exceeding budgets. Action to reduce spend results in decline in service quality and quantity.	Unachievable or over-optimisitic savings plans. Lack of a clear methodology for setting budgets based on an analysis of the outcomes to be delivered. Lack of a risk and evidence-based cost-reduction strategy. Previously unidentified cost pressures.
Spending to meet requirements may have knock-on consequences for spending in other key areas. Failure to meet requirements may result in financial penalties or higher future costs.	Ineffective use of third party providers to help contribute to meeting with legislation, statutory and ministerial commitments. Ineffective planning or use of resources. Over-committing on levels of borrowing to finance current plans at the expense of future plans when repayments are required.

Workforce reductions are likely to be a significant source of savings

73. Our survey indicated that public bodies consider that workforce reductions are likely to form a significant proportion of the overall savings. As well as the widespread pay freeze which now exists across the public sector in Scotland, virtually all of the public bodies in our survey sample are not replacing staff who leave as a result of natural turnover, except in exceptional circumstances where essential skills are required.

74. Most public bodies surveyed are also considering reducing their workforce through redundancy or early release schemes.[42] In the local government and central government sectors this is mainly being done through voluntary early release arrangements (VERA). At the time of our survey, nearly half of local government bodies and a fifth of central government bodies surveyed were also considering compulsory redundancy, to reduce their staffing levels in future.[43] Only around 60 per cent of health bodies surveyed indicated that they were considering voluntary redundancy schemes. This may be because NHS boards have so far been largely protected from budget cuts. However, NHS bodies have still reduced workforce numbers in 2010/11, and have a target to reduce the number of senior managers by 25 per cent over four years.[44]

Public bodies reduced their staff numbers in 2010/11 and further reductions are likely in the future

75. Our analysis of 24 public bodies indicated that all, except one, reduced their staffing levels during 2010/11. The majority of reductions were made through natural turnover and VERA schemes. All VERA schemes incur severance costs depending

42 Public bodies are operating a variety of voluntary redundancy and early release schemes. In general, voluntary redundancy is offered to those under 50 years of age and involves the payment of a lump sum based on person's salary and number of years' service. Early retirement is offered to those aged over 50 years, where a payment is made to a person's pension fund which they then get access to.
43 Our survey was conducted between January and April 2011.
44 Scottish Government news release, October 2010.

on an employee's age, salary and length of service. Central government bodies and local authorities are responsible for determining their own arrangements but NHS bodies are required to follow standard policies outlined in the NHS Agenda for Change agreement. The reported estimated payback period for voluntary staff reductions ranged from between one and five years. Exhibit 9 provides some examples of staff reductions in 2010/11.

76. Most public bodies surveyed also reported that they plan to further reduce staff levels in 2011/12 and beyond (Exhibit 10). However, at the time of reporting, many had yet to quantify what the reductions will be and any associated severance costs. Public bodies provided a number of reasons for this:

- Uncertainty of budgets beyond 2011/12.
- Limited funds to pay severance costs in 2011/12 and beyond.
- The pattern of staff reductions in 2010/11 and the need to consider how this will affect workforce planning in future years.
- Undetermined staffing level requirements to deliver public services in the future.
- Scottish Government policy of no compulsory redundancies in central government and the NHS.
- Uncertainty, when the organisation's future is subject to proposed mergers.

Implementing staff reductions requires careful planning

77. The desire to make financial savings through reducing staff numbers can represent a risk unless it is properly managed. While public bodies may currently be reliant largely on natural turnover and voluntary release/retirement schemes to reduce staff numbers, this could result in the wrong staff leaving. Risks could arise from the failure to assess the impact of staff reductions on each service area leading to:

- the loss of essential skills and corporate knowledge
- reductions in the quality of priority services, at least in the short term

Exhibit 9

Examples of staff reductions in 2010/11

Most public bodies reduced staffing levels in 2010/11. The main areas affected by staff reductions in councils[1] are in education and social work.

Body	Staff reductions (individuals)	Staff reductions as percentage of FTE (see Appendix 2)	Main methods used to reduce staff numbers	Associated severance costs	Areas most affected by staff reductions
Renfrewshire Council	699	9%	Natural turnover, voluntary early release and retirement	£22.7m	249 education (33 teachers) 231 social work
Dundee City Council	336	5%	Natural turnover, voluntary early release and retirement	£5.1m	120 education (90 teachers) 46 social work
South Lanarkshire Council	117	1%	Natural turnover, voluntary early release and retirement	£4.6m	52 grade 3 staff 34 senior teachers (deputy heads and principals)
Aberdeen City Council	402	5%	Natural turnover, voluntary early release and retirement	£8.1m	Education, culture & sport
NHS Greater Glasgow and Clyde	880*	3%	Natural turnover, voluntary early release and retirement	£0.6m	507* nursing staff, 333* admin and support staff, 40* management
Scottish Prison Service	12	0.3%	Natural turnover, voluntary early release and retirement	£0.07m	Non-prison staff

Notes:
1. Councils formed the highest proportion of bodies in our sub-sample.
* Full-time equivalent.
Source: Audit Scotland

- increased pressure on remaining staff
- lack of motivation among remaining staff to innovate, change or do more.

78. A number of councils and NHS boards reported the loss of senior staff through planned retirement, voluntary retirement or VERAs, particularly in key areas such as finance. NHS Greater Glasgow and Clyde, NHS Grampian, the City of Edinburgh Council and South Lanarkshire Council have all either recently lost, or will shortly lose, senior finance staff as a result. These people have often spent many years working in the public sector and have accumulated significant corporate knowledge and experience, which will be difficult to replace in the short term. The loss of key financial skills is a significant risk to public bodies as they come to terms with reduced budgets.

79. Reducing staff levels may also present a risk to the quality of service performance. Exhibits 9 and 10 indicate that education and social work services could bear a significant brunt of council workforce reductions, with some councils already reducing staff in these areas. While these service areas are traditionally big employers, without a managed approach to workforce reductions this could put the future delivery of these services at risk. This is particularly the case in social care services where future demand is likely to increase as a result of an ageing population.

80. There is a need to ensure actions to reduce workforce numbers are combined with a robust analysis of what a public body's current and future service priorities are, the demands and public expectations likely to be placed on them, and the numbers of staff and the range of skills they need to deliver these services. A key factor is to consider the flexibility of the staff who remain and the amount of investment in training required to re-deploy these staff to fill any gaps created.

81. In addition, public bodies need to be alert to the potential for additional pressure to be placed on the remaining staff who will need to compensate for reduced staff numbers. Pressures arising from additional responsibilities or extra workload could result in increased sickness absence or low staff morale. In the year to September 2009, the UK public sector lost 8.7 days per staff employed due to sick leave, around 2.3 days per person more than in the private sector.

82. Staff morale may be adversely affected as some public bodies may seek to renegotiate the current employment terms and conditions for

Exhibit 10

Examples of planned staff reductions in 2011/12 and beyond[1]

Further staff reductions will occur in 2011/12 and beyond, although only a minority of bodies have quantified the number of staff affected.

Body	Total	Time period	Main methods used to reduce staff numbers	Areas most affected by staff reductions
Fife Council	1,136	2011/12 to 2013/14	Natural turnover, redeployment	342* environment and development 284* social work
Glasgow City Council	1,061	2011/12 and 2012/13	Natural turnover, voluntary early release and retirement	839 land & environment services 231 development & regeneration (includes those who left in 2010/11)
The Highland Council	650*	2011/12 and 2012/13	Natural turnover, voluntary early release and retirement	196* education & children 150* business support 108* social work
NHS Dumfries & Galloway	115	2011/12	Natural turnover	
NHS Lothian	750	2011/12	Natural turnover	
Scottish Ambulance Service	114*	2011/12 and 2012/13	Natural turnover	99* patient transport services, 15* management and support services

Notes:
1. Different patterns are likely to emerge over this period reflecting the various stages individual bodies are at in relation to workforce reduction plans.
* Full-time equivalent.
Source: Audit Scotland

remaining staff, which may result in lower reward packages or changes to employment conditions. Public bodies may find it difficult to motivate remaining staff to do more, be innovative or implement the changes needed for future service delivery.

Public bodies are looking at how to do things differently with less money and fewer staff

83. Before the scale of budget reductions became clear, public bodies had been reviewing how they deliver services in order to do more with less. The Scottish Government has regarded public sector reform as a driver of change since June 2006.[45] While a key objective of the public sector reform agenda was to make public services more user-focused, it was also intended to improve efficiency and productivity. The Independent Budget Review Panel and Audit Scotland have reported that the current efficiency targets in place will not be enough to bridge the gap between future spending and funding.[46] The current budget constraints therefore need to be seen as an opportunity to provide further impetus to the reform of public services.

Key risks
Workforce reductions

Key risks to workforce reductions	Potential reasons why the risk may occur
Reduced leadership skills and professional competence to manage with lower budgets.	Loss of essential skills and corporate knowledge.
Reduced quantity and quality of service delivery.	Unmanaged reductions resulting in staff shortages in key service areas.
Lower morale and increased sickness absence. Lack of motivation among remaining staff to innovate, change and do more.	Increased workload for remaining staff as a consequence of staff reductions. Lower reward packages.
Benefits may not be achieved in the time required. Lack of commitment from existing staff to be re-trained or re-deployed to other posts.	Cost and time commitment of re-training and re-deployment. Higher than expected associated costs of reducing workforce levels. Longer than anticipated time taken to make changes happen.

Public bodies are considering how they can better work together although progress to date has been limited

84. A key expectation of the public sector reform agenda was to improve the users' experience through a more joined-up approach to service delivery, either from public bodies working more closely with other public bodies or by working with the private and voluntary sectors. Joint working can cover a wide range of activities including:

- **Working together:** public bodies working in partnership in pursuit of common objectives or outcomes either through their own informal initiatives or through established structures such as Community Planning Partnerships (CPPs) and Community Health Partnerships (CHPs).
- **Sharing resources:** public bodies sharing either front-line service provision or back-office functions such as IT services; merge functions to form a new body which takes on the combined responsibilities of its predecessors; or share assets to make better use of them.
- **Involving others:** public bodies contracting with a third party, such as a voluntary or private organisation, to deliver services.

85. Many joint working arrangements were in place prior to the current budget reductions. However, public bodies surveyed indicated that budgetary pressures mean that more joint working is being considered as a means to reduce costs. The time taken to plan and implement joint working arrangements can be extensive. Only a third of bodies surveyed have so far agreed how to make progress, or have actions in place, to introduce more joint working.

Greater partnership working is planned but, so far, evidence of improved service delivery and reduced costs is limited

86. There are a number of approaches being taken to improve partnership working among public bodies. As part of the NHS Reform (Scotland) Act 2004, CHPs were established to bridge the gap between primary and secondary health care, and between health and social care. CHPs

45 *Transforming Public Services*, Scottish Executive, June 2006.
46 *Independent Budget Review: The Report of Scotland's Independent Budget Review Panel*, July 2010 and *Improving public sector efficiency*, Audit Scotland, February 2010.

were expected to coordinate the planning and provision of primary and community health services in their area. Audit Scotland recently reported that the 36 CHPs in Scotland vary in size, role, function and governance arrangements. Two different types of CHP have evolved; a health-only structure and an integrated health and social care structure. There is no evidence of one structural approach being better than the other in moving services from hospital to the community or joining up front-line health and social care services.[47]

87. The Local Government (Scotland) Act 2003 requires councils and partner organisations to develop a coordinated approach to identifying and solving local problems, improving services and sharing resources through community planning arrangements. CPPs were established as the key over-arching partnership and were expected to help coordinate other initiatives and partnerships and, where necessary, rationalise these. Audit Scotland published an initial review of community planning in 2006 and will publish a further report on CPPs later in 2011.[48]

88. The establishment of partnership working arrangements does not always have to be as a result of new legislation. Informal joint working arrangements also exist within the public sector. For example, NHS Highland and The Highland Council plan to integrate their adult and children's care services through a lead agency model. The single lead agency arrangements will result in both organisations being jointly accountable for determining the outcomes to be achieved for service users and the resources to be committed. However, the lead agency will assume responsibility for all aspects of delivery, strategy, internal governance, operational delivery or commissioning of services and be fully accountable for the delivery of the agreed outcomes. NHS Highland will lead on delivering adult services and The Highland Council will lead on delivering children's services. The plan is expected to be implemented in April 2012.

89. Partnership working is not just restricted to working with other organisations. Engaging effectively with service users provides an opportunity for organisations to tailor services to meet users' needs as well as generating efficiency savings. For example, Glasgow City Council plans to save £13 million over 2011/12 and 2012/13 on the personalisation of services for 4,600 users with mental health problems, learning or physical disabilities. In doing this, the council also aims to give users access to a wider choice of services and for them to take more control over how their support is provided. Personalisation involves allocating service users a budget. Users can then buy alternatives to the traditional care provided so long as the budget is used to meet the outcomes identified in their support plan.

Working together has the potential to improve services and reduce costs but risks need to be overcome

90. Greater joint working between public bodies and with the private and voluntary sectors has the potential to improve services through an increased focus on the user. Depending on financing arrangements, it may also help generate efficiencies although it is unlikely these will be realised quickly enough or be sufficient in quantity to meet fully the current budget reductions which are being faced. At the same time, joint working carries with it a number of challenges and risks which must be overcome if it is to be effective:

- Joint working arrangements take time to organise and require personal commitment from partnership leaders and staff.
- There needs to be clear aims and objectives, with clearly defined outcomes for partnership activity.
- Partners need to be clear about their respective accountability arrangements for the use of resources and performance.
- Mechanisms need to be established to agree potential conflicts between partners. For example, there needs to be a clear understanding of how decisions to reduce a service by one body may increase demand for services provided by another body, and clear arrangements to resolve any differences arising.
- Robust governance arrangements and processes need to be in place to ensure that effective financial, risk and performance monitoring can take place.

Some public bodies have arrangements to share resources but evidence of savings is limited

91. Sharing resources provides public bodies with the opportunity to improve performance by making more effective use of their resources. Arrangements to share resources may focus on improving user services by sharing the delivery of front-line services such as education or social work. Alternatively, they may focus on improving the efficiency of back-office functions, such as human resources, finance or IT. Case study 2 (overleaf) provides examples of both front-line and back-office shared service arrangements in Scotland.

92. In November 2009, Sir John Arbuthnott published his report examining existing shared service initiatives and identifying opportunities for further joint working among the eight councils in the Clyde Valley

47 *Review of Community Health Partnerships*, Audit Scotland, June 2011.
48 *Community planning: an initial review*, Audit Scotland, June 2006.

Case study 2
Examples of proposed and existing shared service arrangements

Sharing front-line services – user-focused
In December 2010, Stirling and Clackmannanshire Councils formally agreed to share the delivery of social services and education services. Each council will retain control over policy and service arrangements for their respective areas, although management arrangements will be shared with joint heads of service reporting to each of the two councils' chief executives. The councils believe that shared arrangements will improve outcomes for service users, increase capacity and produce efficiencies. The councils expect savings through a reduction in management posts in both councils and by providing the opportunity to increase joint purchasing of services. The changes are being implemented in 2011/12.

Sharing back-office functions – internal-focused
In 2007, the Scottish Police Services Authority (SPSA) was established to centralise a number of support services to the police, including IT support and forensics, which were previously managed separately by the eight police boards.

In October 2010, Audit Scotland reported that the SPSA had improved the quality, productivity and efficiency of its forensics, criminal justice and training services since it was established.[1] For example, it has reduced the time taken to analyse forensic samples and the Scottish Police College has improved the quality of its training. However, the transfer of ICT services has proved particularly difficult and the SPSA is not yet able to meet all of its customers' ICT needs.

Note: 1. *The Scottish Police Services Authority*, Audit Scotland, October 2010.
Source: Audit Scotland

Community Planning Partnership.[49] He concluded that there was scope to enhance joint working through sharing services in a number of areas, including closer working among local authorities and health boards to create an integrated health and community care service in each local authority area. In October 2010, the eight Clyde Valley councils announced that they were planning to share services in waste management, transport, health and social care, and support services. However, in January 2011, the Scottish Parliament's Local Government and Communities Committee reported that there was evidence that little progress had been made in implementing the Arbuthnott Report recommendations and raised concerns about reforms being driven by short-term budget reductions rather than longer-term public service reform.[50] In August 2011, seven of the eight Clyde Valley councils published a business case for sharing support services including payroll, finance and IT. The business case proposed that sharing support services could generate savings of £30 million a year after five years, but this would require an initial investment of between £28–£31 million over the first five years.[51]

93. In some cases, sharing resources may extend to the formation of new bodies through merging the functions of two or more bodies. Through the Scottish Government's Simplification Programme, some bodies have merged to form a new body or been brought within the Scottish Government. For example, in April 2011, the Scottish Commission for the Regulation of Care and the Social Work Inspection Agency merged to form a new non-departmental public body, Social Care and Social Work Improvement Scotland. The aim of the new body is to provide independent scrutiny of care and children's services in Scotland. Initial costs of establishing the new body were estimated to be between £4.2 million and £7.2 million, with annual recurring savings of £2 million expected from 2011/12 onwards.[52]

94. As at April 2011, the number of public bodies had reduced from 199 to 147. Audit Scotland's report on *The role of boards* commented that although the Scottish Government has made progress with its public sector reform agenda, the public sector landscape is still complex with a number of different types of body. The make-up of boards and their role has evolved over time rather than as a result of any objective evaluation of the best model of public accountability.[53]

95. Sharing resources does not need to include organisational changes. Sharing or rationalising the use of buildings, vehicles, IT resources and other assets can help generate significant savings on accommodation, maintenance, utility and fuel costs. The reduction in the size of the public sector workforce provides further opportunities to generate savings by reducing accommodation requirements or entering into arrangements to share assets with other organisations.

96. In June 2011, Sir John McClelland completed a review of the management of IT investment in

49 *Clyde Valley Review*, Sir John Arbuthnott, December 2009.
50 *Report to the Finance Committee on Scotland's Spending Plans and Draft Budget 2011/12*, Scottish Parliament, January 2011.
51 *Detailed Business Case Executive Summary*, Clyde Valley Shared Support Services, August 2011. The seven councils were East Dunbartonshire, East Renfrewshire, Glasgow, Inverclyde, North Lanarkshire, Renfrewshire and West Dunbartonshire.
52 *Public Services Reform (Scotland) Bill (Financial Memorandum) as introduced*, Scottish Parliament, May 2009.
53 *The role of boards*, Audit Scotland, September 2010.

the Scottish public sector on behalf of the Scottish Government.[54] The review highlighted opportunities for improving the quality of services through better use of IT and concluded that a fundamental shift is required in planning IT investment, which is estimated at £1.4 billion in 2008/09. In particular, the public sector should move towards sharing IT investment planning among public bodies. An example of this is the recently procured NHS HR system, designed to be used by all NHS bodies covering functions such as payroll, attendance management, staffing arrangements and training administration. The review recommended that the Scottish Government should implement a transformation programme for IT investment. In this way, savings from more effective investment in IT could provide a cumulative saving over five years of between £870 million and £1 billion.

97. Around £9 billion is spent each year on procurement across the public sector in Scotland. In November 2010, the Scottish Government reported that almost £800 million of savings had been made since 2006/07 through improvements in public sector procurement.[55] The savings, generated as part of the Procurement Reform Programme, include £76 million from Scottish Government-led procurement through the establishment of Procurement Scotland and Central Government Centre of Procurement Expertise. A further £200 million in savings from Scottish Government-led procurement over the next three years to 2013/14 is expected from a range of collaborative contracts including corporate and professional services, IT, e-commerce and office equipment.

98. Many public bodies have become more involved in collaborative procurement in recent years. Although savings are being achieved more slowly than anticipated, the level of cross-sector working has improved.[56] For example, since October 2009, the Scottish Government has been responsible for managing national contracts for the supply of electricity and gas to the public sector. The Scottish Government buys energy on behalf of public bodies before the start of each financial year to help bodies manage the risk of buying energy in an unpredictable market. All councils and NHS boards and 33 central government bodies have signed up to these contracts. The Scottish Government estimates that the contracts will make savings of between £10 and £15 million each year across the whole public sector – around five per cent of the amount spent by public bodies on energy.[57]

99. In 2009, the Scottish Futures Trust, on behalf of the Scottish Government, launched the Hub initiative aimed at increasing joint working and use of community assets across the public sector. The initiative is responsible for delivering £1 billion worth of new community assets over the next ten years, which will be paid from revenue budgets on a 'pay-as-you-use' basis. Assets include GP surgeries, physiotherapy and other outpatient clinics, social work and library facilities. It is being implemented across five areas in Scotland, with pilots established in the South-east of Scotland and North of Scotland areas. In each area the participating public bodies team up with a private partner to form a new joint venture company known as a 'hubco', which will be responsible for delivering a number of projects over the next ten years. While projects will mostly be new buildings, they may also include refurbishment of existing infrastructure and asset management services.

100. While there are some examples of existing and proposed shared service arrangements in Scotland, progress has often been slow and there is a lack of clear evidence of the benefits it can bring. In 2009, the Improvement Service carried out a review of major shared service arrangements in Scotland, the rest of the UK, and abroad.[58] It found that service and cost benefits could be achieved but:

- public sector back-office shared services do not generally deliver a positive return in less than five years
- building and maintaining workable relationships among organisations within and across sectors is a major long-term commitment that can be fragile and volatile
- plans are often over-optimistic, managing change is under-estimated and costs can escalate significantly.

Using third parties to deliver services has advantages but they also face financial pressures

101. There are a number of ways that public bodies can deliver services by involving other sectors, eg using the private sector, voluntary sector, social enterprises and mutuals. Done well, outsourcing allows the purchase of expertise and access to specialist knowledge, transfers risk to the delivery partner and may be cheaper than providing a service in-house. However, outsourcing needs to be managed carefully and with due diligence to ensure the provider has the capacity to deliver both now and in the longer term.

102. The public sector already makes extensive use of voluntary organisations to deliver services. The most recent available figures show

54 *Review of ICT Infrastructure in the Public Sector in Scotland*, Scottish Government, June 2011.
55 *Efficiencies from procurement*, Scottish Government, November 2010.
56 *Improving public sector purchasing*, Audit Scotland, July 2009.
57 Based on 2008/09 spend on energy. *Improving energy efficiency – a follow-up report*, Audit Scotland, December 2010.
58 *Review of major shared services initiatives*, Improvement Service, 2009.

that public bodies pay the voluntary sector around £1.9 billion each year, around 42 per cent of the sector's annual income.[59] Over half of this is spent on social care and development services with a further 12 per cent on economic development services and 11 per cent on healthcare services. Although many voluntary organisations operate independently, a large number are wholly reliant on public sector funding.

103. The voluntary sector has raised concerns about the financial pressures it faces as a result of public bodies seeking to implement budget cuts by reducing payments to voluntary organisations. Similar to the public sector, many voluntary organisations have already imposed pay freezes and reduced staff numbers, which may affect their ability to provide the levels of service required. A strategic review about what and how services should be delivered across the public and voluntary sectors would help focus the service provision and outcomes voluntary organisations are expected to deliver.

104. Transferring services to a private sector provider is common where specialist knowledge is required, for example, IT services. This provides access to the latest IT knowledge and software applications, without having to recruit specialists on a permanent basis. However, each outsourcing contract needs to have appropriate governance, monitoring and performance management arrangements to ensure effective delivery of the service. Case study 3 provides two examples of public bodies outsourcing IT services to the private sector.

105. Many councils use arm's-length and external organisations (ALEOs) to provide some of their services. ALEOs are now an established part of local government in Scotland and play an increasing role in service delivery. The main drivers for using ALEOs are

Case study 3
Outsourcing IT services

From 1 April 2010, Scottish Enterprise worked in partnership with Skills Development Scotland to jointly outsource its IT provision to a private sector provider. This included the transfer of staff to the new service provider and is expected to generate savings of £2 million per year.

The Highland Council has also outsourced provision of its IT services to the private sector. The contract is expected to generate savings of £1.3 million in 2011/12 and an estimated total saving of £6.8 million over the five-year contract.

Source: Audit Scotland

Key risks
Reforming public services

Key risks to reforming public services	Potential reasons why the risk may occur
Difficulties in measuring and assessing performance. Focus on dealing with current problems rather than longer-term issues. Disputes and areas of conflict between partners.	Unclear aims and objectives. Poor governance and accountability arrangements. No procedures in place to reconcile any differences that may arise. Lack of clear roles and responsibilities. Lack of clear arrangements for the use of resources.
Inertia among staff and stakeholders in relation to reform.	Weak leadership resulting in lack of direction while setting a poor standard for the rest of the organisation. Poor communication between leaders and staff and other stakeholders. Constructive challenge discouraged.
Bodies delay decision-making over taking action. Benefits are not received for a considerable amount of time.	Uncertainty over time and cost commitments. Poor planning and appreciation of the scale of change required. Initial cost and time commitments of planning and implementing new arrangements.
Quality of service may decline rather than improve. Level of service may be unintentionally reduced. Reforms may not meet the needs of service users. The burden of service provision is unintentionally passed to other public bodies.	Poor coordination between bodies involved and wider public sector. Little or ineffective consultation with service users. Insufficient monitoring and scrutiny of performance.

59 *Scottish Voluntary Sector Statistics 2010*, Scottish Council for Voluntary Organisations, May 2010.

to reduce costs or to deliver more focused services. ALEOs may qualify for business rates relief, attract grants or may be able to trade to generate income. However, a recent Audit Scotland report, *Arm's-length and external organisations: are you getting it right?*, highlighted a number of risks including, high set-up costs, risks with governance arrangements and the potential lack of a clear value for money test.[60]

Strong leadership and governance are vital to deliver the financial savings required

106. There is a clear need for public sector managers to show strong leadership over the next few years as they make difficult decisions about the future shape and role of public services. Key groups such as boards, audit committees and elected members all have a role in overseeing the financial, risk and performance management activities in public bodies and it is important that they operate as effectively as possible to monitor these activities.

107. In September 2010, Audit Scotland reported that strong leadership and clearer accountability is needed for Scotland's public bodies during periods of reduced budgets. *The role of boards* report found that accountability arrangements can be complex, with chief executives and boards reporting in different ways to the Scottish Government, ministers and the Scottish Parliament. This may cause confusion about who leads an organisation and is responsible for its decisions.[61] The report highlighted that board members need to scrutinise rigorously their organisation's risks, financial management and performance and need to be able to make decisions based on clear evidence about the priorities for the body. Successful arrangements depend on having boards with a mix of people with the right skills and expertise.

108. The ability to drive through the necessary changes will involve increasing flexibility, identifying innovative approaches to how services are provided and breaking down traditional barriers to make change work effectively. Above all, there is a need for leaders to focus on the longer term, as well as short-term budget reductions; to ensure that priorities are clear and well communicated; decision-making is open and transparent; constructive challenge is encouraged; and high standards of conduct and performance are expected and delivered.

109. A key requirement is the provision of timely, relevant and understandable information on the costs of services and what outputs and outcomes are delivered. Leaders need to have good information in order to challenge proposed budgets and monitor progress and impact over time. In his report on the 2009/10 audit of the Scottish Government Consolidated Accounts, the Auditor General noted the importance of providing the Scottish Parliament with high-quality and detailed financial information so that it can exercise adequate scrutiny of the proposed budget.[62]

110. The report concluded there was scope to improve the clarity of reporting on the reasons for proposed budget changes and also the reasons for variances in outturn against budget. While the report commented on the Scottish Parliament's scrutiny of proposed budgets, the principle of providing decision makers with detailed information on proposed budgets, and using previous years' outturn to inform scrutiny of subsequent years' budgets, applies across all sectors and individual public bodies.

Key risks
Leadership and governance

Key risks to effective leadership and governance arrangements	Potential reasons why the risk may occur
Poor decision-making or delays in decision-making. Leaders become involved in the daily running and operation of the organisation.	Weak leadership setting a poor standard for the rest of the organisation. Lack of direction in new approach taken. Unclear or undefined roles and responsibilities.
Lack of transparency and openness in decision-making. Lack of accountability, scrutiny or challenge for actions taken.	Poor communication within the organisation and with key stakeholders. Lack of timely, relevant and understandable information on proposed budgets. Decisions taken without full consent of all partners. Constructive challenge is discouraged. Decisions are not followed up with timely and effective action.

60 *Arm's-length and external organisations: are you getting it right?*, Audit Scotland, June 2011.
61 *The role of boards*, Audit Scotland, September 2010.
62 *The 2009/10 audit of the Scottish Government Consolidated Accounts*, Auditor General for Scotland, September 2010.

Appendix 1.

Audit methodology

The main focus of our work was to provide an overview of the financial environment facing the public sector in Scotland and the cost pressures currently faced. It was also to outline what public sector bodies are doing to address the challenges and highlight the key issues and risks they face.

It is an interim report and designed to be one in a series of reports on the way public bodies are managing budget reductions. It follows on from *Scotland's public finances – preparing for the future*, published in November 2009, which contained an overview of the financial environment in Scotland at that time. The first report included key questions for the Scottish Government, the Scottish Parliament and the wider public sector to consider when planning the delivery of public services ahead of budget reductions. This report presents a number of risks which public bodies need to consider and manage as they respond to the reductions outlined in the 2011/12 Scottish budget and beyond.

For Part 1 we considered the current financial environment and reviewed the main changes to the Scottish Government's 2011/12 budget compared with 2010/11 highlighting the areas most affected by budget reductions. In Part 2 we reviewed the main cost pressures facing the public sector, reflecting on a number of recent Audit Scotland reports where these have been highlighted. In Part 3 we reviewed how bodies are planning to reduce costs and make savings based on information received from a sample of 47 public sector bodies covering local authorities, health and central government. In doing so, we outlined a number of key issues and risks associated with the challenges faced including risks in public service reform, financial sustainability, workforce reductions and leadership and governance. These risks formed the basis for the development of a checklist for public sector leaders and elected members to consider when planning for long-term financial sustainability (see Appendix 4).

Our audit had three main components:

- An initial data survey of 47 public sector bodies to collect summary information on budget reductions, proposed action, consultation and governance arrangements.
- Additional information request from 24 of the 47 bodies for updated information on budgets for 2011/12, specific cost pressures, joint working arrangements and planned workforce reductions.
- Desk research of existing information in relation to Scotland's public finances.

Data survey

A total of 47 bodies were selected for our data request, including 15 councils, 15 central government bodies, 11 NHS boards (territorial and special), three police boards and three fire boards. Total revenue spending for these bodies in 2010/11 was around £17.7 billion which is equivalent to 68 per cent of that year's total Scottish revenue DEL budget. The sample bodies employed around 259,000 staff in 2010; around 50 per cent of total public sector staff. Appendix 2 provides a list of the bodies included in our sample.

The survey took place between January and March 2011 at a time when budget plans for 2011/12 were being drafted.

Additional information request

A sub-set of 24 bodies was selected from the original survey sample to request additional information relating to budgets, workforce planning, cost pressures and joint working arrangements. The sub-set largely focused on the largest spending bodies, allowing for sufficient coverage in each of the main sectors. This included ten councils, seven NHS boards, five central government bodies, one police board and one fire board. This was carried out in April 2011 at a time when most budget plans for 2011/12 had been approved. Appendix 2 provides a list of the bodies included in our sample.

Both the initial data survey and the additional information requests were carried out by local auditors and agreed with the relevant bodies.

Desk research

We researched existing information in relation to Scotland's public finances, including various Scottish budget documents, the 2010 UK Spending Review, the Independent Budget Review Panel's report and the report by the Christie Commission.

Appendix 2.

List of 47 public bodies included in our survey

Sector and body[1]		Net revenue expenditure budget 2010/11[2] (£'000)	Workforce (FTE)[3]
Local government			
	Aberdeen City Council	450,907	7,478
	Angus Council	264,700	4,700
	Argyll & Bute Council	267,839	4,284
	Dumfries & Galloway Council	388,791	6,205
	Dundee Council	358,633	6,818
	East Dunbartonshire Council	246,078	4,203
	City of Edinburgh Council	995,335	16,341
	Fife Council	840,999	17,387
	Glasgow City Council	1,603,000	21,765
	The Highland Council	607,186	9,894
	North Lanarkshire Council	790,515	14,516
	Orkney Islands Council	85,648	1,787
	Perth & Kinross Council	335,141	5,143
	Renfrewshire Council	422,485	7,344
	South Lanarkshire Council	724,779	13,001
Police			
	Central Scotland Joint Police Board	49,679	1,222
	Northern Constabulary	52,026	1,150
	Strathclyde Joint Police Board	442,800	10,915
Fire			
	Grampian Joint Fire and Rescue Board	29,151	437
	Lothian and Borders Fire and Rescue Board	42,293	1,202
	Tayside Fire and Rescue Board	24,783	542
NHS boards			
	Borders	199,133	2,657
	Dumfries and Galloway	269,270	3,567
	Forth Valley	422,383	5,278
	Grampian	833,300	11,754
	Greater Glasgow and Clyde	2,292,000	34,863
	Lothian	1,292,648	18,855
	Shetland	46,010	487
	Western Isles	70,290	838

Sector and body[1]		Net revenue expenditure budget 2010/11[2] (£'000)	Workforce (FTE)[3]
NHS special boards			
	National Services Scotland	398,924	3,241
	National Waiting Times Centre	107,011	1,301
	Scottish Ambulance Service	197,372	4,114
Central government			
	Crown Office	112,100	1,776
	Forestry Commission (Scotland)	74,200	150
	Highlands and Islands Enterprise	59,250	276
	Historic Scotland	77,508	1,019
	Scottish Children's Reporter Administration	23,801	480
	Scottish Court Service	73,415	1,456
	Scottish Enterprise	309,100	1,100
	Scottish Environment Protection Agency	77,991	1,273
	Scottish Natural Heritage	64,351	774
	Scottish Police Services Authority	107,999	1,624
	Scottish Prison Service	333,100	4,038
	SportScotland	71,878	262
	Transport Scotland	1,000,420	389
	VisitScotland	60,920	753
Other[4]			
	Scottish Parliamentary Corporate Body	76,512	507
	Total	17,673,654	259,166

Notes:
1. Additional information was requested from the 24 bodies in **bold**.
2. Budget information is for illustrative purposes only.
3. All workforce figures are as of March 2010 with the exception of all NHS boards where figures are from September 2010. Workforce figures for local government were taken from Joint Staffing Watch Survey collected by the Scottish Government and COSLA at March 2010. NHS boards' workforce figures are taken from NHS Information Services Division statistics. Central government workforce figures are taken from the respective annual accounts in 2009/10 and refer to average figures within the financial year rather than at year end.
4. The Scottish Parliamentary Corporate Body also participated in our survey. For the purposes of this report we have categorised it as a central government body.

Appendix 3.

Project advisory group membership

Audit Scotland would like to thank members of the project advisory group for their input and advice throughout the audit.

Member	Organisation
Vicki Bibby	Team Leader, Finance, COSLA
Sandra Black	Director of Finance and Corporate Services, Renfrewshire Council
Chris Brown	Partner, Audit and Assurance, Scott-Moncrieff
Sarah Davidson	Director of Public Service Reform, Scottish Government
Campbell Gemmell	Chief Executive, Scottish Environment Protection Agency
Craig Marriott	Director of Finance, NHS Dumfries and Galloway
Cameron Revie	Partner, PricewaterhouseCoopers
David Watt	Director, KPMG

Note: Members of the project advisory group sat in an advisory capacity only. The content and conclusions of this report are the sole responsibility of Audit Scotland.

Appendix 4.

Checklist for long-term financial sustainability for public sector leaders and elected members

Area		Key questions	Assessment	Required actions
The future of public services	1	Are plans to reform public service delivery integrated across the public sector?		
	2	Do plans involve private and third sector providers?		
	3	Does your body have the freedom to innovate and reorganise future services?		
	4	Have future plans been subject to sufficient and ongoing engagement with service users and communities?		
	5	Expectations of public services are growing. Is this fully incorporated into future plans?		
	6	Are current models of joint working such as partnerships and shared service arrangements working effectively?		
	7	Have clear accountability mechanisms been established which clearly set out the roles and responsibilities of those involved in joint working arrangements?		
	8	Is there clarity around financial, risk and performance management arrangements within models of joint working?		
Workforce planning	9	Are workforce plans driven by longer-term analysis of workforce capabilities and requirements as opposed to short-term cost reduction?		
	10	Do workforce plans address the impact of the potential loss of essential skills and corporate knowledge to the organisation?		
	11	Do workforce plans address the risk of staff shortages in key service areas?		
	12	Fewer staff may result in a transfer of service delivery responsibilities to the third sector. Does the third sector have the capacity and skills to take on the increased expectations placed on them and deliver the required service quality?		
	13	Staff reductions are likely to lead to increased workloads for remaining staff. Have workforce plans considered the impact of workforce reductions on the staff who remain?		

Area		Key questions	Assessment	Required actions
Financial sustainability	14	Is there a clear risk and evidence-based approach to cost reduction within public bodies?		
	15	Is there a clear budget-setting plan which focuses on priority outcomes?		
	16	Are public bodies generating sufficient information linking productivity, service quality and costs to help understand the links between inputs, outputs and outcomes?		
	17	Is sufficient attention given to setting clear baselines covering costs, productivity and outcomes against which increased efficiency can be measured?		
	18	Are benchmarking programmes being developed to allow your organisation to compare its costs and performance with other private and public organisations?		
	19	Is sufficient money being spent on asset maintenance and renewal such that the value of public assets is being sustained?		
	20	Less capital funding may result in the construction of new assets using private finance. How much of future revenue budgets is prudent to use on annual unitary payments?		
Leadership and governance	21	Do audit and other scrutiny committees play a suitably prominent role in the consideration of budget plans and risks to service delivery?		
	22	Can leaders demonstrate adequately the impact of budget reductions on service quality and outcomes?		
	23	Are leaders engaging with each other effectively to ensure a coordinated and integrated approach to cost reduction?		
	24	Is there appropriate transparency, openness, accountability and scrutiny of decisions made about cost reduction measures and future organisational plans?		
	25	Are leaders fully committed to plans to reform and reorganise services?		
	26	Do leaders communicate plans effectively with staff, service users, other public bodies and stakeholders?		

Scotland's public finances

Addressing the challenges

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