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**The Prudential Code: flimsy fig leaf in the coming storm**

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**Prudential Code: flimsy fig leaf in the coming storm**

**Introduction**

This paper is concerned with the operation in Scotland of the Prudential Code for Capital Finance in Local Authorities, which has been developed by the Chartered Institute of Public Finance and Accounting (CIPFA). The Prudential Code, which applies to the whole of the UK, underpins a major change in the control of local authority capital expenditure which was introduced in April 2004. Before then, the primary control on local authority capital expenditure in Scotland was the Scottish Government’s control of local authority borrowing, exercised through the issue of borrowing consents. After April 2004, borrowing consents were abolished and authorities have discretion to determine their own levels of capital expenditure and borrowing, provided they abided by the CIPFA code which is designed to ensure that authorities act prudently and sustainably. The Prudential Code was given statutory status in Scotland under the *Local Government in Scotland Act 2003*, and under the *Local Government Act 2003* in England and Wales

Since its introduction, the code has operated without attracting much comment. The purpose of this paper is to examine how the code is operating in practice in Scotland, and to consider its fitness for purpose. This question of fitness for purpose is particularly acute just now, given that it is increasingly clear that the fiscal environment for local authorities will be much more challenging for the foreseeable future than it was when the code was developed.

The primary conclusion of this paper is that the kind of disaggregated system represented by the operation of the code is unlikely to be able to cope with the challenges it will face. There is a manifest danger that local authorities will find themselves over-committed, both in terms of traditional borrowing, and in terms of the contractual commitments they are undertaking through various forms of Public-Private Partnership, (like the Scottish Future’s Trust NPD (Non-Profit Distributing) schemes.) There is also a danger that, if times turn hard, authorities may be exposed to various forms of ‘off balance sheet’ debt, (arising, for example, from Arm’s Length External Organisations, commonly known as ALEOs), which are not adequately captured in the current operation of the code.

The paper makes a number of recommendations: principal among these are:

*1) Local authorities need to work to longer time horizons than many of them are currently using when they are assessing the future budgetary consequences of the capital funding decisions they are making.*

*2) It is not enough to rely on local authorities independently assessing their future expenditure commitments because they may well be making assumptions which are mutually inconsistent.*

*3) What is required is a joint-system, under which local authorities’ independent financial plans are informed by, and in turn, inform, a national assessment of the prospects for the aggregate of local authority budgets.*

*4) It would not be appropriate for central government to attempt to carry out this national aggregate financial projection role so a suitable independent body would have to be commissioned to carry out this role. But central government will have to play its part. In particular, it will have to display much greater maturity than it does at present in being more open about potential long term financial prospects.*

*5) There are a number of more specific issues about the Prudential Code which need to be addressed, in particular, the code should require authorities to be much more open about issues like the financing costs actually being incurred under the guise of public private partnerships.*

The structure of this paper is as follows:

Section 2 deals with background on the prudential code.

Section 3 is more background, and considers the uncertain outlook for local authority finances.

Section 4 deals with a central issue, the question of time horizons.

Section 5 examines some other specific issues.

Section 6 puts forward proposals about what should be done.

Section 7 draws conclusions.

The principal information source accessed during the conduct of this study consisted of copies of the most recent prudential code statements produced by each of the 32 local authorities in Scotland. While these are public documents, I am nevertheless grateful to all authorities for providing copies of these documents on request. I am also grateful for discussions with representatives of CIPFA, and Audit Scotland: and for written views given to me by the Scottish Government. The views expressed here are my own.

**Background on the Prudential Code**

Prior to 1 April 2004, the principal control on local authority capital expenditure had been by specific consents, known as Section 94 consents, issued by the Scottish Government, or, prior to devolution, by the old Scottish Office. These Section 94 consents were, technically, consents which allowed local authorities to spend on capital assets money raised by local authorities themselves. Since the principal means of local authorities raising money for capital expenditure was by borrowing, this effectively amounted to control of capital via the level of borrowing. There were a number of problems with this system. It was felt to amount to undue intrusion by central government into decisions which would better be taken locally: to be unduly restrictive: and the annual cycle of consents did not fit in well with some authorities’ budgetary cycles.

The new regime introduced in 2004 was intended to overcome such problems. The previous limits on local authority capital expenditure were abolished, and local authorities would, henceforth, be free to make their own decisions on capital investment, as long as these decisions were prudent, affordable, and sustainable. The way in which these attributes were to be assessed is that local authorities would have a statutory duty to adhere to the *Prudential Code for Capital Finance in Local Authorities*, developed by the Chartered Institute of Public Finance and Accounting (CIPFA 2011a). The duty to adhere to the prudential code was specified in the *Local Government Scotland Act 2003*.

The Prudential Code specifies the indicators an authority has to use in demonstrating the prudence, affordability and sustainability of its capital investment programme. But the code does not specify specific control values for these indicators. Instead, each authority has to set its own control values, in the light of an assessment of its own options and circumstances.

Without going into full detail, the indicators whose use is specified by the code are of three main types:

* Indicators relating to the size of the authority’s Capital Financing Requirement, (CFR), where the CFR is the amount of capital investment undertaken by an authority which requires to be financed by borrowing. Capital investment which is funded directly, e.g., by land sales or capital grants, does not increase an authority’s CFR. A prudent authority will ensure the size of its CFR does not become too large.
* Indicators relating to the actual size of borrowing relative to the CFR. If borrowing is chronically larger than the CFR, this may indicate that the authority is actually using borrowing to fund current expenditure – which is a classic way an authority may run into trouble.
* Indicators relating to affordability. For example, the authority will wish to ensure that the ratio of financing costs, (i.e., loan charges, and also payments on finance leases like PFI and NPD schemes) does not rise too high relative to its likely revenues from government grants, non-domestic rates, and council tax.

Authorities are required to engage in an annual cycle, whereby they obtain approval from their council for the limits they propose to set on their prudential indicators, and then monitor performance against these indicators. The process dovetails with another statutory requirement also laid upon authorities - that they adhere to the CIPFA Treasury Management Code: (CIPFA 2011b). This deals with issues like prudent control of the maturity structure of their debt, and the types of financial organisation to whom an authority might lend money.

In later sections, this paper will be concerned with more detailed issues which pose potential problems for the operation of the prudential code. But before turning to these issues, it is appropriate to look in the next section at another kind of background: namely, on the medium term prospects for local authority finances.

**More background: the uncertain outlook for local authority finances**

This section considers some of the factors which will bear upon local authority budgets in the medium to long term. What is clear is that we are moving into a new era, where the degree of uncertainty surrounding local authority finances is likely to be much greater than in the past.

Let’s start by looking at local authority revenue spending, i.e., what local authorities spend on current items like wages and salaries – but also on items like interest charges on capital borrowing, and the annual unitary charge payments on PFI and NPD schemes. The local authority revenue budget is important for present purposes, because if authorities over- commit themselves on capital spend, the pressure will in due course be felt on their revenue budgets – and will lead to either cutbacks in services, or the requirement to raise council tax.

Local authorities’ largest single source of revenue funding is the revenue grant they receive from the Scottish Government, representing about 40% of their revenue income. This grant is paid out of the Scottish Government’s budget, and therefore the outlook for the Scottish Government’s budget is critically important in considering the prospects for local authority revenue spending. This is where the first major element of uncertainty comes in.

Up until 2015, the Scottish Government’s budget was determined mechanistically by the operation of the Barnett formula where all one needed to know to determine the prospects for the Scottish Government’s budget was what the prospects were for the UK government’s budget. This, in itself, is uncertain enough. Post-2008, there are all the uncertainties of how long it will take the UK economy to recover from the 2008 crash, and what the post-crash trend rate of growth of the UK economy will be; how quickly economic recovery will feed through to the public finances: and whether UK Chancellors may in any event choose to alter their target level of public expenditure as a percentage of GDP. (For a time, George Osborne was planning to take public expenditure down to levels, relative to GDP, not seen in the post-war period.)

But as regards the Scottish Government’s own budget, there are now additional layers of uncertainty, brought in by the reforms in the post-referendum fiscal settlement. This is not just a question of uncertainty about how much revenue will be raised by the taxes which the Scottish Government will now control, like income tax, or which will be hypothecated to Scotland, like about half of VAT receipts. Of equal importance will be the implications of the way in which the adjustments to the Scottish Government’s Block Grant will be indexed - the Block Grant Adjustment (BGA) is the amount subtracted off from the Scottish Government’s block grant to compensate for the tax receipts which will now come direct to the Scottish Government. If Scottish devolved tax receipts per head grow more slowly than the corresponding per capita tax receipts in the rest of the UK (rUK), then the way the BGA works means that the Scottish Government’s budget will be squeezed, in the sense that it will be smaller than it would have been under the original Barnett formula; and vice versa if Scottish per capita tax receipts grow more quickly than those of rUK. The Scottish Government’s budget will, therefore, in future be subject to the additional major uncertainty of whether Scotland wins or loses in an economic race with rUK. Given that North Sea oil now looks to be entering into its period of secular decline, then the risk of Scotland losing out in this economic race must be considerable.

It is no easy task to try to quantify such imponderables, even over a time horizon as short as five years. An informed attempt has, however, been made by the Fraser of Allander Institute (2016), in their assessment of the prospects for the 2016 Scottish Budget. The scenarios they consider foresee a real terms cut in the Scottish Government’s budget between 2016/17 and 2020/21 of between 3.1%, on the most optimistic view, to 6.2%, on the most pessimistic view.

How much of the Scottish Government’s budget will be allocated to local authorities by way of revenue support grant depends, of course, on government’s overall priorities – and the commitments that have been made to protect certain service areas. This brings in yet another layer of uncertainty: but the central assessment made by the Fraser of Allander is that the general resource grant to local authorities will decline by 13.5% in real terms between 2016/17 and 2020/21. The Fraser of Allander make the additional assumptions that non-domestic rate income will decline slightly in real terms, but that council tax income will start to rise fairly rapidly, as councils exercise their new freedom to increase council tax by 3% per annum. Overall, the Fraser of Allander estimates that councils’ total revenue funding might drop by 7.4% in real terms between 2016/17 and 2020/21.

*The above figures refer to the assessment of budgetary prospects carried out by the Fraser of Allander Institute in September 2016. The Scottish Government published its actual budget for 2017/18 on 15 December 2016. The time horizons in the Scottish Government document, however, are relatively short: up to 2019/20 for the overall Scottish Revenue Budget, and up to 2017/18 for local authority budgets. The Scottish Government budget does not, therefore, provide as good a basis for assessing the uncertainties facing local authority budgets as the Fraser of Allander report does. Note also that the Fraser of Allander figures, while they predate the Scottish Budget, are broadly consistent with it.*

Even over the relatively short time horizon of the next five years, therefore, the outlook for local authority revenue spending is one of very severe cuts, and, in addition, of considerable uncertainty about the precise level of cuts. This is bad enough: but clearly, given that the revenue consequences of the decisions which local authorities take now about capital expenditure will affect their budgets for the next 30 or 40 years, even a five-year horizon is inadequate for purposes of planning capital expenditure. And once time horizons expand into these longer periods, the uncertainties multiply even more. What form will Brexit take, and how will it impact upon the UK and Scottish economies? How will the fiscal settlement evolve after the review pencilled in to take place after five years of operation? There is a distinct possibility, if the Treasury’s preferred method for indexing the BGA is introduced then, that Scotland might find itself pushed into an even more challenging economic race.

This means that a mechanism, like the Prudential Code, which is designed to ensure that local authority capital commitments are prudent, affordable, and sustainable, has to be able to cope with great uncertainty about long term levels of local authority resources, and the possibility that there could be severe long term cuts in revenues. In this respect, the world in which the Prudential Code has to operate is very different from what was expected when the code was bedding in, when there was general optimism that the UK and the world were set fair on a course for steady and continuing real economic growth. One of the key criteria against which the code will be assessed in this paper is its ability to cope with this new, and uncertain, world.

There is another important respect in which today’s world is very different from the early days of the prudential code – namely, in the cumulative scale of the investment undertaken by local authorities through various forms of Public Private Partnerships (PPPs). PPPs include the old Private Finance Initiative (PFI); NPD, schemes which replaced PFI in Scotland; and investment undertaken via the hub mechanism set up through the Scottish Futures Trust. In 2004, when the prudential code started, the total amount of local authority capital expenditure in Scotland which had been undertaken via PPP projects was something over £800m. By September 2016, the corresponding figure was around £4bn.

The annual unitary charge payment associated with existing local authority PPP schemes is likely to be £650m by 2025/26.

Despite some current uncertainties due to the re-classification of some NPD schemes by the Office for National Statistics, local authority investment through PPP schemes is likely to continue to grow rapidly. It will therefore be a matter of increasing importance that PPP deals are handled appropriately in the prudential code.

**Central Issue: the question of time horizons**

This section considers the question of time horizons: how far ahead should an authority look when it is determining its control limits under the prudential code? Actually, this question is by no means as simple as it may appear at first sight, because the concept of time horizon in this context has two quite distinct possible meanings. To clarify these, it is useful to introduce some notation: namely, to distinguish between a control horizon, and a modelling horizon. What is meant here by these concepts?

A ‘control horizon’ means the time period for which an authority will set its control limits under the prudential code: e.g., ‘during the next three years, this authority will not let its ratio of finance costs to revenue rise above 9%’. The minimum time horizon in this control sense is actually specified in the Prudential Code, and separately by the Scottish Government, as three years.

But in setting its prudential limits for the period of its control horizon, an authority may well wish to look a good deal further forward, to make sure that the actions it takes within its control horizon are unlikely to have adverse long term consequences. It is difficult to see how a prudent authority could set its short term limits over its control horizon without, perhaps fairly informally, looking further forward. This would involve assessing, or, in other words, ‘modelling’, the longer term implications of the commitments it is making now to undertake future revenue spending, as compared with future likely revenues. How far an authority looks forward in this sense will be denoted here as its ‘modelling horizon.’

The distinction between these two types of horizon is implicit in the drafting of the prudential code, but, it will be argued here, is insufficiently developed. Consider, for example, the following quotation from the code itself:

*An authority must consider the affordability of its capital investment during all the years it will have a financial impact on the authority. The authority should therefore consider whether its financial planning horizon should be greater than the three year minimum specified by the code.* (Prudential Code, page 8, para 27)

The distinction drawn here between control and modelling horizons reveals the potential confusion lurking in this quotation. The first sentence is clearly talking about what, in the notation used here, is horizon in the modelling sense. The three year minimum specified by the code, and referred to in the second sentence, is clearly horizon in the ‘control’ sense. But the failure to distinguish clearly between the two types of horizon leaves the impression that what is being specified by the code is a minimum modelling horizon of three years – and that this length of modelling horizon, or perhaps something not much longer, may, at the authority’s discretion, actually be satisfactory.

The implications of this failure to distinguish clearly between control and modelling horizons become very noticeable on reading the Prudential Code statements produced by authorities themselves. All authorities set their prudential indicators for a period of three years, as is statutorily required. In some cases, longer periods are considered For example, West Dunbartonshire projects its indicators forward over a ten year period, and Perth and Kinross for seven years. But authorities like these are exceptions, and there is very little information indeed in most authorities’ statements about any longer term assessment of issues like affordability. In fact, from the way most authorities’ Prudential Code statements are drafted, it appears to be the case that many authorities are working, not just to a three year control horizon – but also, effectively, to very short modelling horizons.

This finding is consistent with a conclusion drawn in two recent reports by Audit Scotland (2015, 2016), highlighting a lack of long-term financial planning by Scottish local authorities. Audit Scotland concluded that many authorities were not carrying out any analysis to bring together information on future financing costs with future budget scenarios, in order to assess long term affordability. While 29 out of 32 councils indeed have medium term financial plans covering 3 to 5 years, fewer than half of authorities had a long term financial strategy covering 5 or more years (Audit Scotland 2016).

Does this matter? The answer, given the uncertain medium to long term prospects for local authority budgets described in the preceding section, is a very definite ‘yes’. When the Prudential Code was introduced, the long term prospects for the economy and public finances seemed to be for sustained steady growth. In these circumstances it is quite easy to imagine that capital expenditure could indeed be prudently planned on the basis of short term modelling horizons. As long as each authority kept a prudent distance from the kerb as it steered along, so to speak, there were unlikely to be any sharp twists in the road ahead, and all should be fine. But as the detail in the preceding section makes clear, the medium to long term prospects currently facing us are very different, with the danger of severe cuts in local authority resources in the medium to long term, and in any event, very great uncertainty. In these circumstances, it is difficult to see how capital expenditure can be prudently planned on a long term basis, if the modelling horizons authorities are using are very short term.

It would be too simplistic, however, to conclude that authorities should extend their modelling horizons, and all would then be well.

First of all, there are a number of reasons why authorities would indeed find it difficult to carry out longer term assessments of the implications of their capital expenditure decisions:-

* Probably the most important thing an authority will want to assess is how the future revenue expenditure consequences of its capital expenditure decisions will compare with the future revenue resources of the authority. But since the largest single source of future revenue resources is grant from government, making this assessment will ideally require information from government on the likely level of grant to local authorities over the medium to long term. Providing such information is not something that any government is likely to find itself willing or able to do.
* Even aside from the question of future levels of government support, the modelling involved would be intrinsically complex, involving assumptions about non domestic rate income and council tax levels: and assumptions about local demographic factors which will affect the demand for council services. This complexity has implications not merely for the level of resource and expertise which an authority would have to put into making the assessment: but also for the difficulty of explaining the resulting outputs to any relevant audiences.

But even if authorities could be persuaded to extend their modelling horizons, this would not solve the problem of assessing the longer term affordability of current capital plans for Scotland as a whole, because there is another problem – namely, that there is no reason to assume that authorities would be working to consistent long term assumptions. In fact, each authority could well be naturally optimistic about its ability to attract economic growth and population to its own area. The effect would be that the aggregate of the individual local authority demographic projections underlying their own individual models could be over-optimistic relative to a rational projection of national demographic trends. In other words, even if authorities were individually acting entirely rationally, they might nevertheless be collectively over-optimistic about the long term affordability of their capital investment plans.

There is therefore a real dilemma: there is a need for longer term planning horizons, but it is not a solution simply to encourage authorities to extend their own planning horizons. A possible solution to this dilemma is outlined in the next but one section in this paper. The next section looks at a number of specific issues suggested by study of authorities’ prudential code statements.

**Other issues**

This section looks at a number of other, specific, issues suggested by examination of authorities’ prudential code statements.

*Lack of Accountability* – one of the important functions that the Prudential Code is meant to fulfil is that the prudential indicators ‘are designed to support and record local decision making in a manner that is publicly accountable’. It is difficult to see, however, how public accountability is being achieved in any meaningful sense, given the lack of information about longer term financial modelling, even if this is being undertaken at all; and also given the lack of information on specific key questions.

One particularly important area where no information is available to the public is on the actual financing costs implicit in the now very important area of PPP funding – particularly in relation to NPD and hub schemes. Such schemes commonly attract significant revenue support from the Scottish Government. This is likely to make them relatively attractive to local authorities, compared with the option of funding conventional procurement via prudential borrowing, which attracts no such government support. But this is all being paid for from the public purse, so it is important that the public knows what the borrowing and other costs associated with an authority’s PPP schemes actually are. Without this information, we cannot be re-assured that the government support available to PPP schemes is not distorting decisions in favour of what may be a relatively expensive way of financing capital expenditure. However, the lack of detail available in the current prudential code indicators means that information on the true financing costs of NPD projects is not available.

*Arm’s Length External Organisations (ALEOS) –* ALEOS are bodies which are formally separate from a Council, but subject to its control and influence. ALEOS typically run functions, like car-parking, or housing, which in former times would probably have been managed directly by the Council. The scale of ALEOS has grown rapidly. By 2011, the majority of councils operated ALEOS (Audit Scotland 2011), and by 2012/13, the budgets controlled by ALEOS totalled over £1.3bn, and ALEOS employed over 25,000 in Scotland (Scottish Parliament 2016).

The Prudential Code as it currently stands does not require authorities to include the activities of ALEOS when they are considering the sustainability of the authority’s finances. This is surprising. Guidance issued by CIPFA (2010), stipulates that the statutory role of the chief financial officer of an authority does not stop at the boundaries of the authority, but extends into partnerships and similar bodies. The point is not just hypothetical, since it is clear that the activities of ALEOS could have important implications for the finances of an authority. If an ALEO were to run into financial problems, then some or all of its debts could revert to the authority – and, in addition, the authority might well incur additional expenditure in maintaining the service previously provided by the ALEO.

The reason why ALEOS are not covered in the code is, apparently, because they were relatively small when the code was being developed: and there was an intention that the code would be updated in due course to cover ALEOS. Some authorities do mention ALEOS in their prudential statements, particularly when the authority has specifically underwritten ALEO debt. But given the current scale and growth of ALEOS, the potential exposure of authorities to ALEOS must now be large: and it should be a priority for the code to be formally extended to cover exposure to ALEOS.

*Treasury Advisors -* in producing their Prudential Code and treasury management code statements each year, authorities are usually assisted by hiring independent treasury advisors. From one point of view, this practice clearly makes sense, since it brings in independent expertise, and gives an external check on the assumptions and judgements being made by the authority. It is noticeable, however, on reading authorities’ Prudential Code statements, that this aspect of the external advisor market has come to be dominated by a very small number of firms. There is a potential danger in this, in that it may mean that key judgements being made by different local authorities may no longer be independent.

One such judgement, for example, relates to the prospects for Lender Option Borrower Option loans, commonly known as LOBOS. LOBOS are a relatively new form of loan construct, under which the lender has the option to terminate the loan at any point of their choosing, and require the borrower, in this case the local authority, to repay the principal. Lenders are likely to exercise this option when interest rates rise: because they will then be able to invest their capital at the new, higher interest rate. Therefore, the key judgement about whether an authority’s LOBO loan is likely to pose an additional burden on its finances is really a judgement about the likely timing of future interest rate rises. If local authorities are being heavily influenced in this judgement by a very small number of advisors, then their judgements will not be independent from each other – which potentially magnifies the overall effects of authorities making a wrong call.

*Potentially distorting effect of reserve balances –* it is clear from reading authorities’ Prudential Code statements that, for a significant number of authorities, their assessment of the affordability of their capital plans is heavily influenced by the cushion afforded because they are holding relatively high levels of reserves. At the end of 2014/15, councils had useable reserves of about £2bn in aggregate (Audit Scotland 2016). But the fact that a reserve exists now, and could be used to help fund revenue expenditure over the next few years, says nothing about whether revenue expenditure would be affordable in the longer term. As a result, the availability of balances, together with the very short modelling horizon which authorities appear to use, potentially gives a misleading impression of long term affordability. This is another aspect of the time horizon issue discussed in the preceding section.

**What should be done?**

As has been seen above, and as confirmed by the findings of the Audit Scotland report (2015), the analyses of the long term affordability of capital investment carried out by authorities are inadequate. The recommendation of the Audit Scotland report was that authorities should develop this kind of detailed analysis.

The position of the Scottish Government on this point, however, is of interest. A Scottish Government spokesperson noted: ‘it would be helpful if the next iteration of the Prudential Code could reflect more fully on the need for longer term financial plans.’ However, the Scottish Government is holding back from issuing specific guidance: ‘The difficulty with issuing guidance is that a local authority will comply with the guidance whereas we would want the local authority to determine for itself what should be included in their strategies and plans’ (Source: unpublished communication from Scottish Government official).

The underlying reasons for this degree of central government caution are not known but can perhaps be guessed from a point made earlier in this paper, namely, that if central government requires local authorities to carry out longer term assessments of affordability – then authorities are likely to respond immediately by asking central government for a steer on likely levels of central government grant support, and this is a request which central government would be neither willing, nor able, to grant.

Moreover, even if all authorities were individually attempting rational and sophisticated assessments of long term affordability, they could well be collectively over-optimistic about the long term affordability of their plans – because of natural optimism about the prospects for their own individual areas.

Both of these problems should have been apparent to Audit Scotland when they were making their recommendation that authorities should develop their longer term financial planning: so the Audit Scotland recommendation can only be regarded as an inadequate response to the problem. And yet the problem is very real: this paper has outlined the threatening and uncertain prospects for local authority revenues in the medium to long term: and, indeed, five councils are already expecting funding gaps of more than 5% of their service costs by 2018 (Audit Scotland 2016). Against such a background, we are likely to run into serious problems unless a much better fist is made at assessing the long term affordability of local authority capital plans.

What can be done? It is argued here that a better system is, in fact, possible based on one that would involve an enhanced financial planning capability in individual local authorities working alongside, and together with, an enhanced national financial modelling capability.

Imagine a situation where there was a central body which took an informed assessment of the prospects for the UK and Scottish economies, of what was known of UK and Scottish Government spending priorities, and of uncertainties like Brexit: and then used this information to produce a range of variant projections for the medium to long term prospects for local authority revenues. This is very much the kind of process which the Fraser of Allander Institute (2016) conducted as part of its recent assessment of the priorities for the Scottish Budget but what would be required would be to extend this process some five, or even ten, years further – with a naturally much greater range of uncertainty in the spread of the resulting variant projections in the later years of the projection period.

Imagine also that each local authority was carrying out its own financial planning over similar timescales: and that each authority was then feeding in to the central modelling body its own forecasts and assumptions about its revenues, (and their composition); its spending requirements, (for services and financing costs); and also on the demographic assumptions it was making in producing its own projections.

The central modelling body would then be in a position to do a number of things. It would aggregate the spending and revenue projections of the individual local authorities, to produce a national aggregate composite projection for comparison with its own variant projections of local authority revenues. And it would aggregate authorities’ demographic assumptions – to see how these compared with, for example, the latest projections produced by National Records of Scotland.

This in itself would be an extremely informative process: and, once the results were published, it would be doubtful if there would be a need for much more formal activity. There would be no question of controlling local authority plans to any central projection: or of dictating to authorities what assumptions they should adopt. But the comparison of the central body’s variant projections with the aggregate local authority forecast would immediately suggest whether the system appeared to be running into danger: and would provide a good basis on which individual authorities could go back, and modify their own assumptions, in next year’s iteration. In this way, authorities are being provided with a much more informative basis for making their own plans – without infringing the desire for authorities to have ownership and control of these plans

Correspondingly, the Scottish Government, as an observer in this process, would have a much better information basis on which to decide whether it needed to intervene at any point, for example, by issuing specific guidance.

Note that it is not envisaged that the Scottish Government would, or could, play the role of the central modelling authority. It would be quite inappropriate for it to attempt to do so. For one thing, it would immediately find its judgement clouded by political considerations, since governments are not able to speculate about the medium term future in other than the rosiest terms, or they will be accused of foreseeing the failure of their own policies.

Implementing this type of system would not be easy. For example, who could play the role of the central modelling authority? There are possibilities, e.g., a body like the Fraser of Allander Institute is clearly developing much of the required expertise. A body like the Fiscal Commission, however, is probably too close to government to fulfil this role. More difficult, potentially, is the problem of how the chosen body would be funded, given that it will, inevitably, be producing projections which will be, on occasion, politically uncomfortable.

There is also the problem of whether authorities themselves could develop their own financial modelling expertise to the required level: and also of whether they would be willing to submit the required detail on their plans, in a standard format, to the central body. On the other hand, the information that authorities would themselves gain from the operation of such a scheme would be invaluable to them: so they would have a strong incentive to participate.

**Conclusions**

What this examination of the operation of the Prudential Code in Scotland has demonstrated is that problems with the code exist at two levels. At a fairly detailed practical level, there are a number of specific issues which need to be addressed: for example:

* To achieve proper accountability, authorities have to be prepared to be much more open about the details of their activities – and in particular, about the detail of the financing and other costs of their PPP schemes.
* The code should be extended to make sure that potential commitments arising from ALEOS are properly covered.
* It would be desirable if authorities had available to them a wider pool of specialist advisory companies.

These are important points and are, in principle, capable of fairly ready resolution.

Much more intractable is the fundamental issue which comes through in this study: namely, that the modelling horizons used by most authorities in setting their prudential code indicators are too short: and that, in the uncertain environment for local authority finances which will be faced for the foreseeable future, simply sticking to the prudential code as it is currently practised can give no guarantee that authorities will not face severe financial problems in the medium to long term.

It is disappointing that these issues have not been more actively addressed. There are, possibly, a number of reasons for this. One is the genuine difficulty of improving the current system: however, as has been argued in the preceding section, there are important improvements which could be made. But there is another important reason why the Scottish Government, and local authorities, may have been unwilling to act – namely, that aspects of the present system suit both sides very well.

For the Scottish Government, the present system means that they don’t have to attempt the very difficult task of issuing longer term guidance on the possible future path of central government support to local authorities: and, in particular, that they do not have to incur the political opprobrium of potentially admitting that all may not be possibly for the best in the prospects for the economy and public finances. It is also convenient for the Scottish Government that the present system draws a veil over the actual funding costs implicit in the various schemes for funding capital from revenue which, for understandable reasons relating to the arcane rules of government accounting, the Scottish Government is actively encouraging.

For authorities themselves, the priceless gift under the present system is the freedom to take their own decisions, without the detailed and irksome central government control implicit in the previous system of borrowing consents.

To progress the kind of improvements suggested in the previous section, both sides will have to have the maturity to move beyond their present positions. Local authorities would not be required to give up their present freedom: but they should be willing to work to longer term modelling horizons: to share the projections and assumptions they will be making: and to be willing to modify their plans in the light of what will emerge from the central modelling body.

While it is not suggested that the Scottish Government take on the central modelling role - indeed, it has been argued above that they cannot do so - nevertheless the system would operate much better if central government (both at Westminster and Scotland level), were willing to speculate more realistically about long term prospects.

Subject to these necessary cultural adaptations, the primary proposal made in this paper is that an appropriate body should take on the role of providing longer term variant projections of local government fiscal prospects: and of aggregating individual authorities’ separate projections into a national version, to compare with the central body’s own variants. And, that it should also comment on the consistency, or otherwise, of authorities’ demographic assumptions.

If such a system were in operation, then it would provide a corpus of information against which each authority could assess its own plans: without such a corpus of information it is difficult to see that individual authorities could conduct a meaningful longer term planning role. And while authorities would be acting independently, both in their modelling, and in setting their short term prudential indicators, there would be a much better chance that they would be acting broadly consistently.

The outlook for local authority finances is unprecedentedly gloomy and uncertain. Against this background, unless much more effective longer term planning takes place, then Scottish local authorities could well find that they cannot afford the revenue consequences of the commitments they are making on capital expenditure. If this happens, the consequences, in terms of increases in local taxes, and cutbacks in services, are likely to be severe. There is therefore an urgent need to improve the current system for assessing the affordability of local authority capital expenditure. This paper suggests a way forward.

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