FINANCIAL MANAGEMENT IN THE SCOTTISH EXECUTIVE PROPOSALS FOR FURTHER REFINEMENT

by Jo Armstrong

1 Introduction

"Executive's £270m error another fiscal black hole"
The Scotsman, 18/02/05, on funding required for heath staff salary costs

"free health care sums are £130 million out"
The Scotsman, 16/02/05, on funding costs for free personal care

1.1 At face value these recent press headlines are a cause for concern. The alleged £400 million under funding amounts to 1.9% of the Executive's total discretionary spend and, if accurate, would indicate yet more pressure on Scotland's already tight finances. However, the drive for efficiency savings announced in 2004 is testament to the Executive's desire to free up scarce resources and get better value for money for every pound spent in the public sector. What then do we make of the potential for added pressures implied by these two headlines?

1.2 First, we need to take care when interpreting headlines. Here the £130 million shortfall for free personal care is forecast to occur in the year 2022[1]. That being the case, it would be hard to suggest the Executive is facing an imminent funding problem. Secondly, in isolated cases, shortfalls can be easily accommodated. In 2004-05 the Executive was able to re-assign £621 million of its unspent budget so easily meeting a £400 million gap. Indeed, over a full 3-year spending review period additional costs of this magnitude should be relatively easy to absorb. Nonetheless, if underfunding occurs repeatedly with a number of large initiatives, the robustness of the Executive's budgets could be undermined.

1.3 In dealing with truly isolated cases the Executive can make use of the end year flexibility mechanism (EYF). This is a mechanism which allows for the spending of undrawn funds at the end of each financial year on

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priority areas and initiatives. To gain this flexibility the Executive simply sets aside an equivalent amount of funding as is being allocated to the EYF pool which can then be utilised in later periods by the programmes that "contributed" to the fund.

1.4 Whilst EYF has provided the Executive with such flexibility to manage its budgets in the past, there are several reasons why this may no longer be possible or desirable going forward. This paper aims to show why flexibility is likely to diminish over time and why there may be limitations to using EYF as a long-term financial management tool. In light of this, the paper also outlines a series of possible developments to budgeting and longer term financial planning which would aid the Executive's financial flexibility and transparency.

2 Challenges in managing the budgets

2.1 Why then is the Executive likely to face a reduction in the value of EYF as a financial management tool and where should enhancements be made to the Executive's financial management systems? To help answer this question it is important to assess a number of key challenges facing the Executive.

Forecasting

2.2 Forecasting spending commitments across the whole of the Executive's budget is neither straightforward nor uniform. For example, there will be cases where accurate information on the cost of delivering a specific programme is difficult to acquire, such as where new technology or processes are being implemented for the first time. On the other hand, where the intent is to implement a proposal that is either an extension of an existing one or where something similar has been implemented in another jurisdiction, it is hard to see why poor cost estimates would be the result.

2.3 Any budgeting or forecasting approach must distinguish between those projects for which there is little or no firm data on the cost of their provision and those where there is a far higher degree of certainty. Whilst using EYF funds to fill a gap is possible under either scenario, filling the gap is only part of the solution. If what is happening is the effects of two errors in forecasting cancelling each other out then, prudent financial management would require a detailed analysis of why gaps arose. In addition a detailed contingency plan outlining how it may be possible to minimise the chances of them recurring in the future would also be sensible.

Wider effects from using EYF

2.4 In addition to problems with forecasting, there are three other wider issues associated with EYF which merit discussion, namely,

- the opportunity cost of using EYF funds;
- future levels of EYF flexibility;
- the on-going contributions from Scottish Water.

Table 1: EYF Comparison 2001-02 to 2003-04

	2001-02	*2002-03*	*2003-04*
Scottish Executive portfolios			
(a) Provision for future spend	**141**	**28**	**119**
(b) Slippage in committed capital projects	**141**	**101**	**114**
(c) Fluctuations in demand led expenditures	**121**	**33**	**7**
(d) "Other Variances"	**57**	**170**	**163**
Windfall income[3]	**17**	**328**	**0**
TOTAL Scottish Executive Portfolios	**477**	**660**	**403**
Arms-Length-Bodies			
Scottish Water	**114**	**34**	**208**
Forestry Commission	**3**	**2**	**3**
Crown Office	**0**	**1**	**2**
Health Boards	**49**	**24**	**7**
Food Standards Agency	**0**	**1**	**0**
TOTAL Arms-Length-Bodies	**166**	**62**	**220**
TOTAL EYF	**643**	**722**	**623**

Note: 2003-04 total includes a carry forward of £4 million
Source: Scottish Executive, 2004 (a)

2.5 First, it is not clear that the current use of EYF takes into account the investment forgone as a consequence of using it to fund gaps. If the value of the foregone investment were to be included in the implicit investment decision then can we be sure in all circumstances that the net benefits arising are greater than would otherwise have been the case? In such circumstances we should be seeking to assess the opportunity cost of using these funds. This then leads to the need for a greater understanding of, and information on the marginal project and the associated cost-benefit trade-off. Again, simply filling the gap ignores this longer-term and more strategic issue.

2.6 Secondly, it is likely that the flexibility afforded by EYF is going to diminish purely as a consequence of the Executive's overall budget getting tighter but also due to a change in the way budgets will be managed in the future.

2.7 To explain how this latter point could reduce flexibility requires an analysis of why funds become available for use under the EYF mechanism. The Executive has 4 main categories, namely,

a) Provision for future spend - a provision set aside for planned spending commitments in future years

b) Slippage in committed capital projects - caused by such factors as inclement weather affecting a build programme

c) Fluctuations in demand led expenditures - covering demand-led budget areas such as Regional Selective Assistance.

d) "Other Variances" - this covers a wide range of relatively small and very disparate programmes across the Executive with no unifying factor.[2]

2.1 As Table 1 shows, £623 million was available for EYF in the 2003-04 exercise, of which £403 million being attributable to one of the 4 Executive categories (the 2001-02 and 2002-03 positions are shown for comparative purposes).

2.2 In some Executive programmes there may be a need to set aside a provision for future spend even though there may be no formal contractual arrangement in place. These are planned future funding requirements. To accommodate such commitments the Executive introduced a revision to the EYF approach namely, the concept of a central unallocated provision (CUP). This development allows 100% carry forward of any undrawn but "committed" part of a department's budget, thus overcoming the possibility of the department losing some or all of any associated underspend.[4] With this change the Executive is aiming to create a greater degree of certainty in its spending forecasts. However, the corollary to this must be a lowering in flexibility as less "free cash" is available at the year-end for use to fund other priorities. In addition, this approach may lead to some of the category (b) items being re-classified as category (a) items, as the departments undertake a more detailed assessment of their programme delivery dates, further reducing the EYF flexibility.

2.10 The most consistent reason for monies being allocated to the EYF pool is through slippage in committed capital projects. This accounted for 30% of the funds available in 2003-04, including arms-length-body contributions (see Table 2). Of the £186 million EYF available from this category, £72 million came from Scottish Water (39% of the total), £37 million from Transport (20%), £28 million from Justice (15%) and £19 million from Health (10%).

Table 2: 2003-04 Total EYF and EYF due to Capital Slippage

	Total EYF	*EYF from Capital Slippage*
Justice	**27**	**28[5]**
Education	**21**	**0**
Tourism, Culture & Sport	**3**	**3**
Health	**19**	**19**
Enterprise & Lifelong Learning	**46**	**0**
European Funds	**7**	**1**
Transport	**58**	**37**
Communities	**65**	**5**
Environment & Rural Affairs	**90**	**13**
Finance & Central Services	**49**	**7**
Administration	**18**	**1**
TOTAL Scottish Executive Portfolios	**403**	**114**
Scottish Water	**205**	**72**
Other "arms-length-bodies"	**13**	**N/a**
TOTAL	**621**	**186**

Source: Scottish Executive 2004 (a)

2.11 The Executive indicated that all 4 of the major contributors to this category were experiencing delays in implementing or completing capital programmes. For the full value of this funding to be maintained in the future, the cash amount of £186 million would need to be adjusted to take account of inflation. Otherwise, the associated outputs may end up being lower than originally planned. Again a simple application of EYF ignores this important budgeting issue.

2.12 The final reason why flexibility is likely to diminish in the future is due to the changes currently taking place in Scottish Water. Scottish Water has historically been a key contributor to EYF. However, as it becomes more efficient at managing its large investment programme their contributions to EYF should fall so reducing the “free cash” available to the Executive.

3 Possible options for change

3.1 There is no ideal or perfect budgeting system and forecasting costs and revenues of the size and complexity managed by the Executive is fraught with difficulties. Nonetheless, there are 4 main areas where possible development or augmentation would seem both desirable and possible. These would be in:

Æ the annual budgeting exercise;
Æ the 3-year spending review cashflow forecasts;
Æ the longer-term cashflow forecasts; and,
Æ the wider use of cost benefit analysis and value for money audits.

Annual budgets - Inputs and Outputs

3.2 Currently, the Executive produces an annual forecast of expenditures and revenues in providing a budget for the year ahead. This forecast and subsequent revisions are essential to show Parliament that all programme commitments within the year can be met. However, of equal importance is a detailed statement of what outputs (rather than outcomes[6]) are expected to be procured with these expenditures. This development would then allow monitoring not only the rate of spend on a monthly, quarterly and annual basis but also monitoring of the progress within each programme in achieving stated output targets for the year. This combined set of information would provide a strong signal of where programmes are on target, where they may be ahead or where they appear to be slipping behind. It then becomes easier to make adjustments ahead of the year-end and enhance the possibility of bringing activities back on track. Waiting until the end of the year exposes the programmes and the Executive to all the associated problems of carrying forward spending from one financial year to the next.

3.3 The Scottish Executive’s Annual Evaluation Report[7] provides some of this information, with the most recent version reviewing the objectives and targets set out in the 2003-04 budget. This is a useful document performing the same function as a corporate annual report. It does not, however, provide details on what targets have been delivered on a programme by programme basis, what still has to be delivered and how programmes will get back on track by the end of the review period. The suggested developments proposed in this paper would perform the function of a corporate financial management information system.

Annual Budgets - Fixed and variable commitments

3.4 The Executive’s budget distinguishes between capital and revenue items. This is important in aiding understanding on, for example, how improvements are being made to Scotland’s infrastructure for the longer-term through spending on capital items. An additional way of presenting the data could be the provision of information on which costs are fixed and which are variable within each budget line. This would aid understanding on where flexibility within the budget actually exists. For example, budgets with a high labour cost component are unlikely to be flexible in the short term, eg, staff costs in the health budget. Alternatively, budgets with a larger proportion of one-off spend items, eg, additional contributions to local authority spending on roads, need not be continued in future years making this budget item variable in nature. Providing such a breakdown in the budgets ensures greater clarity about the nature and size of the short and long-term flexibility within the Executive’s budgets, both globally as well as at the departmental and programme level.

3-year spending review cashflow forecasts - appropriate deflators

3.5 The current spending review forecasts cover the 3-year period 2004-05 to 2007-08. These are adjusted over time to take account of, *inter alia*, changes in Whitehall’s spending which automatically leads to funds flowing to Scotland. These aggregate budgets are reported in both nominal terms (ie, including the effects of inflation) as well as in real terms, (ie, deflating the nominal numbers by the most appropriate cost/price deflator). Nominal forecasts set a limit on what cash will be made available for each department, meaning recipients have to budget within these cash numbers. A useful development to this would be forecasts at a more disaggregated level (ie, budget levels 2 and 3) in both real and nominal terms. This makes it far easier to understand where inflationary pressures may exist within the various budget commitments. However, to be fully meaningful the nominal forecasts would need to use the most appropriate inflator (or for real forecasts, the most appropriate deflator). For example, it may be more relevant to use a wage or earnings index rather than RPI where costs in a programme are predominately staff related. Not doing so potentially obscures the real challenges facing departments and those dependent on individual programmes.[8]

3-year spending review cashflow forecasts - risk and uncertainty

3.6 3-year cashflow forecasts require assumptions about the value of key variables. Inevitably, these will be subject to varying degrees of risk or uncertainty. To increase the confidence in such forecasts risk assessments could be undertaken and sensitivity analysis carried out to identify the level of variance that may exist within any particular reported forecast. As was indicated earlier, this is vital where forecasts are being made for innovative or complex programmes and where the degree of accuracy around costs is low.

3.7 Where this would seem a most useful development is in the cost estimates reported in the Financial Memorandum to the Parliament. These outline the likely forecast of costs associated with the implementation of totally new programmes or new legislative initiatives and as such accurate up-to-date data on the costs of implementation may be more limited.

3.8 Sensitivity analysis could then be used to help identify the key factors underpinning any particular programme costs. These key factors could then be subjected both to a greater degree of pre-implementation scrutiny as well as to more intense on-going monitoring. The outcome would be greater clarity around the delivery costs as well as the probability and size of potential cost overruns.

3.9 Finally, where uncertainty as distinct from risk exists, this needs to be fully taken account of in any cashflow forecast by the provision of a detailed set of strategies outlining how it will be accommodated within the budget forecasts.

Longer-term cashflow forecasts – scenario planning

3.10 Currently, budget forecasts cover only the 3-year spending review period. These are re-forecast every two years as part of the on-going spending review process. A possible development here could be the production of longer-term forecasts say, up to 10 years. This would provide a framework for the Executive to model the cashflow impact of maintaining existing spending commitments, introducing new programmes and ceasing spending on programmes that have reached the end of their commitment period.

3.11 This longer-term cashflow forecast can then be more sensibly used in conjunction with the application of various scenarios of the wider macro and regional economic environment facing Scotland, the UK and Europe and against which longer-term programmes and initiatives will need to be developed.

3.12 With this development the Executive can then more readily answer such questions as:

ÆWithin the longer-term forecast expenditure limits, which programmes can be funded and which cannot?

ÆWhat is the optimal package of spending options and what does this mean for the timing of their rollout?

Table 3: Estimated payments under current PPP contracts

	02-03 actual (£m)	*05-06 Plans (£m)*	*06-07 Plans (£m)*	*07-08 Plans (£m)*	*TOTAL DEL 07-08 (£m)*	*PPP in 07-08 as % of Total Budget*
TOTAL	**318**	**407**	**420**	**431**	**25,964**	**1.7%**
Of which:						
Justice	**13**	**14**	**14**	**14**	**1,069**	**1.3%**
Health & Community care	**72**	**102**	**105**	**106**	**10,272**	**1.0%**
Transport	**0**	**32**	**35**	**40**	**1,379**	**2.9%**
ERAD	**92**	**118**	**120**	**123**	**941**	**13.1%**
FCSD	**113**	**131**	**134**	**137**	**6,955**	**2.0%**

Source: Scottish Executive 2004 (c), Table 0.07

Longer-term cashflow forecasts – future spending commitments

3.13 In addition, 10-year forecasts would allow a significantly greater analysis of what spending is already pre-committed through contracted payments. For example, between the period 2002-03 and the end of the current review period 2007-08, payments under the various Public Private Partnership (PPP) contracts will have risen 36%, from £318 million to £431 million (see Table 3).

3.14 Although this represents only 1.7% of the Executive's total Departmental Expenditure Limit (DEL) in 2007-08, evaluating individual departmental lines shows a different picture. For example, whilst ERAD faces roughly similar increases in its PPP payments over the same period, up 33% from £92 million to £123 million, at 13% this amounts to a greater proportion of its 2007-08 budget.

3.15 Whilst interesting in itself, the short-term forecasts do not show the long-term impact inherent in some of these contractualised commitments say, for example, in rail projects or the various PPPs. In particular, many of the PPP contracts have a commercial clause that triggers a review of the PPP payments every 5 years. It would seem valuable to know what the effects these payment adjustments might have on the Executive's as yet unknown future budget.

Longer-term cashflow forecasts – linking to short-term forecasts

3.16 Finally, when producing 10-year forecasts it is essential that they are derived in the same way as the 1-year and 3-year forecasts. Providing a level of consistency between the various financial forecasts would increase transparency and accountability by showing how and when short-term decisions are feeding through into the longer term.

Cost benefit analysis and value for money audits

3.17 All new major initiatives that seek funding from the Executive require to be put through a cost effectiveness analysis or a full cost benefit analysis (CBA). All investments with a positive net present value (NPV) at the test discount rate of 3.5% real[9] should be funded, assuming funds are available. The use of CBA is particularly well used across a wide range of investment areas such as in Transport, Health and Regional Selective Assistance. They can be applied to both capital and revenue based investments alike. A value for money (VFM) audit may differ from a full CBA in that it may exclude some of the wider and less quantifiable costs and benefits that may arise from a particular investment. However, VFM and CBA aim to address the same key issues of:

ÆIs an investment worthy of the proposed public sector contribution?
ÆWhich options are the best either in absolute or relative terms?

3.18 The use of CBA or VFM could be extended in two ways. First, the Executive's existing programme of commitments could be subjected to a detailed CBA or VFM analysis. This will provide evidence to justify continuing some programmes whilst leading to the cessation or restructuring of others. It would also allow the comparison between old and new funding commitments. To take such an approach forward a practical proposal could be to introduce a rolling programme of analyses where, for example, all currently funded initiatives are subjected to a review once every 5 years. Some of the Executive's spending already faces a quinquennial review, most notably the funding channelled through non-departmental public bodies (NDPBs). Subjecting the remainder of the Executive's spending to similar reviews would provide a level playing field and ensure historically funded programmes remain justified and value for money.

3.19 Secondly, the Executive could also be aiming to learn about what outputs and outcomes have been achieved from the investment and spending already undertaken. This could be done through the implementation of a rolling programme of evaluations or value for money audits which could then provide valuable feedback into the decision-making process for future investments. The Executive already undertakes a number of VFMs audits, and this approach is more widely applied in local government. However, a wider application across the whole of the Executive's activities along with a full dissemination of the results would be extremely valuable. With this information it would be possible to enhance the debate around what has worked and why and where programmes could be both continued or enhanced.

4 Conclusions

4.1 This paper proposes a number of enhancements to the Executive's financial management systems covering both short and longer-term budgeting and planning. The main rationale for such enhancements arises from the need for more sophisticated financial management as budgets get tighter and the expectation that the flexibilities currently available to the Scottish Executive will diminish over time. Nonetheless, it is important to stress that these developments are aimed at complementing what is already underway within the Executive following the proposals advanced by, for example, the Financial Issues Advisory Group (FIAG) and the Parliament's own Finance Committee such as their proposals for a long term financial planning model.

4.2 To develop the proposed enhancements the Executive will need to rely in many cases on third parties for basic information. This could jeopardise its ability to deliver. For example, local authorities, NHS Trusts and the many other NDPBs hold the data on the cost of delivery as well as what they procured and delivered with their Executive receipts. It would seem essential that the Executive indicates what information on inputs and outputs it wishes to receive by budget line, providing the basis of a common data set across all its many budget recipients.

4.3 Notwithstanding this data difficulty, the proposals for budgeting and planning outlined above rely on techniques that are well used in both the public and private sector. Whilst there will be no one organisation which has the template the Executive might wish to adopt, learning the lessons by collaboration would greatly speed up the process of effective implementation.

4.4 Finally, having good data and knowing what needs to be done is a necessary but not sufficient condition to secure the required changes in financial management. Just as important is having people in the central finance function with the requisite skills and authority to perform the scrutiny and co-ordination function. Whilst the Executive aims to make this finance group stronger, the individual departments may wish less central scrutiny as they would argue they are ultimately accountable for the management and allocation of their own budgets. However, for the proposed developments to be implemented in a timely and consistent manner across the whole of the Executive's portfolio a strong central finance function is essential, even more since the HM Treasury scrutiny role has all but disappeared.

Sources

Cuthbert J and Cuthbert M (2005), Free care for the elderly, Fraser of Allander Institute, Quarterly Economic Commentary, Vol 29, No 4, February 2005.

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Scottish Executive (2004a), Detailed Explanatory Note on End Year Flexibility 2003-04, June 2004. Available at: www.scotland.gov.uk/News/News-Extras/211

Scottish Executive (2004b), The Scottish Executive Annual Evaluation Report 2005-06, March 2004.

Scottish Executive (2004c), The Scottish Executive Draft Budget 2005-06, October 2004.

Endnotes

1 Cuthbert and Cuthbert, 2005
2 Examples of such programmes include (a) delays in funding being released in ELLD's Enterprise in Education Determined to Succeed Fund of £4 million; carry forward in Renewable Energy due to a delay in the Corpach CHP project of £3 million.
3 Windfall income comprises one-off benefits of (a) HM Treasury agreeing to fund debt breakage costs associated with the Glasgow housing stock transfer and, (b) the release of a provision to cover possible cost of appeals following the revaluation of non-domestic rates.
4 A measure to incentivise departments to manage their budgets more effectively.
5 The £27 million total EYF for Justice is the sum of £28 from "capital slippage", -£9 million from "fluctuations in demand led expenditures" and £8 million from "other smaller initiatives".
6 In many instances it is not sensible to indicate annually whether anticipated final outcomes have been delivered. Nonetheless, expenditure on outputs should be linked to the achievement of longer-term final outcomes and these should then be verified over time through the application of structured monitoring and evaluation techniques.
7 The Scottish Executive, 2004(b)
8 The provision of this data does not necessarily mean a higher level of funding being automatically allocated to any programme should the appropriate index be higher than forecast RPI. Budgets could still be set with an RPI-related growth factor should there be a wish, for example, to encourage the delivery of efficiency savings.
9 Based on HMT's The Green Book.