LOCAL GOVERNMENT COMMITTEE

Tuesday 8 January 2002
(*Afternoon*)

Session 1

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LOCAL GOVERNMENT COMMITTEE
1st Meeting 2002, Session 1

CONVENER

*Trish Godman (West Renfrewshire) (Lab)

DEPUTY CONVENER

*Dr Sylvia Jackson (Stirling) (Lab)

COMMITTEE MEMBERS

Mr Keith Harding (Mid Scotland and Fife) (Con)
*Mr Michael McMahon (Hamilton North and Bellshill) (Lab)
*Tricia Marwick (Mid Scotland and Fife) (SNP)
*Iain Smith (North-East Fife) (LD)
*Ms Sandra White (Glasgow) (SNP)

*attended

WITNESSES

Mike Geraghty (Argyll and Bute Council)
Mike Gerrard (Partnerships UK)
Dr John Gibson (EFG Research)
Stewart McGregor (Argyll and Bute Council)
Dougald Middleton (Ernst & Young)
Professor Stephen Smith (University College London)
Professor Gerry Stoker (University of Manchester)
Councillor Dick Walsh (Argyll and Bute Council)

CLERK TO THE COMMITTEE

Eugene Windsor

SENIOR ASSISTANT CLERK

Irene Fleming

ASSISTANT CLERK

Neil Stewart

LOCATION

Committee Room 2

Scottish Parliament

Local Government Committee

Tuesday 8 January 2002

(*Afternoon*)

[THE CONVENER *opened the meeting at 14:09*]

Local Government Finance Inquiry

The Convener (Trish Godman): Okay comrades, we can begin. I hope that members had a nice break; we should be raring to go after it. This is the last marathon meeting for the local government finance inquiry. It is good to welcome Rita Hale back again.

We start the meeting this afternoon by taking evidence from John Gibson, who is a partner in EFG Research. I welcome you to the committee, Dr Gibson. The clerks will have gone through the drill with you. We have received your research paper and have read it—at least I have read it and I suspect that the rest of the committee has, too. In your presentation, we would like you to focus on the key findings of your research. I will then open up the meeting to questions from committee members.

Dr John Gibson (EFG Research): The key finding of my research addresses a crucial question that, three years ago, the House of Commons Environment, Transport and Regional Affairs Committee, which shadowed the Department of the Environment, Transport and the Regions, deemed not yet answered and perhaps unanswerable. That committee had to decide on—and we must remember that this was a big issue in its investigation into the financing of local government—the proportion of expenditure that should be financed by local taxes and the proportion that should be financed by national taxes.

Disappointingly, the Government was reluctant to increase the proportion of expenditure that was financed locally, so a debate took place on whether such funding would make much difference to local autonomy—which is not my priority—or to local accountability and the vigour of local democracy, which, after all, is the top stated priority of the Government.

The committee could come to no conclusion because there seemed to be no definitive study on the matter. I hope that I have an answer. Perhaps it is immodest of me to call it definitive, because I do not feel that it has been that difficult an achievement. I find that yes, yes, yes, the proportion of local expenditure that is financed locally makes a difference to turnout. In England, during the period from 1975 to 1991, it made a significant difference.

The key to that finding is to examine the data on local elections more carefully—and quite reasonably, in my opinion—and to rearrange them to make like-for-like comparisons according to the stage in the national political cycle and how much the national media and the party organisations are wound up. When one does that, one sees clearly that all the turnout trends move from south-west to north-east—that is, they go up over time. Not one goes from north-west to south-east, so there is an effect. The effectiveness of my findings is doubled if we take into account the fact that this was taking place when the powers, status and freedom of local government were on a downward trend. The potential to use an increase in local taxes to increase turnout is therefore very large.

The key analytical breakthrough—I feel a little pretentious calling it "analytical", because it was arrived at through a bit of a rearrangement of the data—more or less hits us between the eyes. It has been there a long time. The data were there, just under the surface, and have been considered a great deal.

14:15

I sensed that there might be a surprise answer. The stimulus to my investigation was a paper by Rita Hale and the report of the House of Commons select committee. I was aware of the question. My answer had slotted into place before October, and I wrote it up. That is the key finding. There is just a little innovation, and then we get the answer to what I know is a very big question. The question keeps recurring, but now we have an answer.

We are not in a theological rut. The Westminster committee said that it felt that it was stuck, but there is no need to be stuck. There are important implications for Scotland. I presume that the Scottish data would show a similar effect to the ones that I have analysed. I could be questioned on the implications for Scotland.

I think that I can guess the Government's stance on the question. One of our greatest political economists, Sir Samuel Brittan of the *Financial Times*, said that Governments often like to be lied to when they need to save a rather major lame duck. They like someone to come in with a report saying, for example, "I've got a viable restructuring plan that will put this shipbuilding company on its feet in 10 years." However, just as Governments like to be lied to, sometimes they do not like to be told the truth or, if the truth is around, they do not like to hear it. It worries me that the Government will not like to hear the message. I say the Government, but I realise that the world has moved on and that there are quite a few Governments around now. I do not know Scotland very well, but I presume that the Scottish and UK Governments share traits such as those.

However, that is what I think is the finding. There are some strong implications for Scotland. I presume that members have read the paper or at least glanced over the major diagrams and statistics.

Another important issue arises, which is how to raise the proportion of expenditure that is taxed locally. We are lucky to have here Professor Smith, who is an expert on local taxation. One element that we have not tested yet—I think that Professor Smith would agree with me on this—is the fiscal capacity of council tax to support a greater amount of local expenditure. One must be in the world of guesses and my guess is that, if council tax became a bit less regressive, it could support a fair bit more expenditure than it supports at present.

Those remarks were about England. In Scotland, council tax's capacity is much greater still. I think that the figures show that council tax yields per capita are even lower in Scotland than in some of the poorer regions of England despite the fact that incomes per capita are higher in Scotland than in the poorer regions of England.

In some ways, we are obviously not getting the full potential from council tax. I notice that the Chancellor of the Exchequer is dipping in with major property taxes. Those include the stamp duty on transactions, which is a tax on property and has been growing greatly, and inheritance tax. In the south-east of England, it seems that inheritance tax is growing very quickly indeed.

I have always been a supporter of more local taxation, to be raised by local authorities. One remark has always struck me and brings the issue home: nothing improves well-being as much as undiscovered theft—until the theft is discovered. I believe that J K Galbraith made that remark. There is an element of that when there is not enough local taxation and no matching element. We are then into the crying game, which is of asking for more grant through the needs assessment. In England and Wales, we call that the standard spending assessment—at least until next year.

I have visited a lot of local authorities and only about 2 per cent said that they had had enough in the way of needs assessments—that was a private confession. No one's needs assessment is ever adequate. Having a matching element and more local taxation reduces the crying game and what one might call grantmanship.

Should we look for an increase in local business taxation? If I am a supporter of greater local taxation, should I support greater local business taxation? My paper tends to show that local business taxation is a much lesser stimulus to voting and participation than domestic taxation. Although local business taxation gives autonomy, it does not deliver much in terms of extra accountability.

The Convener: I hope that I am not being rude, but I would like to return to the local domestic tax. Does the evidence that you examined suggest that people are more likely to vote in local elections when the local domestic tax finances a bigger proportion of local government spending?

Dr Gibson: Yes.

The Convener: I asked you to highlight the findings from your research, which you have done. Do you mind if I open the discussion to questions?

Dr Gibson: No, I welcome that.

Ms Sandra White (Glasgow) (SNP): I will follow on from the convener's question. You said that you support more local taxes and you discussed council tax in detail. Is the main message of your research that local government should seek to increase the proportion of spending that is financed from local resources if it wants greater local autonomy? Do you favour council tax or another form of taxation?

Dr Gibson: That is not quite the main message. Local business taxation is the best route to greater local autonomy and it would not involve much pain or disorder among voters, although undoubtedly there would be some response. Especially in Scotland, there is some margin to raise the yield of the council tax, which would increase voter participation. There is mileage in reforming the structure of the council tax. That mileage could be achieved without jumping on to the next stage, which is to have a local income tax, as exists in other countries. However, it is probably beyond the council tax to finance up to 37.5 per cent or 50 per cent of local expenditure.

Ms White: My question was not about voter turnout, but about local councils. Is your main finding that increasing local taxation would give councils more autonomy?

Dr Gibson: I am not sure what you mean by local autonomy. Autonomy is linked to independence. I could exhibit my autonomy by not taking much notice of you. In that sense, the term "autonomy" could denote problems.

Ms White: I meant accountability.

Dr Gibson: Local business taxes serve some purpose in increasing accountability, but they do not give as much mileage per pound as domestic taxes. I have occasionally taught public finance, although I have no reputation in the field, but I do not regard taxation as a good chance to milk the cow fully. Taxes should not be painless or stealthy. I prefer painful taxes that people notice, but Governments tend to prefer stealthy taxes that people do not notice. Earlier, I referred to undiscovered theft. I want accountability and I think that figures should be produced regularly. If a person is paid an extra £100, how much of that goes into income tax, value added tax and all the other taxes? I do not think that our population would get close to guessing how much, but the figures are large.

14:30

Ms White: Transparency would also come into it.

Dr Gibson: There is a lot of stealth around.

Mr Michael McMahon (Hamilton North and Bellshill) (Lab): Thank you for your evidence. When you were talking, I was reminded of a sociology lecturer who once told me that empirical evidence sometimes provides complex explanations for the patently obvious. Perhaps you were saying that some things are more straightforward than they first appear to be.

You spoke about non-domestic rates and their impact on accountability and electoral turnout. Who should determine the level of non-domestic rates? Should that be a central function or should it be left to local authorities?

Dr Gibson: I have one or two ideas about that, which involve something more complex than what we have observed so far. We are running with two models: the first is the old, pre-1989 model, which was local authority set and controlled; the second is post-1989, which is set and controlled by central Government. However, intermediate positions are available in which central Government would control a chunk of non-domestic rates and local government would control another chunk. In fact, I would like constraints to be placed on some central Government taxes. If central Government is to increase a stealthy tax, it should have to increase a visible tax at the same time. I realise that I am getting dangerously close to the fringes of cloud-cuckoo-land.

Mr McMahon: You started by saying that the share of income that is raised locally, as opposed to centrally, has an effect. Would the third or middle way model that you envisaged not also have an effect? There must still be agreement about how much is raised centrally and how much is raised locally.

Dr Gibson: A decision must be taken about how much is to be raised. I do not like the existing 0:100 split. I am not too sure about going all the way back to the old system in which 100 per cent was determined locally and 0 per cent was influenced by the centre. I concede that most other systems work with more than one local tax. In that sense, British—English and Scottish—local government is deprived compared to local governments abroad.

I would like safeguards to be put in place, as some elements in the previous system made it too easy for local government to use business taxes. I am a little uneasy: I do not want to sit in front of the committee as an expert on local taxation. I am not sure that I can bring that off today.

Tricia Marwick (Mid Scotland and Fife) (SNP): Let us turn to the findings of your research into the turnout rates for local elections in England and the question whether your findings compare with those of studies into turnout rates for local elections in other advanced democracies. Have you conducted any such comparison?

Dr Gibson: I do not know of a European study along those lines. I checked with some of my contacts and conducted some research, as I wanted to go back to the mid-1970s. I remember bumping into one or two Europeans who said of turnout in their local elections, "We started to go down from the mid-1970s or early 1980s." When I investigated European trends further, I could not find an example of local election turnout going up—it has been going down in just about all cases. That is also true of national election turnouts.

I was happy, incidentally, that the period of my research stopped at 1991. I know that the turnout has gone down further in recent years. I do not think that there has been an equivalent European study—it does not seem to have been as big an issue on the continent. I may be insular in that regard, but I am not aware of such a study. At least, I have not been told of one and I have not noticed one when searching academic papers.

Tricia Marwick: The committee is interested in and concerned about voter turnout in local elections. Your evidence seems to suggest that people are more likely to vote in local elections when the local domestic tax is a higher proportion of local government spending.

Dr Gibson: Yes.

Tricia Marwick: The Scottish Parliament has just agreed to hold the 2003 local elections on the same day as the Scottish parliamentary elections. What impact will that have on accountability on the part of local government?

Dr Gibson: Not a good one. I cannot sit in front of you as an expert in local elections, but I do not like the joint arrangement at all. I have a couple of different ideas for increasing turnout at local elections, aside from what is in my written submission. If the committee were to invite me to put those ideas on paper, I would gladly do so. They would not take up much paper—nothing like as much as the submission before you. However, the ideas would not be welcomed by any British—Scottish or English—Government.

In my opinion, local elections should be held separately from national elections wherever possible. That gives a choice to the local elector at every local election. They will be voting Labour, Liberal, SNP or Conservative—sorry if that order offends anybody—in their ward, to choose their representative. Every time that an elector goes along to vote in a local election, I think that they should face a second column on the ballot paper. The question for that second column should be, "If there were a by-election for the national Parliament in this constituency today, who would you vote for?" That would mean asking the average Scot whether they are capable of filling in two crosses in two columns of four, one in each column. I would say that they are capable. Indeed, there are much more complicated voting or ballot forms abroad. If we cannot put two crosses in two columns, we might as well give up.

Doing that would serve two purposes. First, it would act as an opinion poll—an alternative to a Philip Gould poll—on how the electorate thought the national Government was doing at that time. There could be various interpretations. The local vote would take place, and there would be a national vote. People could split their vote, and there would be flexibility. There would be an extra reward for going to the poll and there would be more national organisation behind the local elections every year. I hope that that idea is original, and that I did not first hear it on the BBC. I would like to think that it was one that EFG Research came up with, although I realise that it is unlikely to be welcomed by the Government.

In setting out my second idea, in contrast with my paper, I go along with what has been said by scholars in some very interesting data from abroad. Some Polish local governments hold proportional representation elections on the same day as first-past-the-post elections. If I told members the results of those elections, they would be astonished. What emerges clearly from the results is that increasing the number of councillors and decreasing the size of wards has an effect on voting and on turnout. EFG Research might need to be paid some money to go into that matter more carefully.

Dr Sylvia Jackson (Stirling) (Lab): I want to ask about your idea that taxes should be painful and that, if they are, people become engaged and go out to vote. Do you accept, as you say in your paper, that, if that is not done in a transitional way, people might go out to vote but they might get rid of whoever is in local and national Government at the time?

Dr Gibson: That is a funny thing and it is a problem. The urgent swing of the pendulum is noticeable in some Governments, including those in Poland, where Governments seem to lose elections with 10 per cent popularity whereas the Opposition comes in with 80 per cent support. Two months later, the situation is reversed. When are the electorate going to learn?

Some sort of non-partisan agreement is needed that says, "We will not try to bribe the electorate. We will substitute our stealth taxes with taxes that the electorate notice." Governments play awful games and they have got to stop playing them. I am not sure if I addressed how they should stop doing so.

Dr Jackson: If you wanted to write to us to say a bit more about that, I would be interested to have the information on what I see is a problem.

Dr Gibson: You are right. I concede that I have often wandered down these byways before, although not in front of a committee. I have done so privately and, when I do, I tend to find a wall in front of me.

Dr Jackson: If we are looking for one big message from your research, is it that increasing local domestic sector taxes would give greater accountability to local government?

Dr Gibson: Yes.

Iain Smith (North-East Fife) (LD): When you were undertaking your research, did you consider whether other factors might affect turnout, in addition to the proportion of local government finance that is funded by domestic taxation? Did you consider issues such as revaluation and other things that happened in the 1970s and 1980s, which on occasions, I recollect, excited the public?

Dr Gibson: You had a revaluation in 1995, but we did not. I am sorry to use the words "you" and "we".

Iain Smith: Other factors were involved including the relative popularity of the Government of the day.

14:45

Dr Gibson: That is a good point and it will be interesting to see what effect there is on Scottish turnout. However, luckily I stayed with English data.

On revaluations, there is a good quotation from Machiavelli. I do not remember it precisel, but its clear message is: do not stir the population up unnecessarily. Revaluations are always potential bad news.

It is interesting that quite a lot of scholars thought that the council tax would be as big a problem as the poll tax. I never subscribed to that view. By the time that the council tax was introduced, the Government had learnt how to control disturbances. We did not have much turnout to boast about that time, did we? That is undoubtedly an important factor.

I immediately concede that the national environment introduces some special factors. The local elections of 1982 were presumably special in that way. The local elections in 1992 were special because Labour workers were disheartened. One gets such special factors. In 1988, the country was optimistic and content—or quite a lot of it was. It may be possible to take the study further. It probably is.

Iain Smith: The local elections in 1982 were significant: that was when I was first elected.

The Convener: They were highly significant in that case.

Iain Smith: Do you have a view on the appropriate balance between central and local funding of local government spending? What would the rough figure be?

Dr Gibson: I would be much happier with a balance of 50:50 than one of 25:75. One can get hung up about the gearing effect. Funnily enough, there was much trouble about the gearing effect during all the years when local authorities were not allowed to gear at all—they were not allowed to increase their spending. The importance of the gearing effect can be exaggerated. When a needs assessment is unjust, that is painful if the balance of funding is 25:75. It is less painful if the balance is 50:50. A balance of 50:50 is healthier.

Your question is important. We are close to another unanswered question. There is no definitive study on it. Nobody has shown how much local election results are distorted. Does the electorate respond to percentage differences in local taxes compared to those of neighbours, or does it respond to absolute differences? Although I have written an academic paper on funding and turnout, I do not know the answer to that question.

A balance of 50:50 is certainly better. Some would argue that the proportion is irrelevant. I think that senior civil servants who are involved would say that it does not affect much. However, it may cause distortion. In support of their position, such people point out that, when we ask the local electorate how much local government expenditure it supports, we find that it thinks that it supports a much higher proportion of expenditure than it does. From that they draw the conclusion that, because the local electorate does not understand everything, we are quite safe with a ratio of 25:75. I regard that as a spurious argument.

I do not want to make a meal of this issue. The research that produced the findings that I have just cited was done by Professor William Miller of the University of Glasgow. I do not know whether it has been published yet. I find some political science research very strange. Members of the public are approached and asked what proportion of local government expenditure is funded from local taxation. Who is being approached? When are they are being approached? Which local authority area do they live in? What is their council tax band? Even if questioning were restricted to one local authority, there would be a 3:1 ratio in the size of people's bills. People respond to bills. If a survey takes place across authorities, there may be a 6:1 ratio in the size of the bills of those questioned.

Such research has potential, but it could be taken a stage further. We could try to relate what people think they finance to what they pay. We would then get answers that a Government that was considering fairly what proportion of local expenditure it wanted to finance by local taxation might find informative. That may be a matter for a hypothetical Government rather than for any Government that we know of in these islands.

I would be much happier with a ratio of 50:50 than with one of 25:75. With local business taxation, we could go even further.

The Convener: We have exhausted our questions. Thank you for your contribution, in which you raised some interesting issues that we have not heard before.

In answer to a question from Tricia Marwick, you said that you were unhappy about elections for central Government and local government taking place on the same day. Last time round, the Scottish Parliament and local government elections were held on the same day. People had three votes: a vote for a constituency member under the first-past-the-post system, a vote for list members and a vote for a local councillor. As individuals, and in the course of our work as a committee, we have picked up on the fact that the electorate is very clear about whom it wants to vote for at parliamentary and council level. It is possible for people to vote for two different parties in different elections.

I was interested to hear what you said about offering a reward to people for going to the polls. I wondered what that reward would be. Perhaps people could be given days off during the week—a sickie, as they say in Australia.

You also referred to the possibility of increasing the number of councillors and decreasing the size of wards, which is the opposite of what we have heard suggested before now. You have given us food for thought. Thank you very much for coming. If we have to contact you again, we will do so.

We welcome now to the committee Professor Stephen Smith from the department of economics at University College London. You have been sitting in the public gallery, so you know the drill. We have read your paper and we have some questions to ask. However, in the first instance I ask you to comment on your paper, then I will open up the session for questions.

Professor Stephen Smith (University College London): I will highlight briefly the lines of argument in my submission. I proceed from the position that I think that problems arise in a system of local government finance in which there is such a large lump-sum central contribution and in which, therefore, there is such high gearing of local discretionary spending decisions into local tax rates. I will be happy to talk about why I take that position.

Starting from that position, I go into three possible routes that one might take to reduce gearing. The first route would be to make a contribution from central funds to each marginal pound that is spent by local authorities. My case is that there is a strong argument for doing that and that a considerable proportion of the benefits of local spending accrues to non-residents of the local area. The central subsidy to local spending would be a reflection of those spillover benefits to residents elsewhere.

The second way of reducing gearing would be to increase the contribution from the existing local tax, so that we simply make the council tax bigger. The route to doing that would be, perhaps, to increase the number of bands, particularly at the upper end, and to increase the degree of progression between the bands. At the moment, the amount paid in council tax rises much less than in proportion to property value. One could steepen that relationship. In fact, long-standing research indicates that the council tax is a relatively flexible instrument that would allow one to do that fairly easily. That would make it easier than at present to think of raising more revenue from the council tax.

Thirdly, one could reduce gearing by looking for other local taxes. In general, I would think of those taxes being run in parallel with the council tax, rather than as a replacement. In my submission, I discuss briefly a number of possibilities. One could look for additional sources of revenue in the form of assigned shares from national taxes. However, I think that that is largely irrelevant to the issue; it would not solve the problem of gearing and would be largely a fiction.

One could raise additional local revenues through the non-domestic rate. That, essentially, becomes an issue of substance only if local authorities are given the power to vary the local domestic rate. There are clear disadvantages to doing that, although one could perhaps overstate their importance in the short term.

One could look for other bits and pieces of local revenue in the form, perhaps, of local environmental taxes or other small revenue sources. In the main, I take the position that those should be justified in terms of their environmental benefits rather than as revenue sources. Indeed, I think that there are big dangers if one uses or milks environmental taxes as a source of local revenues.

My argument then leads to two possible candidates for significant revenue instruments for local government. A local sales tax would be feasible, although at the moment European Union rules would make such a tax difficult to introduce. A local income tax would be extremely feasible and seems to me to have stronger merits than pretty much any other route.

The Convener: Thank you for that. I will kick off the questions. On page 1 of your written evidence, you say:

> "It is desirable to reduce the average grant contribution to local government resources by reforms which would make it possible for locally-raised tax revenues to contribute a higher percentage of local financial resources."

Will you explain what you mean by that and why you take that view?

15:00

Professor Smith: The primary concern is the impact of the central lump-sum grant on the gearing problem. A numerical example in my submission goes through the steps. Consider a council that derives only a quarter of its income from local taxes, but must cover all the costs of discretionary spending—additional spending at margin—from local taxes. If the council decides to increase its spending by 10 per cent, that will push up the local tax bill by 40 per cent. That may not be a problem if everyone accepts that the council has spent an extra £20 million and is raising an extra £20 million in tax, but it will be a problem if people compare percentage changes in spending with percentage changes in taxes. If voters compare the performance of their authority with neighbouring authorities, there is a significant possibility that they might be misled about the relative efficiency of authorities. There is a high incentive for local authorities to devote senior management time to lobbying on grant distribution, if that is so important. It is probably more desirable for senior management in local authorities to manage the authorities than to try to influence the grant distribution.

Dr Gibson said that, if the grant assessment is such a huge proportion of local revenues, it is extremely painful if it gets things wrong. We all recognise that there are serious limitations on how accurate and fair grant distributions can be. We should recognise that the grant distribution will be unjust or arbitrary for particular authorities from time to time. For those reasons, there is a case for raising the proportion of local government spending that is covered by locally financed revenues.

Iain Smith: I come from a local government background and understand your concerns about the effects of gearing—your submission deals with those. One of your proposals is that there should be central Government support for authorities' marginal spending. How would that work? There are difficulties with the proposal. In the past, the central Government revenue support pot has been cash limited, as it is at present. It is a fixed amount. If one council gets more money, another council inevitably gets less. How can that problem be solved without opening the floodgates? How can an uncontrollable pot be avoided? How can we avoid the Government's having no control over the total amount of additional spending?

Professor Smith: You are right—there would be serious problems if one tried to operate such a system with a fixed and rigid year-on-year cash limit on the central grant. A similar system operated in the pre-poll tax regime. To equalise resources in the system, there were positive or negative contributions to local authorities' marginal spending. The grant total depended on local authorities' spending decisions. At the end of the year, there was a clawback to get the total right. Such an approach introduces further instability into local authorities' budgets and is undesirable.

There is a transitional problem and a long-term issue. In the long term, it would not be a disaster if that part of local public expenditure were not rigidly controlled from year to year; it would not fluctuate wildly. I presume that local authorities would make spending decisions that, on aggregate across 50 local authorities, would be fairly stable from year to year. The regime would therefore not be a source of unpredictability in local expenditure. The fact that the amount of grant fluctuated from year to year, depending on local authority spending, would not be a big problem for the overall management of the economy.

A shorter-term problem is that moving to that regime would, for the first couple of years, probably create much unpredictability about how much money local authorities would choose to spend and, consequently, what the claims on grant would be. It would be difficult to introduce such a regime in times of extreme financial stringency, but the problem would be short term and transitional rather than one that I would worry about too much in the long term.

Iain Smith: I am interested in your optimism. Is there not a danger that marginal decisions of local authorities would always be to increase spending, because to reduce it would be perceived as a way of losing grant? If local authorities were getting 30 per cent, or whatever, for any additional pound that they spent, they would get 30 per cent less if they spent a pound less.

Professor Smith: I hope that local authorities would make their spending decisions on the basis of whether what they were supplying was what voters wanted, because the voters would be contributing the other 70 per cent. In the long run, one would hope that local authorities would bear in mind when they chose their level of spending that a constituency outside the authority was chipping in 30p for each marginal pound. That would reflect the fact that 30 per cent of the consumers of some local services were non-residents. To get the extra 30 per cent, the authority would have to contribute something locally. I do not think that the sky would be the limit for how much local authorities would spend under such a regime. They would spend a bit more than they currently spend in areas where spillovers are large.

Dr Jackson: Your submission states that your preferred option for broadening the local tax base is a local income tax. Why is that your preferred option? How do you envisage the UK and Scottish Parliaments and the Scottish Executive moving towards that end?

Professor Smith: One of the reasons for a local income tax being my preferred option is that it is powerful. If the major objective is to find a revenue instrument that can increase sharply the amount of money that local authorities raise from their own resources, we must look for a tax that would be capable of raising large amounts of money. Many of the taxes that we might talk about are not capable of doing that; income taxes are clearly capable of doing it.

The other reason for the attractiveness of local income tax is that it is one of relatively few taxes that would not require a complicated set of rebating arrangements at the bottom end of the income scale. One of the factors that has made council tax and its predecessors expensive to run is that it is inconceivable that you could have a system such as council tax without subsidising, through social security or a rebating system, the council tax payments of people with low income levels. A lump-sum bill of £700 a year would clearly be unsustainable for someone whose annual income was a few thousand pounds, so there must be a rebating regime at the bottom end. An income tax would deal with that by sending small bills, or zero bills, to people with low incomes. Although there might be some complications in the administration of such a tax, it would allow us to forgo the problem of devising and enforcing systems of rebating. Preventing fraud in rebating is an issue.

The fact that a local income tax, in technical terms, is less regressive—it bears less heavily on poorer households—is also a significant attraction. It shares that attribute to some extent with a local sales tax, which is also a big tax that could raise lots of money, but which has practical difficulties.

How would we go about introducing a local income tax? In terms of the legal situation, I do not think that I have anything to contribute; I know next to nothing about the precise way in which such a tax would be inserted into the powers of local government in Scotland.

The practical issue, on which I will say more, is how one might insert such a tax into the administration of the income tax system. The issues are not significantly different from those that would be raised if the Scottish Parliament chose to vary income tax to the extent that it is allowed to do. Some kind of registration or declaration of residence would be required, which has not until now been an issue in the income tax system in the UK. Plenty of people are taxed by the income tax system without the Inland Revenue really knowing, or needing to know, where they live. Plenty of people are taxed through pay as you earn, in essence on the basis of information that is supplied by their employer.

The Inland Revenue's information about the private addresses of individuals can be out of date, or even non-existent, and nothing goes wrong. However, with a local income tax, one would need to have a system to record accurately the residence of individuals, both to charge them the right amount of tax and to attribute the right revenue to the right local authority. That would not merely be a matter of registration; it would need to be a matter of enforcement, or else people would choose to declare residence in places with low tax rates.

Some of the issues that arise have similar requirements to what would have to be done to charge a different income tax rate in Scotland than in other parts of the UK. Clearly, with a local income tax, there would be more places with different rates than if there were simply a single different income tax rate in Scotland, so there would have to be more micro-level enforcement of residence declarations. Broadly, however, the same operation and processes would be needed.

I am inclined to think that the power to vary tax should be confined to earned income. A large proportion of the tax on investment income—the tax on interest on bank deposits and other forms of investment—is deducted at source, without any need to be sure of where the taxpayer lives. There would be tremendous administrative advantages in keeping that system, so that one did not need to find out where every person with a small bank deposit lived so they could be charged the right amount of tax. I do not think that a variation in the tax on investment income would be difficult to enforce, but it would be administratively complex and would not necessarily be particularly valuable.

The other attraction of confining the system to earned income is that that would reduce the possibility that people at the upper end of the scale might move around to avoid the higher rates of tax. One would not want to have a system in which local authorities with high revenue needs suddenly lost large parts of their tax base—that is, the people who contribute most in taxation. Excluding unearned income from the tax base would reduce the incentive for such avoidance behaviour. It would then be appropriate to tax unearned income at a flat rate, or some rate that roughly equalled the average of local authority rates but which was the same across the territory, and to allow local authorities to vary the earned income component. There would obviously be issues of timing about how budgets would be set, and about what rate would be charged and how that would relate to budgets, but all those problems would be soluble; they would just need some thought.

Dr Jackson: I have one more question. I mentioned the UK Government not so much with regard to the legal aspects, but with regard to a politically sensitive issue. I was referring to how you sell the tax—perhaps that is the wrong phrase. How would you inform the public at large about how you were changing the system of taxation? What might need to be done at the UK end as well as at the Scottish Parliament end? My question arises from previous comments, when we discussed how a dramatic change to a local income tax could be politically very sensitive.

15:15

Professor Smith: There are two dimensions to that. There would be a UK-wide dimension, supposing that the UK were to follow that route. There are obvious issues about communicating to the voters what is going on. One would need to clarify that what was going on was a shift in financing. Perhaps that could be done by packaging the change with an explicit reduction in national income tax in order to make it clear that a portion of income tax was being transferred, as opposed to the total income tax burden being expanded. That would be necessary and desirable if one were to get the message across.

There is a self-evident question of difference in how one presents what is going on in Scotland vis-à-vis the rest of the UK, but a simple consequence of devolution is that things might happen differently in Scotland. I am not sure whether that raises any specific problems of public acceptance south of the border. However, there is an issue about how the Treasury might feel about such a change. For years, the Treasury has taken the view that its ability effectively to manage the economy would diminish if it let local government get its hands on income tax rates. I am sceptical of that, because I do not think that many of the arguments that have been used to support it have been persuasive. If local authorities want to spend more, and if local residents want their local authority to spend more and are prepared to pay the tax to finance that spending, it does not seem to me that that would cause greater problems for the management of the economy than would arise if individuals spent more on particular commodities.

Tricia Marwick: In your written evidence, you said that returning the non-domestic rate to local councils' control could in the longer term

"create distortionary incentives for the relocation of business activity".

Are you aware of any evidence or research that shows that, prior to nationalisation of non-domestic rates, differences in non-domestic rate levels affected decisions on business location, or is that risk theoretical?

Professor Smith: It is fair to say that there is no evidence that relates the pattern of activity to the pattern of business taxes. Certainly, the studies that were undertaken to consider that relationship did not come up with anything dramatic. On the other hand, one would be surprised if statistical tests had the power to identify such a relationship in that sort of process, given the effects of things that one would expect to see worked out over quite a long period of years. Business investment decisions have all sorts of complicated elements. For example, someone might build a factory that they hope will last for 15, 20 or 25 years, or they might extend an existing factory and have to decide whether to go for a split site or to build in a high-tax area. Another issue is that such decisions are taken over quite a long time horizon and it is not clear how they would relate to business tax rates in a particular year, or to average business tax rates over four or five years. I am not entirely surprised that the research did not find the relationship about which Tricia Marwick asked.

Slightly more worrying evidence comes from work that was done to calculate the impact of differences in business rates on the rate of profit that would have to be earned in different locations in order to leave investors in those different areas with the same amount of net profit after tax. Professor Robert Bennett did some work at the London School of Economics that showed that there were quite big differences between the amount of profit that a business would have to earn in different locations in order to get the same return after tax. That suggests that if a business owner were genuinely asking, "Should I put myself here, here or here?" there would be a big disadvantage to going to the high-tax areas. There is an indication that one would be surprised if there were not effects on the decisions of certain types of businesses.

Tricia Marwick: We were talking about relocation or setting up businesses in the first place. Would not regional selective assistance grants, for example, have a much greater impact on where a factory would be located than would the business rates, which are small beer compared to the possible incentives that could otherwise be given?

Professor Smith: I certainly do not want to overstate matters and say that business rates are the only factor that determine where people set up businesses. Many other factors are much more important, including where businesses' customers and skilled work force might be. Nevertheless, it is the case that business rate differentials were not trivial in relation to average rates of profit in the long run of a business investment.

Although business rates are relatively small in a particular year, they are paid every year. If a business invests over 25 years and chooses to locate in a place where business rates are twice as high as they are in another place, it pays an extra amount each year, in effect, and that adds up to quite a lot.

Ms White: I am interested in the revenue-sharing aspect of your submission. You touched on a point about local income tax in response to Sylvia Jackson's question. I would like clarification on that. You said that other taxes, along with council tax, would be the preferable option. Would the local income tax that you mentioned be run alongside the council tax, or would only local income tax be used?

Professor Smith: There are arguments for keeping council tax even if we had a local income tax. There is no doubt that local income tax would have the power to pay for all local government if we wanted it to. However, there are advantages in the UK fiscal system of having some taxation on housing, which is otherwise pretty much untaxed. We are a small country that has a lot of pressure on space and in which there are housing problems in many areas. Encouraging over-consumption of housing by leaving it as one of the few wholly untaxed items of consumption is probably not desirable. There are arguments about the neutrality of tax treatment of different things on which people could spend their money. There are arguments for keeping some kind of taxation on housing. That is why I would keep the council tax in place.

Ms White: That certainly answers one of the questions that I was going to ask you about council tax. We have been talking about revenue sharing and you also mentioned the fact that national taxation could be transferred. Business tax is basically that type of taxation—it is an assigned revenue.

Professor Smith: Exactly—it is at the moment.

Ms White: In an ideal world that type of revenue would change. Will you elaborate on why assigned revenues do nothing to improve the funding balance between central and local government and why they do not reduce the gearing of the council tax?

Professor Smith: The key element to reducing the intensity of the gearing effect is having other taxes on which to spread the cost of additional local spending. If the local authority spends an extra £10 per head, in the current system all that money is borne as an increase in council tax. That can have a large percentage effect on the council tax because of the gearing effect. I am examining other taxes across which the extra £10 could be spread. The impact on council tax would then be smaller and some of the impact would be spread across other discretionary taxes.

Typically, what I have understood by tax revenue sharing is a system in which—rather like the German system—central Government sets the tax rate and says that 60 per cent goes to central Government and 40 per cent goes to local government. Local government gets 40 per cent of whatever the take is, but does not have the power to influence how much it gets.

In some ways, tax revenue sharing seems to be just like a grant, except for the fact that the amount that is allocated depends to an extent on the level of economic growth. If the economy grows faster, the tax base rises, so authorities get a bit more money. That system does not help in spreading the cost of extra local spending, however. That is why I do not see it as a solution to the gearing problem. If one of the major current difficulties with local government finance is to do with sharp gearing, tax revenue sharing does not seem to be a priority for solving problems.

Ms White: So there could perhaps be more autonomy for local authorities to raise taxes without having to gear or to match-fund what central Government gives them.

Professor Smith: I do not think that simply getting shares of assigned revenues would give local authorities much more than they already get. Basically, they get money—the amount of which they have no control over—that they can spend, but I presume that assigned revenues would be a substitute for some part of their existing grant. I do not think that the opportunities that are open to local government would be changed all that much by what Ms White suggests.

Mr McMahon: Paragraph 2 of page 2 of your submission says that a

"contribution from grant to local spending at the margin would be appropriate"

in certain areas, which you go on to explain. In evidence that we have taken, it has been apparent that there is no agreement between local authorities and central Government about what constitutes an assigned grant, a designated grant or a hypothecated grant. How can it be decided what an appropriate contribution is if criteria cannot be established in relation to whether grant funding is appropriate about which central and local government can agree?

Professor Smith: There seems to be quite a lot of confusion about the local grant system. The fundamental distinctions are between grants that local authorities can spend as they choose and grants that authorities are told they must spend on certain things. In part, the current system appears to be unclear about precisely which forms of grant have one character and which have the other. The way in which the overall grant total is calculated—on the basis of a breakdown into various service areas—implies that something about the overall grant relates to particular services. However, that grant is just a lump sum and local authorities could, within the various constraints that are set by their statutory responsibilities, choose to spend it differently from the way in which it is presumed it would be spent under the grant calculation.

However, what I propose is fundamentally different from anything within the current system and would look like a rather different kind of grant in the sense that it would match spending decisions that were made by a local authority. It would not be calculated through a needs assessment, but on the basis of some audit of the budgetary plans of the local authority.

For example, a local authority might have budgeted to spend so much this year and central Government will contribute, say, 30p for each pound that is budgeted. There would be some correction in subsequent years to ensure that the amount that was paid corresponded to spending that had taken place. It could be determined whether that 30p per pound was simply treated as general grant and whether the same rate of contribution was made against all areas of spending. On the other hand, it could be determined whether, for example, local education spending was subsidised at 30p, local road spending was subsidised at 70p from central Government—because most people on the roads travel through the local authority area in question—and local amenity spending was subsidised at 10p, because most of the benefits flow to local residents. Clear accounting rules would need to be set in relation to which local spending was in each category, but it would be possible to do it.

Mr McMahon: I am perhaps misreading you, but are you saying that spending would be determined by the local authority and that central Government would then have to match it? Can you envisage a situation in which central Government would be quite happy to have its spending commitments determined by the policies of certain local authorities?

Professor Smith: It is a question of central Government standing in place of non-residents of a local area and representing their interests in a local authority's spending decisions. For example, people who live outside Edinburgh benefit in a number of ways from what the City of Edinburgh Council spends. They benefit from cultural spending and from the fact that the roads are provided and maintained. They might be employers who benefit from a work force that has been trained by the education system in Edinburgh. It would be bizarre, but one can imagine local authorities negotiating with one another to ensure that their residents' interests were taken into account in the spending decisions of neighbouring authorities.

I envisage something much more rough and ready, in which the central authority makes a contribution on behalf of non-residents of a local area to the spending decisions of that area. That suggestion has not been debated much in the UK, but the idea that central Government might make matching grants to local government, to reflect the fact that a proportion of local spending benefits flow outside the local area, is encountered frequently in local government finance systems elsewhere in the world.

15:30

Mr McMahon: The city councils, in particular, have told us that they feel that they have additional burdens and that they provide services from which residents in outlying local authorities benefit. It has been suggested that metropolitan status for cities might be a solution to that problem. Alternatively, city authorities could be allowed to retain the growth element of any investment that comes from funding business rates. Does that figure in any of the revenue-raising proposals that you have examined?

Professor Smith: I do not like the proposal to give local authorities a share of the business rate revenue from additional business that appears in their area. That looks fine at a particular point, but over time it will introduce all sorts of complications and anomalies into the distribution of grant or to the financial resources that are available to local authorities. It is far from clear that the areas that attract the most business will be the areas that have greatest need for financial resources. If we examine needs and resources and then offset with extra grant the additional business rate that authorities receive, the whole scheme becomes pointless.

We could end up in a situation where there is much inequity between areas, resulting from the time at which we started the clock running on the scheme. In the long run, we could examine the pattern of business rate income in general. The long-term implications of allowing local authorities to retain incremental business rate income would be similar to those of allowing local authorities to keep all the business rate income that they currently receive. Clearly, that would result in a very uneven distribution of resources. Giving local authorities a share of additional business rate income might seem like a sensible and logical reform over the next couple of years, but it would create problems that would be very hard to disentangle. We would end up with a very messy system of local finance.

The Convener: Thank you for your evidence. I was interested that you said in your paper that a sales tax had some merit, but subsequently pointed out that there might be problems with the European Union in relation to VAT. While you were answering Sylvia Jackson's question about how we would promote the new system that you propose to those of us who live in the UK, I was struck by the fact that anti-tax political parties have emerged recently in European Union countries such as Denmark and Norway. That fact, rather than whether or not he regarded it as a good idea, might lead the Chancellor of the Exchequer to decide not to introduce such a system. If we need to ask you for further evidence, we will certainly do so. Thank you for your attendance.

We will proceed. We have before us Professor Gerry Stoker from the department of government at the University of Manchester. Welcome to the committee, Professor Stoker. I know that you have been sitting in the public gallery. We have read your paper, to which you can talk for between five and seven minutes. I will then open up the meeting for questions. You can speak for less time if you want—it is entirely up to you.

Professor Gerry Stoker (University of Manchester): I am happy to go straight to the questions.

The Convener: Okay. That throws us all into great confusion, because I have not opened my papers. I will catch members' eyes in a minute, but I will ask you the first question, which is on page 1 of our briefing paper. What research have you undertaken into the funding of local government in, for example, western Europe or North America, and the relationships that exist in those places between the extent of local autonomy and local accountability, and central and local funding for those things? You say in your written evidence:

"It would be difficult to argue with any conviction for instance that the Netherlands or Italy, local government systems with modest fund raising capacity, are less vibrant and dynamic than the systems with higher local revenue raising such as Portugal or Spain."

You make a comparison there. Some would argue that democratic systems of government are relatively new to Spain and Portugal. What would you conclude about the state of local government in Sweden, Norway, Denmark and France—where democratic systems of government have been in place for much longer—in terms of local autonomy and local accountability and the balance of funding? That involves comparing and contrasting.

Professor Stoker: You have gone for the traditional, easy opening question.

The Convener: That is what you get for not giving us a précis of your submission.

Professor Stoker: The truth is that I do not know of anyone engaged in a systematic analysis that would answer directly the questions that you asked. Some people have engaged in comparative analyses of financial systems and of European and North American local government systems—I am certainly one. I would argue that the amount of money that is raised at a local level is only one factor in explaining how autonomous or otherwise the system is. There are at least two other, equally important, factors.

The first general factor is the system's capacity. In the UK, the amount of money raised locally is part of that capacity. However, I have worked with the Council of Europe and talked to local government representatives from central and eastern Europe who may well have considerable capacity to raise local funds. In fact, they might be responsible for 80 or 90 per cent of local fund raising, but given the paucity of funds that are available from that 80 or 90 per cent they feel that their local government systems have considerable problems. In other words, one can be as autonomous as one likes, but if one has no resources to be autonomous about, it is not a particularly valuable autonomy.

The first thing to ask is whether there is capacity within the system. The ability to raise one's own funds is one element of capacity. The availability of a respectable and appropriate level of funding from other sources is another. I think that a third element, which seems to mark out generally the Scandinavian and UK systems, is the quality of available staff. When we consider what makes a system autonomous, the ability of local government to raise its own funds is only one element of the broad factor of capacity.

The second factor is the context in which local authorities operate, including legislative constraints, administrative oversight and the general policy context. There is no doubt that the Scandinavian systems that have been referred to score highly in providing a positive legislative context and—at least until recently—a positive policy context within which local government operates. Scandinavians complain a lot about the level and degree of administrative oversight that comes from the centre and they have tried to do something about it in recent years. The Scandinavians are in a healthier state than some southern European systems, which often have a formal commitment to considerable autonomy, especially in the newly democratised countries, but also in the more established democracies. One can draw a pattern from the context, but it is not always straightforward or simple.

The third factor is—for want of a better word—confidence. A feature of autonomous local government systems that stands out is that they believe in their capacity. They think that they can get out there and achieve something. I have examined Barcelona in considerable depth. I am sure that most members have heard about Barcelona and that some of them have visited it. Given Barcelona's good reputation for development and presentation, it is amazing that it has limited control over planning matters—let alone financial issues—in the city. It shares a lot of the decision-making responsibility with the regional government and agencies from outside Barcelona. Barcelona has been able to do what it has done because of the enormous confidence of the city, its excellent leadership for 20 or 25 years and the way in which it has built on the sense of being a significant organisation.

I have an overview of the way in which local government works throughout Europe and North America. To judge what makes a system autonomous, one must take into account the three considerations that I mentioned—the overall capacity in terms of resources, the context in which the system operates and whether local authorities have the confidence to make a difference. We should use that framework to judge the autonomy of local government in Scotland.

The Convener: Are there any glaring weaknesses or pitfalls that should be avoided? You examined countries in Europe and North America. Did anything come out that would not work here or that we should avoid if we consider raising taxes in other ways?

Professor Stoker: I mentioned the most glaring problem, which is large-scale underfunding. When local councils are given responsibilities for which there are no funds, that is devastating to the councils, soul destroying for the people who end up with the responsibilities and damaging to the political system. In effect, it gives people responsibilities on which they cannot deliver, which undermines public confidence.

Tricia Marwick: You made it clear in your written evidence that you see no relationship between the proportion of local government spending that is funded locally and the level of local government autonomy and accountability. You have explored that further. If we take your argument to its logical conclusion, it appears to suggest that the majority of central Government spending could be funded from, for example, European Union sources without any loss of autonomy at the United Kingdom level. Do you believe that that is so?

15:45

Professor Stoker: If the EU simply handed over a general grant to Whitehall and said, "Spend it as you will," and also said, "You can raise up to 25 per cent further revenue," I do not think that Whitehall would feel entirely lacking in capacity to engage in initiative and influence, just as the Scottish Parliament, despite the fact that it largely receives funds from the UK taxation system, does not announce regularly that it cannot do anything for the people of Scotland. It rightly feels that it can do something. The capacity to spend money is what makes the real difference to people's lives, not the capacity to raise it from them.

Tricia Marwick: One of the arguments that we might have in future is about fiscal autonomy for the Scottish Parliament. That argument is already bubbling away under the surface in all the parties. It will be an interesting debate. Do you have any comments on the possibility of fiscal autonomy for the Scottish Parliament or do you think that it is unnecessary?

The Convener: Does that have anything to do with the inquiry?

Professor Stoker: I was going to give a quick answer, which is that, as a former resident of Scotland who is now resident in England, I am relaxed about how the Scottish people choose to fund their services. If they choose to fund their services themselves, I would be perfectly happy for them to do that.

Ms White: You mentioned that central Government directs local government along a path of—what is the word for it? I am trying to think of the proper word without being too contentious. I will start again.

Central Government has plans and expects local government to go ahead with those plans without proper funding. You mentioned that it is difficult for the people who are left with the responsibility for implementing the plans. Do you think that the balance of funding between central and local government makes it more difficult to attract people into local politics? Does that give the impression to people outside local politics—the voters, for instance—that a local authority does not have a say in how its area is governed?

Professor Stoker: I agree with the thrust of your argument—with the qualification that I make in my submission. For me, the key is not the overall balance of funding, but whether local authorities have some discretion that people can notice over tax spend decisions. To have that discretion would create the level of interest in local government and the level of attraction to local government as a place of work for politicians and officials that I would like. Our system has gone far too far in removing that discretion. My submission is a pragmatic and—I hope—politically achievable attempt to rebuild some element of tax spend discretion so that there can be local rows about what we should spend our money on.

Ms White: I am happy with that answer.

Mr McMahon: I return to the point that you made about how Barcelona promotes itself and is so successful. You say in your written submission that, for councils,

"it is at the margins that most real budget decisions are made".

The emphasis is on "at the margins". We see that in some cities in Scotland. For example, Glasgow City Council used its marketing ability to bring the Scottish Exhibition and Conference Centre to the city. That is a successful initiative. Birmingham has the International Convention Centre, which managed to secure the G8 summit in 1998—that obviously raised its profile. However, by accepting that most real budget decisions are made at the margins, are you not accepting that councils are just bit players in the business of government and regeneration?

Professor Stoker: No, I do not think so. Every organisation with which I am involved makes its budget decisions at the margins.

Whitehall makes its budget decisions at the margins. Most public expenditure is committed. If a budget discussion is held each year, public bodies do not say, "Right, we have a zero base and we start from that zero base." Public bodies have prior commitments; they have things that they have already started to provide for and organisations and buildings that they supply or, in some cases, employ. In other words, public bodies have a range of commitments. The reality is that, as they are part of public bodies' set budgets, those commitments are not going to change overnight.

Many decisions are about how to get the discretionary element back into budgets so that public bodies can spend a little bit more here, perhaps by spending a little bit less there, or so that they can prioritise areas and put extra money into them. That is the reality of budget making for private as well as public bodies.

Most people make their decisions about budgets at the margins. The crucial thing is to accept that and, rather than have others impose choices, to give public bodies—including local authorities—the capacity to make a difference on the basis of their own choices at the margins.

Mr McMahon: Is it not possible that, if a local authority had the appropriate tax-raising powers, it could make decisions that would be significant rather than marginal?

Professor Stoker: That is probably a theological question—when do a number of marginal decisions become significant? Is it okay for us to shake hands and say that we will know when it happens? I agree with the broad point made by Michael McMahon but, at the moment, I am trying to talk about moving the system forward in a way that is politically feasible. That is why I use the word "marginal", as it is a word that helps win the political argument for those sorts of changes.

Iain Smith: I read your paper with considerable interest, as it contains a number of interesting ideas about new sources of finance that could be made available to local government. However, I am concerned that many of your ideas might work in an urban environment and in the bigger cities and towns, but may not work in the more rural areas.

Examples include car-parking and congestion charges, business improvement districts—BIDs—and even dog fouling, as it is easier to generate dog fines in a population of 100,000 than it is in small villages of 5,000 to 10,000 people. Do you have proposals to assist rural public bodies or, because they do not have the access to such pots of money, would they simply become more disadvantaged and less able to develop improvements?

Professor Stoker: There are two things to say in reply to that question. The first is to apologise that the paper and the thinking were developed largely in an English context. There are rural areas in England, but in many ways England is a much more urbanised society. That affects the thinking in the paper. The second thing is that some of the taxes proposed in the paper, including some of the tourist taxes, could work in so-called rural areas. Some of the discretion over charges could also work.

The bid principle—that a group of people club together to get something that they feel is particularly valuable—could also work in rural areas. It could be expanded beyond clubs of businessmen, which is what the business improvement district idea is about, to clubs of other organisations and groups.

That brings me to the end of the range of ideas that I can put forward for rural areas. The paper tries to establish a principle for the way forward. Although I had urban areas, with which I am more familiar, in mind, it would not be beyond the wit and capacity of people in rural areas to think of things that could raise the marginal taxes about which I am talking.

Iain Smith: Thank you for the honesty of that answer. I remain concerned that, in relation to tourist taxes, for example, the level that would have to be raised in a rural area to make a difference would be greater than it would have to be in a city such as Edinburgh, which has more available beds.

I welcome some of the points that you make in your submission, such as the suggestion that in order to get improved services local people could agree to an additional tax in a referendum. That is sensible. You also suggest that central Government might offer matched funding in such circumstances. Would that funding be time limited? Would the referendum scheme have to include a strategy for dealing with the end of that funding? If that did not happen, would the long-term result of the fact that a great deal of Government money was tied in to such schemes be that the pot was limited and the money was top-sliced and ring-fenced in a way similar to that which we see in relation to some existing grant schemes?

Professor Stoker: I definitely believe that the matched funds should be time limited. I imagine that the extra funds will also be time limited because the public would give approval for extra money to be raised only for a set period of time. That would allow the public to make a judgment about whether the authority has spent the money effectively and whether the desired benefit has been delivered. The second element in my argument is that, alongside additional sources of funding, we need additional forms of accountability in order to convince people that, when they pay additional money through various forms of charges and taxes, they and their community benefit.

Dr Jackson: Thank you for your paper. The mechanisms and structures that you describe by which communities and businesses could come together to work with councils are interesting.

Do you imagine that some of the local taxes that you have proposed might be run on a level lower than the council level? I think that communities might want to organise a tax to pay for a specific project.

Professor Stoker: I agree. In the BIDs model that we have just discussed, a group of business people would agree to pay a sum of money in return for a service. That could apply at several geographical levels. I have argued that we should think about applying it at several functional levels, as groups other than those made up of business people might be willing to enter into that sort of agreement.

We envisaged that additional central funding might be made available to match funds raised by a local authority. Similarly, a local authority might provide support funding in circumstances in which funds had been raised in particular localities. The idea behind the support funding is to help areas that have problems of socioeconomic deprivation to raise funds in the manner that we have proposed. I imagined that the additional money would not simply be handed over by virtue of the council or the neighbourhood committee winning a referendum, but would reflect some judgment about the level of social and economic need in the area.

Dr Jackson: What do you think about the future of non-domestic rates? You did not mention that in your paper and I imagine that you think that the situation should remain as it is.

Professor Stoker: I was trying to talk about what I regard as politically viable changes. It would be politically difficult to make a significant change to non-domestic rates. In England, it would be near to impossible, but you are in a better position than I am to judge whether more could be done in Scotland. The other reason why I did not deal with that is that the other proposals that I made are for accountable forms of taxation, in that there is an attempt to relate the money raised to where it is to be spent and, if possible, to consult or get the approval of those who will pay the tax. The problem with the non-domestic business rate is that, while it provides local authorities with a form of funding, it is an unaccountable form of funding. That is why, although it is on a smaller scale, the business improvement district proposal is attractive. It opens up a dialogue between business representatives and the local authority in a way that has been absent in the past in some areas.

The Convener: You say—and everyone would agree with you—that it is impossible to deliver services without enough funding. I suggest that many local authorities would tell us that, no matter how much they are given, there will never be enough funding, but that the public expects them to deliver services.

I was interested in your comments about additional forms of accountability and in what you said to Sylvia Jackson about involving communities in a way that they have not been involved before. However, I want to put on record that the best and most interesting point that you made was that the committee should visit Barcelona. Thank you for attending.

There is tea and coffee in the corner and I am dying for a cup. We will have a five-minute comfort break.

16:01

Meeting adjourned.

16:10

On resuming—

The Convener: I welcome our fourth witness, Dougald Middleton, who is a partner with Ernst & Young. I apologise for the long wait that you have had; we are running late. As you have been sitting in the gallery, you will know the drill. You may speak for a couple of minutes, then I will open up the discussion for questions.

Dougald Middleton (Ernst & Young): I had not intended to speak at any length about the submission. I apologise for the fact that the committee received it so late; it got tied up over the Christmas period.

Some of the ideas that we set out in the submission on not-for-profit-type structures for the procurement of capital projects and for services in local government are reasonably exciting. They take forward several tried and tested initiatives and build on precedents in the marketplace. The proposals are practical, deliverable and could achieve real benefits in terms of value for money for the public purse and community involvement and empowerment in service delivery. The framework is positive and is worthy of further exploration by the Executive.

The Convener: Thank you for that introduction. We had difficulty hearing you—perhaps you could move your microphone closer. We received two submissions from you. Do you want to highlight anything in the final version that was not in the original one?

Dougald Middleton: The change is in emphasis and presentation more than anything.

Dr Jackson: Your submission outlines how a trust might be set up to fund public sector infrastructure and how a trust that is set up to fund and manage assets, such as schools and road developments, might operate. Although a 100 per cent debt finance scheme should be cheaper than a conventional 90 per cent debt and 10 per cent equity private finance initiative/public-private partnership scheme, would the financing costs in fact be higher than those of a conventionally funded capital project over the life of the asset?

Dougald Middleton: If you strip out financing and view it by itself and do not consider the overall service delivery package over the full term, the straight answer is yes. The argument that the difference between financing models is value for money is based on the benefits that using external finance has been shown to bring to the due diligence on projects—it gives value for money on the capital costs side and on the on-going revenue costs side of the project.

For most PPP, PFI and—potentially—not-for-profit capital projects, such as schools and roads, the key driver for the costs over 30 years is the upfront capital cost, or the efficiency in delivering the construction element of the project. The other costs over the 30-year term tend not to be as significant. Ensuring that that cost is driven down is the key to overall efficiency.

Dr Jackson: However, you are saying that, over the piece, that cost would be higher than the cost with a conventional scheme.

Dougald Middleton: Yes. If the financing were stripped out by itself, it would be higher.

Mr McMahon: I have a straightforward question. I hope that you can give us a simple answer. What is meant by the term "risk transfer" as it applies to trust models?

16:15

Dougald Middleton: I shall begin my answer with a potted history of what PFI and PPP have delivered. The key benefit of those forms of procurement is the fact that a great deal more time is spent at the outset of projects undertaking project planning and developing the designs, the specifications and—crucially—the contracts, to ensure that individual risks or bunches of risks are transferred contractually to the people who are best placed to manage them. For example, the risk on the outturn price of a building is ultimately passed to the construction company, which is contracted to provide a building at a fixed price almost irrespective of what happens in the intervening period. That is efficient risk transfer.

In our paper, we suggest that the same principles should be applied to the trust model, so that the trust acts to pass risk to the party that is best placed to handle that risk efficiently. Clearly, risk transfer can be taken to extremes, so that risks are passed to people who are not best placed to handle them or risks are created almost for the sake of transferring them, but that simple principle—transferring risk—is what we are trying to get across.

Iain Smith: I was a member of a council that started to consider PPP projects several years ago, but which still does not have a brick on the ground, so I would argue against your view that PPPs provide efficient procurement and project planning. From your previous answer, I understand what you mean, but most local authorities consider such procurement complex, time consuming, not very efficient and rather expensive.

I would like to hear more about transferring risk and getting projects off local authorities' balance sheets, which seems to be one of the main drivers behind the PFI/PPP approach. Would it still be necessary to get projects off councils' balance sheets if a new capital finance system were introduced for local authorities, which moved away from the section 94 consent approach towards a prudential approach?

Dougald Middleton: The current balance sheet treatment is a driver for PFI and PPP. I understand why the need to get projects off the balance sheet is a key driver for spending departments that are capital constrained, especially those in the UK Government and the Scottish Executive. However, I would argue strongly that getting expenditure off the balance sheet at the level of the UK Treasury should not be one of the key tests for PFI and PPP or for the trust model. Seven or eight years ago, the Government was in a completely different fiscal position from the one that it is in now. That has distorted the analysis and has led to illogical decisions.

That said, with any form of local government finance, there will be a requirement or a desire—I make no judgment about which it is—to control the total amount of money, be it capital or revenue, that is spent in any period. In some ways, the balance sheet treatment has become a shorthand version of a control mechanism. Some members may remember as far back as when the Ryrie rules were still in place in local government finance. The rules, which were invented by the Treasury, provided a similar mechanism to control capital expenditure in local government and the use of private sector finance that may otherwise have been outside the controls. I do not think that the balance sheet issue is a huge one at the top level of Government finance.

Iain Smith: That is helpful and confirms my personal view, which is that, given that everything is paid out of the public purse, it does not matter at the end of the day where it appears on the balance sheet.

One option that is being examined is moving to a prudential system. Have you examined that approach in relation to your trust model? Would the trust approach work with a prudential regime for local government planning? Would it provide benefits? Would it provide the best of both worlds?

Dougald Middleton: Yes. I see no reason why the model should not operate efficiently within a prudential form of funding. I see benefits and synergies from it; I am positive about that.

Ms White: There has been a lot of debate about PPP and PFI and now we have a paper from you about trusts. I will concentrate on what you have said about trusts and not go into PFI and PPP too much. I am interested in what would happen if a trust had responsibility for a school and something happened, for example the population declined, and within 10 or 15 years the school was closed. What would happen to the school under the trust model? I am using a school as an example.

Dougald Middleton: There are no magic solutions to issues such as that with the trust model. Under the trust model, we raise what is essentially bank finance, but the finance could be raised partly from public sector grants, partly from public sector revenue funding and partly from private sector funding. Whenever there is a long-term funding commitment to a project or asset, the providers of the finance will want to know that there is a long-term future for that asset, for example a school. That is why the trust model is particularly suitable for grouped assets—for example, a number of schools or a number of different transport projects. In essence, a portfolio is created and a series of projects are funded rather than just one.

Let us take the example of a school. If a local authority, which in essence is the funder of the trust, took a decision to close a school or not to continue to fund it, currently the local authority would be expected to pay out the outstanding funding on the project. There are various ways of dealing with that. Sandra White is talking about trusts competing with one another. If there were a number of schools in the same location and they were all funded similarly, I can see how that situation could arise. The trusts would be analogous to housing associations, which probably provide some of the best examples of what we are talking about. Housing associations are funded in that manner. They have a level of corporate governance and, in major urban conurbations, in effect compete with one another for tenants. In general, the market has become comfortable with funding the organisations on that basis.

Ms White: Are you saying that when local authorities enter a partnership—perhaps even a PPP or a PFI—they consider a long-term strategy? Would that be part and parcel of a bid to refurbish or build a school, to ensure that the project would be viable for the 25 years for which it is normal for a project to run?

Dougald Middleton: Big policy decisions about the level of education provision and the location of that provision are rightly the domain of the local authority. That has been the case in Glasgow, Edinburgh and other places where there have been major PPP projects in secondary education, for example. In Glasgow, the decisions associated with the reorganisation of the provision of secondary education were taken ahead of the PPP contract. A trust model would not change that requirement in any way.

The Convener: In answer to Sandra White's question, you mentioned the use of bank finance. Can you envisage a trust that would use private sector expertise and local authorities? If so, how could it insure against the liability to which Sandra White referred in her question about a school that lasts only 10 years?

You also talked about bigger projects. The committee is interested in local government. Some local authority areas are very small and would have no need to deal with a huge number of schools. If a project was not bank financed, but worked with private sector investment—or even if it was bank financed—how would smaller local authorities insure against the kind of thing that Sandra White asked about? A great demographic change might happen—a company that employs a lot of people might suddenly close, all the kids might go somewhere else and the school might close down. Some sort of insurance measure needs to be built in. You answered the question about picking up the bill—you said that local authorities would do that. Will you move away from bank finance and tell me what you think about the private sector doing that?

Dougald Middleton: I was using bank finance as shorthand for private sector capital, because bank finance tends to be used predominantly in that area, although sometimes bonds are used. There is no reason why a combination of finance from a bunch of different sources—public sector capital, public sector revenue support and private sector capital—cannot go into projects. How to optimise that combination is not being explored sufficiently at the moment. I spoke to one of your next witnesses about that before I sat down. Some interesting issues must be addressed. It is possible to mix and match across various projects.

There are two reasons why projects tend to have been funded over the longer term—longer, say, than 10 or 15 years. Primarily, that has been driven by short-term affordability considerations in the public sector. Advertising the project over a longer period of time costs less per annum. That forced longer-term finance into play. There are ways of introducing more flexibility. Mixing and matching funding could do that—the private sector could advertise the financing of the project over a shorter period and the public sector could do it over a longer period.

Some quite difficult contractual structures, which match shorter-term contracts to longer-term finance, are being introduced for the London underground. Care must be taken to retain policy control where it should lie, which is with the public sector—the local authority.

If the public sector tries to pass risks to the private sector that it cannot control—such as whether a school will stay open in 10 or 15 years—it will charge a risk premium, which completely outweighs the benefit of passing on the risk. I do not think that there is a right or a wrong answer. The question is specific to individual projects and circumstances. In principle, grouping projects together tends to spread the risk out a wee bit more.

Tricia Marwick: We are often told, particularly by people in local authorities, that PFI/PPP is the only game in town and that if a council wants to refurbish or rebuild schools, the option is PPP or nothing. In your submission, you identify the community investment trust as an alternative, the key difference being that any surpluses are reinvested in service delivery rather than distributed as profit. How much uptake has there been by local authorities of community investment trusts? Have you been in touch with local authorities or with the Convention of Scottish Local Authorities? Are they interested in developing community investment trusts further or is PPP still the only game in town?

16:30

Dougald Middleton: The situation is reasonably difficult for individual local authorities. We have spoken to a number of councils—one of which will give evidence to the committee after me—that have been proactive in considering and developing their thinking on the investment trust model. The City of Edinburgh Council is also considering that model for some of its transport projects. Some local authorities are willing to take up the model, but there has been real reluctance on the part of central Government to drive innovation in this area. I include in that Her Majesty's Treasury and the Executive, to an extent.

In essence, the trust model differs from PPP only in that corporate governance and the use of surpluses are different. The level-playing-field support that is required to revenue fund the trust is the same as would be required under the PPP model. In my view, the change in moving to a trust model is only marginal and I see no reason why local authorities cannot make the change now. As far as I am aware, there is no need for primary legislation or for a significant change to the funding regime. What must change is policy, to promote innovation and take that next wee step into the unknown.

The situation is directly analogous to what happened when PFI and PPP were first introduced. People were not quite sure what they would look like, but we got there in the end. Some of the work has been good and some of it has been not so good but, overall, advances have been made in certain areas of service delivery.

Tricia Marwick: I will ask you what may be an unfair question. Why is the Executive reluctant to move forward? Is that because the investment trust model is new and innovative or are there other reasons?

Dougald Middleton: There is an element of "Can you prove that something is definitely better before you have done it?" The answer to that question is probably no. However, if you never do it, you can never prove that it is definitely better, so you never do it. An element of such circular thinking arises in respect of any innovation, not necessarily only in the Executive—it is found in the private sector and in companies such as mine, so I am not making a partisan point.

There is a need for political and policy leadership to move the trust model forward. Such leadership is beginning to be seen in London. The proposal for Railtrack is clearly to transfer it to a not-for-profit trust. The Welsh Water proposals have shown that a major infrastructure company can be financed as a not-for-profit trust. The history of the housing association movement and its public funding is well understood and well respected. Parallels should be drawn and new approaches should be considered.

Mr Smith said that there is PFI/PPP fatigue in some councils. Complex capital projects take a long time to develop properly, irrespective of the form of procurement. There is a lack of appetite for another change, but that can be overcome and some councils are willing to make changes.

Dr Jackson: I want to follow up points that Tricia Marwick and the convener made. I am a little confused. You say that the main difference between community investment trusts and PFI/PPPs is corporate governance, but there must be differences in funding, too. Will you explain those? I was confused when you told the convener that many different organisations and people could be involved in the funding side in respect of bank debt or bonds. Will you explain that and tie it up with the not-for-profit idea? Why is private investment involved in funding?

Dougald Middleton: In traditional PFI/PPP projects, the funding structure tends to be 90 per cent bank debt and 10 per cent risk capital equity. The theory is that banks do not take any significant risks in projects. They need a cushion so that if something goes wrong, they are not first in line.

I have not expanded this argument in my paper, but I have made it elsewhere at great length. In the contract structures that PFI/PPP companies use, the public sector—the client—passes down a bunch of obligations to the special purpose vehicle that sits in the middle of the contracts. In turn, those obligations—primarily construction and maintenance obligations—are passed down to specialist providers. Often, they are shareholders in the SPV under the contracts that pass all the risks through the SPV down to the providers of those services. That leaves the SPV sitting in the middle in a more or less risk-free state.

Dr Jackson: Did you say SPV?

Dougald Middleton: Special purpose vehicle.

Dr Jackson: I see the reference in your submission now, but you spoke quickly.

Dougald Middleton: The special purpose vehicle sits in a risk-free state. In fact, it sits in a better than risk-free state because it also benefits from performance guarantees from the construction company and the facilities management company, if we consider the diagram in my submission. If something goes wrong with the construction contracts, those two players tend to take all the risks.

In essence, we are arguing that there is no need for that second risk cushion in many, although not all, projects. That is demonstrated once the construction phase of projects is completed. When some PFI/PPP contracts are refinanced, all the equity is taken out and, post-construction, they are, in effect, 100 per cent debt financed. I contend that a big value-for-money gain can be made by structuring the contracts in a 100 per cent debt-financed way at the outset. That needs to be tested with the market.

Dr Jackson: So your proposal is about reorganising risk and, possibly, taking the risk that there is not as much risk as is assumed. Is that what you are saying?

Dougald Middleton: It is about dealing with the risk more efficiently. The risk exists, but I think that at the moment it is being priced more than once.

The Convener: The Scottish Parliament Finance Committee is considering PPP and PFI. It will be interesting to see what conclusions it reaches. I agree that we should look more widely than just at PPP and PFI, which some of us are not totally convinced is the only game in town. Today you have given us another idea, which we appreciate.

It has been interesting to hear someone who is not from a local authority take a different view on PPP. Local authorities have told us that they have to opt for PPP, as it is the only game in town. Such projects take up a lot of officials' time. You are saying that that is fair enough if the work is being done properly. You have given us some interesting things to think about. Our next set of witnesses will give us some examples. You may want to hear what they have to say, although I am sure that you know them. Thank you for your attendance.

We welcome representatives of Argyll and Bute Council. With us are Councillor Dick Walsh, who is the education spokesperson for the council; Mike Geraghty, who is the head of service in education; Mike Gerrard, who is the head of PPPs at Partnerships UK; and Stewart McGregor, who is the director of finance for the council. I understand that Councillor Walsh will speak for a couple of minutes. When I open up the discussion to questions, any of the witnesses may answer. They all have different expertise.

Councillor Dick Walsh (Argyll and Bute Council): Thank you for giving us the opportunity to present our project to the committee. We in Argyll and Bute are enthusiastic about the project, for a variety of reasons. It is important that I give the committee an illustration of the unique challenges that face not only Argyll and Bute Council, but the Parliament, which funds the council to a great extent.

Argyll and Bute stretches from the greater Glasgow conurbation on its eastern boundary to the island of Tiree in the west and the Mull of Kintyre in the south. I am reliably informed by my officers that the Mull of Kintyre is some 12 miles from Antrim and that it lies further south than Berwick-upon-Tweed. I have not measured that personally, but I take the advice that has been given to me as kosher.

Members will appreciate that there are increased costs involved in delivering services to a large area with 26 inhabited islands, three peninsulas and no central areas of service delivery. We carried out a property condition survey of our school estate, which consists of 95 schools: 82 primary schools, 10 secondary schools and three special educational needs schools. The survey indicated that Argyll and Bute Council's school estate required substantial investment to deliver a service that was fit for purpose and for the 21st century.

We recognise that the situation of Argyll and Bute Council is not unique, but common to many local authorities in Scotland. The problems that we have inherited require a radical solution. That solution needs to be a long-term and sustainable one. Our current resources are insufficient for us to make improvements on the scale and at the pace required.

We recognised that action by the council was urgently required. Such was council members' enthusiasm that we established a project team in September 2000. We had no identified budget but, because of the urgency that council members attached to the issue, we decided initially to fund the officer structure from the council's reserves.

16:45

From the outset, there was unanimous, cross-party support in the council for the public-private partnership and the non-profit-distributing organisation. In August 2001, the council agreed to work with Partnerships UK, which would be our partner in developing the whole NPDO approach. We were delighted when, in September 2001, the Executive announced that it was prepared to accept bids for revenue support towards PPP initiatives. Our outline business case has been put before the Executive and we are hoping to gain support for it.

Our communications strategy was an important element. Widespread consultation was held with the trade unions, because the facilities management aspect of our project is important to them as well as to teachers, parents and school boards. A number of public meetings were convened and seminars were held to keep members appraised of our position.

The initiative presented us with an opportunity to work in partnership with the Executive to promote the aims that both the Parliament and Argyll and Bute Council wish to be achieved, particularly in providing effective, efficient services in education. We are confident that our project will deliver high-quality and properly serviced and maintained school buildings for the next 30 years. We are also confident that the project is financially and educationally sustainable.

The issue of flexibility was raised following a question to Dougald Middleton. We are confident that the project that we are proposing will be flexible and will be able to respond to demographic changes. It will certainly meet the community aspirations for schools, following the consultation exercise.

As a result of the investment and likely spend, the project will potentially boost the economy of Argyll and Bute. We have secured discussions with both the enterprise companies that are responsible for the area, so that they can gear up should we be successful with our project.

We are confident that our NPDO approach will be a pathfinder for an enhanced form of PPP. That is recognised in the council. From the advice that we have received, we understand that no legal or financial barriers have been identified. We accept that the approach is a new one in education, although it previously existed for leisure services and social housing.

We hope that our approach will improve market interest. We feel that our project is both bankable and deliverable and hope that it will gain recognition from the Executive and the public sector as a whole.

Mike Geraghty (Argyll and Bute Council): Before I start my contribution, let me say that, as we are involved with PPPs and so on, things can get a bit like acronym jigsaws. I offer my apologies in advance for that.

I remind members that, in any PPP agreement, a consortium will contract to design, build, finance and operate an asset-based service. I emphasise that we are dealing not just with capital costs, but with operational and maintenance costs throughout the lifetime of the contract. When talking to people, we have sometimes likened such agreements to a domestic mortgage, whereby a household pays an annual charge for their house. The additional factor to bear in mind with regard to PPPs is that that house would be serviced and maintained for the duration.

PPP is an umbrella term for a variety of legal and financial structures, the best known of which is probably the private finance initiative, or PFI. Therefore, the terms PFI and PPP are not synonymous. We have been developing our NPDO approach with our co-sponsors, Partnerships UK. We argue that that approach is a form of PPP that is in some ways different from the traditional PFI. It is financed by a fixed return on the debt, comprising the senior debt and the subordinated or junior debt—the 90 per cent and the 10 per cent debt to which the previous speaker referred. Instead of that 10 per cent being subject to the possibility of windfall gains and refinancing, it will be subject to a fixed return.

The previous speaker said that the risk element is passed from the 10 per cent debt holders to their subcontractors. Our model also recognises that. Given that those debt holders are not being exposed to more risk, there seems to be no reason why they should get more return. However, it is important to flag up the fact that we recognise that subordinated and senior debt providers will make a commercial return on the money that they lend and on the works that they procure.

The non-distribution of surpluses to equity investors is a feature of the NPDO. Any surpluses made through profit trading, windfall gains and refinancing will be reinvested within the NPDO to the benefit of the project. The management of that project is incentivised through the servicing of the debt—it is based on performance.

The governance aspect within the NPDO lends an added dimension to a PPP. The organisation will be run as a commercial business to provide best value. We envisage a consultative board of stakeholders providing additional value by allowing significant stakeholder voices to be heard. We do not envisage that participation extending to voting rights, which will be at a strategic and consultative level. Additional benefits, however, will arise from that accountability and openness.

The design, build, finance and operation risks rest with the NPDO or with the subcontractors, not with the council. The council will manage the NPDO through a contractual relationship that will involve its performance-based payment regime. It is important to stress that the council will not manage the NPDO directly, but that the relationship will be contractual.

We think that, within the terms of the PPP, there are significant financial, political and governance issues that suggest that the NPDO, at this stage, offers more advantages than a traditional PFI.

The Convener: Before I open up the meeting for questions, I will ask a question that you might not want to answer because, as you said, your bid has been submitted to the Executive. Throughout your paper, you stress that the scheme will be large, but you do not cost it. What is the likely cost of the scheme? Do not answer that if you do not want to.

Mike Geraghty: We have submitted our core bid to the Executive for the refurbishment of all schools within the estate—the capital costs. You will appreciate that some figures are commercially sensitive, but the capital cost is £90.11 million. We have discussed that. If members want to access the other information directly from the Executive, we have no objections to that.

The Convener: I just wanted to get an idea of the cost, because you pointed out that the scheme was large. Thanks for that. I now open up the session for questions.

Iain Smith: Following on from that point, you might not want to give exact answers to this question, but it would be useful if you could give an indication. You said in your evidence that PPP provides the best value for money for the scheme. What is the magnitude of savings that you expect to achieve in comparison with the conventional system?

Mike Geraghty: That is one of the areas that we would prefer not to deal with in public. Again, that information is lodged with our bid and we are more than happy for the committee to access it in that way. I can say that we are talking about significant savings.

Iain Smith: How sensitive are the assumptions that you have made in relation to changes in interest rates and the risk that is transferred, for example? Is that so significant that it will make a difference or are those marginal issues?

Stewart McGregor (Argyll and Bute Council): The outline business case was put together with the assistance of external advisers. The sensitivity analysis was carried out in accordance with the normal approach. I do not regard myself as an expert on that, which is why we employ external consultants. Mike Gerrard from PUK might want to add to that.

Mike Gerrard (Partnerships UK): In so far as there are generic assumptions that affect all projects, they affect this form of project no differently from any other. In that sense there is no difference between the various business models that one might adopt.

Ms White: I congratulate Argyll and Bute Council on being one of the few councils to consider two different aspects of financing. I found your paper very interesting. You mention that your bid is in and that, if you receive the go-ahead from the Executive, it will automatically go out as a contract for tender for either PPP or NPDO—it is not yet set in stone. Is that correct?

Councillor Walsh: Yes.

Ms White: I was going to ask a question on school closure. You mentioned that the risk lies with the subcontractors, rather than with the council. Therefore, if something happened and the schools had to close because of lack of pupils, the council would not be responsible for keeping up the payment of the moneys. Is that correct?

Councillor Walsh: The critical point for the council is the terms of the contract. It is important that such areas are examined critically and carefully in order to safeguard the council. The properties will always ultimately belong to the council.

Ms White: What would be the consequences for the council if a school had to close, but the building remained in its ownership? Would the council still have to pay off the debt?

Stewart McGregor: That is an interesting question, which has taxed my mind from the outset, as the other witnesses know. We are looking so far into the future that it would be good to have a crystal ball. The issue is not just changes in demography. There could be changes in the delivery of the education service, particularly in our area, through the use of information technology, for example. The best assurance that I have had is that it is important to get the legal document constructed as tightly and as flexibly as we can, so that if such circumstances arise—ones that are no different from those that we would face anyway—we have a document that enables us to respond to them. Whatever we have to pay our legal advisers, we will want value for money in that document.

Ms White: Thank you for your honesty and for making it plain to everyone that not just the trust or the other model but PPP models could fall into that trap. That has not been highlighted enough.

Mr McMahon: Throughout the evidence that we have heard, the term "prudential rules" has been used frequently. Would Argyll and Bute Council want to proceed with PPP/NPDO schemes if the prudential-rules approach to local authority capital finance was in operation? If so, why?

Stewart McGregor: I will have a stab at answering that. I understand that prudential rules will not be introduced immediately. There will perhaps be a two-year lead-in period before section 94 consent is replaced by prudential borrowing. The Chartered Institute of Public Finance and Accountancy is drawing up a code of practice, but prudential borrowing is two years down the road. I defer to Dick Walsh to say how a delay of two years sits with council members' expectations. That is one factor with prudential borrowing, but there is also the factor of affordability. We need Scottish Executive support to develop the scheme, whether that support is from prudential borrowing with continuing revenue support grant to the scheme or from the PPP arrangements. I will give Dick Walsh a chance to speak about deferments of a couple of years.

17:00

Councillor Walsh: At this point in time, we must deal with the problems that we have inherited. We must work with the rules that are available. A number of bodies, particularly political groups, are considering how we access resources to resolve problems. One of those groups mentions the Scottish trust for public investment—I think that that is what it is called—but that has not been agreed to by any Government body and the resources to develop it do not exist. We must work within the rules that are available to us.

Mr McMahon: I realise that. I did not ask how you operate. My question was whether the introduction of prudential rules would have an impact on your decision to go ahead with the schemes. I do not know whether you have looked ahead at that issue. I accept that at the moment you are working within certain rules. Have you considered how prudential rules will affect PPP/NPDO schemes?

Mike Geraghty: The requirement of a section 94 borrowing consent against a capital cost of £90 million would place a substantial debt on the council. The scale and pace at which we could procure the improvements that are required for our schools are such that we must progress the matter as quickly as possible. Within the framework and the initiative that the Executive has established of revenue support for PPP projects, there are 500 million reasons why we should go for that and they are all pounds.

Dr Jackson: I want to ask about the timetable for the initiative, including when you expect to hear from the Scottish Executive.

Mike Geraghty: The Executive has advised us that we can expect a response by the end of April 2002.

Dr Jackson: What do you expect the timetable to be, if you go ahead?

Mike Geraghty: I need to refresh my memory, because we revised the timetable. I think that, when approval has been given, there will be a 73-week procurement timetable. To try to maintain momentum, the council decided not to stand down the project team. We want to ensure that further consultation work is done with all parties and that further developmental work is undertaken so that, if and when a positive response is received from the Executive, we are best placed to make progress. Some schools in our estate require to be replaced, including Hermitage Academy, which is the largest school in the estate. We are keen to expedite that.

Dr Jackson: So you have a phased programme.

Mike Geraghty: Yes. A phased programme is ready and it has been submitted along with the outline business case.

Dr Jackson: Thank you.

The Convener: I am pleased to—

Mike Geraghty: My apologies. I have been reminded that the time scale was advanced from 73 to 91 weeks.

The Convener: I am pleased to see that you have cross-party support. An election in the middle of the process might change things a bit. I am sure that it will not but, no matter what happens, you have cross-party support. As you will have raised expectations among the local people whom you represent, those expectations have to be realised.

I am also impressed by the amount of consultation that you undertook, including consultation with trade unions, teachers, parents and others. In the early days of the inquiry, we heard from trade union groups and councils that were concerned about contracts. I would have to say that there were mistakes on both sides in not reading, or reading something into, the small print. In the final analysis, contracts are very important. When the committee has looked at issues other than local government finance, we have picked up on that. For people who work in schools, for example, PPP relates to issues such as conditions of service.

I found your presentation interesting. I said earlier and I will say again that PPP/PFI is not the only game in town. We have to start to widen our thinking and to look at other ways of funding what is necessary.

To stick with schools, we want our children to be in buildings that are safe and warm. We also want our children to be taught a wide range of subjects. That is our aim and we note that it is also yours. I am pleased that you are going about realising that aim using a wider base than has perhaps been the case in the past. As I said, PPP/PFI is not the only game in town and we will keep our eye on how it develops.

I thank you for giving evidence. I am sorry that you were kept waiting. Today's session has been long. If we need more information from you, we will get in touch.

Mike Geraghty: Thank you.

Budget Process 2003-04

The Convener: Would you believe that, after five o'clock, we are moving on to agenda item 2? We are to consider the authorisation of the appointment of an adviser to assist us in the scrutiny of the budget process. Those of us who were on the committee last year would agree that it was helpful to have an adviser, who cleared up many of our questions quickly. Will members look at the paper and let me know whether they agree with the proposals. We have to agree what is proposed before names are suggested. Are we agreed?

Members *indicated agreement*.

Meeting closed at 17:07.

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