

**BUDGETARY OUTLOOK****1 INTRODUCTION**

- 1.1 This report summarises the budgetary outlook from 2016-17. It sets out anticipated changes to the base budget and assumptions in relation to pay awards, non pay inflation, cost and demand pressures, fees and charges and funding. The assumptions are set out on the basis of best and worst case scenarios. The outcome is a significant funding gap. Relatively small variations in assumptions can lead to fairly significant changes in the funding gap over 5 years so a narrower range of worst and best case scenarios have also been prepared. Based on the narrower range of worst and best case scenarios the funding gap is estimated to be between £37.5m and £28.1m over 5 years.

**2 RECOMMENDATION**

- 2.1 The recommendations in relation to the budgetary outlook are set out in the covering report as part of a consolidated set of recommendations.

**2 DETAIL****3.1 Base budget**

- 3.1.1 The updated budget for 2015-16 based on 31 October information is:

	£m
Pay costs	137.3
Loan charges	20.3
Non pay costs	147.8
Expenditure	305.4
Income from services where we set fees and charges	9.9
Income from fees and charges that we do not set	19.2
Income from grants and contributions	32.5
Income	61.6
Net expenditure	243.8
Funding	244.0
Surplus (deficit)	0.2

- 3.1.2 Moving forward the following changes to the base budget are estimated:

- Loan charges are forecast to decrease by £4.5m over the 5 years from 2016-17.
- Loss of contracting out rebate for pension costs is expected to increase costs by £2m annually from 2016-17.
- Auto enrolment is expected to increase costs by £1.8 per annum from 2017-18.
- Other minor variations and allowance for increments will probably increase costs by £0.7m thereby offsetting the balance of the reduction loan charges.

3.1.3 Overall the base budget will be expected to remain at the same level over the 5 years.

### 3.2 Pay awards

3.2.1 Pay awards are likely to be strongly influenced by inflation and pay increases in other organisations. If inflation remains low that will keep pressure for pay awards low. As the economy recovers and the private sector is able to increase wages this is likely to increase the demand for pay awards by public sector workers. The trend of recent pay freezes or low levels of pay awards may also increase this pressure.

3.2.2. With pay costs of around £137m then a 1% pay award would cost £1.4m per annum and a 2% pay award would cost £2.8m per annum. Over 5 year period a 1% pay award would add £7.0m to the Council's expenditure whilst a 2% pay award would add £14.0m.

3.2.3 The assumptions set out above on pay costs lead to quite a significant variation in the level of pays costs over 5 years – a difference of £7.0m. A narrower range of assumptions is set out below. If pay costs were to increase by 1% for 2 years, 1.5% for 2 years and 2% for 1 year this would add £9.8m to the Council's expenditure. If pay costs were to increase by 1% for 1 year, 1.5% for 2 years and 2% for 2 years this would add £11.2m to the Council's expenditure.

### 3.3 Non pay inflation

3.3.1 Forecasting inflation over the medium term is challenging. The Bank of England target for inflation is 2% however the September consumer price index (CPI) was 1.2%. CPI is based on a basket of goods and services and whilst the actual level of price increases in an organisation will depend on the makeup of its cost base it is a useful general measure of inflation. Year to year the Council can consider the extent to which it allows for inflation on anything other than an unavoidable/inescapable basis but it is prudent to consider the medium/longer term impact of inflation.

3.3.2 With non pay costs of £96m net of income from fees and charges we

do not set and grants and contributions then recurring inflation of 1% would cost £0.9m per annum and inflation of 2.5% would cost £2.3m per annum. Over a 5 year period inflation of 1% would add £4.5m to the Council's expenditure whilst inflation of 2.5% would add £11.5m.

- 3.3.3 The assumptions set out above on inflation lead to quite a significant variation in the level of cost increases over 5 years – a difference of £7.0m. A narrower range of assumptions is set out below. If non pay inflation were to be 1% for 1 year, 1.5% for 3 years and 2% for 1 year this would add £6.9m to the Council's expenditure. If non pay inflation were 1% for 1 year, 1.5% for 1 year, 2.0% for 2 years and 2.5% for 1 year this would add £8.2m to the Council's expenditure.

#### 3.4 **Income from fees and charges**

- 3.4.1 Income from fees and charges that can be varied at the discretion of the Council is around £10m per annum. The Council may wish to increase these by more or less than the rate of inflation. The Council may wish to consider the service impact, impact on outcomes as well as the financial impact.

- 3.4.2 Increases in fees and charges of 1% would increase income by £0.100m per annum and increases of 3% per annum would add £0.300m. Over 5 year period increases of 1% would reduce expenditure by £0.5 whilst increases of 3% would reduce expenditure by £1.5m.

#### 3.5 **Cost and demand pressures**

- 3.5.1 The Council has experienced a variety of cost and demand pressures over the years. These have arisen from a range of sources. Cost and demand pressures can arise from new legislation, changes in Council policy, an unavoidable increase in demand or cost of a service eg demographic changes or increased maintenance costs etc. On average these have worked out at £1.9m per year over the last 3 years. Members will wish to consider any requirement for cost and demand pressures against the overall budgetary outlook and the impact on budget reductions required through service choices if adopted. If no allowance is made for cost and demand pressures then obviously this would not add any additional costs to projected expenditure but should these arise they would need to be dealt with year to year. If £1m per annum was allowed for cost and demand pressures this would add £5m to the Council's expenditure over a 5 year period. The Council will want to review any necessity for cost and demand pressures each year.

- 3.5.2 A narrower range of assumptions around cost and demand pressures would be between £0.4m per annum and £0.8m per annum giving a total increase in budget of £2.0m or £4.0m over 5 years.

## 3.6 Funding

### 3.6.1 Forecasting funding needs to take account of a number of variables:

- The overall level of public sector budgets.
- The amount of budget allocated to the Scottish Government.
- The amount the Scottish Government decides to allocate to fund local government.
- The impact of population reductions in Argyll and Bute Council's share of local government funds.
- The level of the floor mechanism.
- The scope for any future council tax increases.

### 3.6.2 In February 2014 the estimated changes in overall funding were

- 2016-17 -1.6%
- 2017-18 -1.8%
- 2018-19 +0.5%
- 2019-20 +0.5%

### 3.6.3 Projections from 2015-16 to 2018-19 indicate an average annual fall in the Scottish Block based on the Barnett formula of 1.6%. This is before allowing for income from non domestic rates and council tax. Beyond 2018-19 the Office for Budget Responsibility expects spending growth to return to more "normal" levels. Based on this the following assumptions could be adopted:

- 2016-17 -1.5%
- 2017-18 -1.5%
- 2018-19 -1.5%
- 2019-20 +1.5%
- 2020-21 +2.0%

These are of course forecasts and assumptions and the impact of economic growth, future elections and both local and global events could change these. On that basis it could be assumed that a variation of +/- 0.5% around these figures was not unreasonable.

### 3.6.4 The Scottish Government has protected the health budget and has also given a form of protection to the local government budget by seeking to maintain its proportion of the overall Scottish budget. If a similar approach is adopted going forward then any changes in the Scottish budget will be reflected in the budget available for local government.

### 3.6.5 Population is a key determinant of the share of local government funding that each council receives. With a reduced population and a forecast of further reductions in population compared to an increased and increasing population for Scotland as whole the Council would be expected to receive a smaller share of the overall funding going forward.

### 3.6.6 There is an element of the local government finance distribution

known as the floor mechanism. This limits the overall reduction in funding or sets a minimum increase in funding for councils. The Council is currently caught within the floor mechanism and given the falling population it is likely to remain in the floor mechanism for the medium term. The floor mechanism is likely to be set around no council being 1.5% to 2.0% worse off than the overall finance settlement.

- 3.6.7 Taking account of the overall forecast on public spending, how that might impact on the Scottish budget and then the local government budget and the impact of the floor mechanism then a set of projections for future funding are set out below.

Year	Worst Case	Best Case
2016-17	-3.5%	-2.0%
2017-18	-3.5%	-2.0%
2018-19	-3.0%	-1.5%
2019-20	-0.5%	+1.0%
2020-21	+0.5%	+2.5%
Total	-10.0%	-2.0%

- 3.6.8 The impact of the funding assumptions above is that based on the worst case funding could reduce by £24.3m over the next 5 years whereas under the best case it could reduce by £4.9m over the same period.

- 3.6.9 The assumptions set out above on funding lead to quite a significant variation over 5 years – a difference of £19.4m. A narrower range of assumptions based on a mix of the assumptions on public sector budgets and floor mechanism etc is set out below.

Year	Narrower Worst Case	Narrower Best Case
2016-17	-3.0%	-2.5%
2017-18	-3.0%	-2.5%
2018-19	-2.5%	-2.0%
2019-20	+0.5%	+0.5%
2020-21	+2.0%	+2.0%
Total	-6.0%	-4.5%

The impact of these assumptions is that funding could reduce by between £14.6m and £10.9m over the next 5 years.

### 3.7 Summary

- 3.7.1 The budget for 2015-16 has expenditure being slightly less than funding. Going forward the overall base budget remains unchanged in total. However the impact of pay inflation, non pay inflation, cost and demand pressures and funding changes is likely to see a significant

funding gap emerge. There are many assumptions making up the future forecast of the funding gap. Appendix 1 sets out the worst and best case scenarios. Relatively small variations in assumptions can lead to fairly significant changes in the funding gap over 5 years so in Appendix 2 a narrower range of assumptions have been set out.

3.7.2 In Appendix 1 the worst case scenario sees a funding gap of £54.3m emerge over the next 5 years. In the best case scenario the funding gap is £14.9m. These gaps emerge due to the following factors.

	Worst Case £m	Best Case £m
Pay cost increases	14.0	7.0
Non pay inflation	11.5	4.5
Cost and demand pressures	5.0	0.0
Fees and charges increases	-0.5	-1.5
Funding changes	24.3	4.9
Total	54.3	14.9

3.7.3 The difference between worst case and best case is very large. A narrower set of assumptions have also been prepared to narrow the difference between the worst and best case scenario. Whilst the figures set out above are a useful reminder of the extent to which small changes in assumptions over years can have a significant effect on the overall position a narrower range of assumption is probably more useful from a planning point of view.

3.7.4 Appendix 2 sets out the revised or narrower assumptions. These see a narrower worst case scenario with a funding gap of £37.5m emerge over the next 5 years. In the narrower best case scenario the funding gap is £28.1m. These gaps emerge due to the following factors.

	Narrower Worst Case £m	Narrower Best Case £m
Pay cost increases	11.2	9.8
Non pay inflation	8.2	6.9
Cost and demand pressures	4.0	2.0
Fees and charges increases	-0.5	-1.5
Funding changes	14.6	10.9
Total	37.5	28.1

3.7.5 In trying to narrow down this range to a more likely scenario for planning purposes it is worth considering the latest forecast by Fiscal Affairs Scotland which suggests for the period 2015-16 to 2018-19 an average annual real terms reduction of 3.5% on the Scottish Barnett Block budget. After allowing for income from non domestic rates and council tax this real terms reduction falls to an average annual reduction of 2.7%. In cumulative terms then over 4 years this would equate to between a 14.0% and 10.2% reduction in expenditure. This would suggest a budget gap for the longer term of between £27m and

£35m. This is in line with the forecast funding gap based on the narrower range of assumptions.

3.7.6 Based on the forecasts by Fiscal Affairs Scotland and the narrower set of assumptions for financial planning the indications are the Council is facing a gap of between £27.5m and £37.5m over the next 5 years. This equates to annual funding gap of between £5.5m to £7.5m.

### 3.8 Issues to consider as part of budget strategy

3.8.1 The challenging nature of the budgetary outlook, the range in forecast financial positions and the sensitivity of these to relatively small changes in the assumptions for pay awards, inflation and funding needs to be recognised. This presents a very challenging budgetary outlook in relation to both service choices and how the Council supports delivery of the single outcome agreement.

3.8.2 The longer/medium term financial position will need to be kept under review.

3.8.3 Adopting an annual incremental approach to the budget would require savings (based on the narrower range of assumptions) as set out below to be made to balance the budget annually.

Annual Savings	Narrower Worst Case £m	Narrower Best Case £m
2016-17	-11.5	-9.7
2017-18	-13.5	-11.0
2018-19	-8.8	-6.5
2019-20	-3.0	-1.3
2020-21	-0.7	0.4
Total	-37.5	-28.1

3.8.4 A structured approach such as that set out in the report on service choices should provide a more managed basis for balancing the budget and aligning council priorities with available resources. This would allow the Council to consider the overall level of savings required over the 5 years building up to between £27.5m (narrower best case) and £37.5m (narrower worst case) over the next 5 years. This equates to an average annual funding gap of between £5.5m to £7.5m.

3.8.5 This report sets out the scenario from 2016-17 which allows a period of around 15 months before the start of the 2016-17 financial year. This gives the Council a time window to adopt a longer/medium term and structured approach to balancing its budget.

3.8.6 It is important the Council takes a longer/medium term view of its budgetary outlook and that as the budgetary outlook and budget is

developed or reviewed this should be on the basis of a 5 year approach where detailed budget information is prepared for the first 2 years with summary financial information for following 3 years.

#### **4 CONCLUSION**

- 4.1 The budget position is stable for 2015-16 but there is a very challenging budgetary outlook from 2016-17. Small changes in assumptions over a 5 year period can have a significant effect on the likely funding gap. The funding gap is estimated to be in the order of £27.5m to £37.5m over the next 5 years.

#### **5. IMPLICATIONS**

- 5.1 Policy – Sets out financial outlook and proposed budget approach that will provide a financial envelope for policy decisions.
- 5.2 Financial – Sets out a range of future financial positions and funding gaps.
- 5.3 Legal – None directly from this report but Council will need to balance budget .
- 5.4 HR – None directly from this report but there is strong link between HR and budgets.
- 5.5 Equalities – None directly from this report but any proposals to address the budgetary outlook will need to consider equalities.
- 5.6 Risk – None directly from this report but any proposals to address the budgetary outlook will need to consider risk.
- 5.7 Customer Service - None directly from this report but any proposal to address the budgetary outlook will need to consider customer service.

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10 December 2014

Appendix 1 – Wider range of financial scenarios based on worst and best case assumptions.

Appendix 2 – Narrower range of financial scenarios based on worst and best case assumptions



**Appendix 1 – Wider range of financial scenarios based on worst and best case assumptions**

WORST CASE	2016-17 £m	2017-18 £m	2018-19 £m	2019-20 £m	2020-21 £m
Funding	-8.5	-17.0	-24.3	-25.5	-24.3
Base budget	-1.2	-3.2	-1.3	-0.2	0
Pay awards	-2.8	-5.6	-8.4	-11.2	-14.0
Non pay inflation	-2.3	-4.6	-6.9	-9.2	-11.5
Fees and charges	+0.1	+0.2	+0.3	+0.4	+0.5
Cost/demand pressures	-1.0	-2.0	-3.0	-4.0	-5.0
Funding surplus/- gap	-15.7	-32.2	-43.6	-49.7	-54.3
Year on year movement in funding surplus/- gap	-15.7	-16.5	-11.4	-6.1	-4.6

BEST CASE	2016-17 £m	2017-18 £m	2018-19 £m	2019-20 £m	2020-21 £m
Funding	-4.9	-9.7	-13.3	-10.9	-4.9
Base budget	-1.2	-3.2	-1.3	-0.2	0
Pay awards	-1.4	-2.8	-4.2	-5.6	-7.0
Non pay inflation	-0.9	-1.8	-2.7	-3.6	-4.5
Fees and charges	+0.3	+0.6	+0.9	+1.2	+1.5
Cost/demand pressures					
Funding surplus/- gap	-8.1	-16.9	-20.6	-19.1	-14.9
Year on year movement in funding surplus/- gap	-8.1	-8.8	-3.7	1.5	4.2

**Appendix 2 – Narrower range of financial scenarios based on worst and best case assumptions**

NARROWER WORST CASE	2016-17 £m	2017-18 £m	2018-19 £m	2019-20 £m	2020-21 £m
Funding	-7.3	-14.6	-20.7	-19.5	-14.6
Base budget	-1.2	-3.2	-1.3	-0.2	0
Pay awards	-1.4	-3.5	-5.6	-8.4	-11.2
Non pay inflation	-0.9	-2.3	-4.1	-5.9	-8.2
Fees and charges	+0.1	+0.2	+0.3	+0.4	+0.5
Cost/demand pressures	-0.8	-1.6	-2.4	-3.2	-4.0
Funding surplus/- gap	-11.5	-25.0	-33.8	-36.8	-37.5
Year on year movement in funding surplus/- gap	-11.5	-13.5	-8.8	-3.0	-0.7

NARROWER BEST CASE	2016-17 £m	2017-18 £m	2018-19 £m	2019-20 £m	2020-21 £m
Funding	-6.1	-12.2	-17.0	-15.8	-10.9
Base budget	-1.2	-3.2	-1.3	-0.2	0
Pay awards	-1.4	-2.8	-4.9	-7.0	-9.8
Non pay inflation	-0.9	-2.3	-3.7	-5.1	-6.9
Fees and charges	+0.3	+0.6	+0.9	+1.2	+1.5
Cost/demand pressures	-0.4	-0.8	-1.2	-1.6	-2.0
Funding surplus/- gap	-9.7	-20.7	-27.2	-28.5	-28.1
Year on year movement in funding surplus/- gap	-9.7	-11.0	-6.5	-1.3	0.4