

# **THE REVIEW OF LOCAL AUTHORITY GRANT DISTRIBUTION IN SCOTLAND: ARGUMENTS FOR A SIMPLER APPROACH**

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## **PRINCIPLES OF GRANT DISTRIBUTION**

The Scottish Executive is engaged in a review of local government finance, which is concentrated on developing three year budgeting, developing public service agreements, and the simplification of the grant system. It has ruled out any change in local taxation meantime.

This paper is concerned with the grant system. It reviews the problems of the current approach and proposes a simpler, incremental approach to promote grant stability, and to recognise the limitations of needs assessment models in practice.

When the Scottish Parliament was elected in 1999, the new Executive decided to maintain the inherited needs-based system for the first year, although Ministers agreed additional deprivation allowances for a few councils which were politically controversial, pending a review of the weightings for deprivation in grant distribution in 2000-1. In his address to the COSLA Conference in March 2000, the Finance Minister observed:

We have now had an opportunity to see what works and what doesn't work. The system we have belongs to the pre-local government reorganisation era. Trying to make that system work for 32 unitary councils inevitably creates strains. The system has needed the various damping, mismatch and safety net schemes that have grown up around it

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in recent years.  
(McConnell 2000, p.8)

The Ministers concluded that an overhaul of the system is now necessary.

The present system of Grant Aided Expenditure is calculated by the client group method. It replaced a simple demographic method in 1982, and has been subject to ongoing reappraisal and refinement since then, in the Distribution Committee of the Working Party on Local Government Finance. Whilst not unproblematic (see Midwinter, Mair and Ford 1987) it did result in 'a reasonably controversy-free allocation of GAE for over a decade' (Mair 1996). Problems began to emerge following the reorganisation of local government, because of the absence of expenditure data for the new authorities necessary to calculate the regression coefficients on which weights were attributed in the secondary effects. The temporary solution adopted was to extend the secondary indicators from the old to the new system, using weights derived from expenditure data for the predecessor authorities. This became a source of instability, and a system which had worked reasonably well became seen to be problematic.

The mechanics of the system are well described in the Scottish Executive General Guide 2000. Grant Aided Expenditure is the amount that the Government thinks that authorities need to spend in total on the provision of services, and a GAE figure is provided for each individual authority. These are not regarded by the Executive as spending targets or guidelines, and authorities are free to determine their own spending priorities within the total. The Executive also issues expenditure guidelines which are closer to authorities' actual expenditure, which can form the basis of selective capping of expenditure if the Executive thinks either the planned level or planned increase is excessive.

The calculation of GAEs is through the client group method, which the Executive regard as an objective method of estimating authorities' relative expenditure needs. It seeks to take into account variations in the need for and cost of providing services to a similar standard with a similar degree of efficiency. The indicators selected to assess that need must be outwith the control of local authorities, offer plausible explanations, and be associated with inter-authority expenditure variation. Primary Indicators (PIs) are identified for each service, mainly on the basis of judgement, and regarded as the most significant single determinant of expenditure. Secondary Indicators (SIs) are regarded as reflecting additional needs or costs. Most PIs are demographic, such as school pupils, but others measure physical factors

such as road mileage. A range of secondary indicators is in use as proxies for poverty, and others measure sparsity and density. PIs distribute 92% of the GAE total, SIs only 2%. A further 6% is allocated on the basis of local authority expenditure on topics where it is recognised that authorities have little or no discretion over spending, eg police and fire pensions. The client group treatments are under regular review in the Distribution Committee, which comprises representatives of the Scottish Executive and COSLA. It is more heavily based in statistical analysis than most grant distribution systems in Europe. (Gibson and Bately 1994). However, the system has come under increasing strain in the 1990s, following the introduction of universal capping in a context of high grant dependency, and the instability generated in the system by reorganisation. Ministers are now discussing the possibilities of moving to a simpler system with COSLA.

In 2000-1 nearly £6 billions of planned local expenditure was allocated by the GAE formula, with hypothetical figures for each service. A further £784 millions is allocated in respect of loan and leasing charges and public/private partnership support, on the basis of a methodology agreed with COSLA. This is not subject to review at the moment, simply the formula for allocating resources for spending on services.

Together these totals constitute Government Supported Expenditure (or GSE), with a total of £6,742 millions. The final decision ministers make at this global level is the amount of Aggregate External Finance it will provide leaving the balance (local authority self-financed expenditure, or LASFE) to be met from council tax. For 2001-2 the figure is £5,707.2 or 85%. (This includes income from non-domestic rates, which is allocated to authorities on a per capita basis.)

## **PROBLEMS OF MEASUREMENT**

Economists tend to favour empirical approaches over normative approaches to needs assessment, because they provide a mathematical basis for weighting the secondary indicators (i.e. determining what to allow for the secondary indicators in resource allocation). Policy analysts are more sceptical, regarding the empirical methods as fraught with problems. The limits to regression analysis were well recorded in the Audit Commission's 1993 review of its application in the English system, arguing that there is no single right approach to the distribution of resources, and that value judgements and political decisions are critical (Audit Commission 1993). The problem is that even the best system based in statistical analysis will contain

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within its margins of error, and the regression technique cannot clearly isolate need from other factors such as policy or efficiency, and indicator weightings derived in this way may be distorted. As one health specialist observed over the application of statistical analysis to health resource allocation:

the search for an empirically-based resource allocation formula of high precision in the name of promotion of equity is largely fruitless given the impossibility of measuring the true need for, and costs of, providing health care, especially with the limited data available.  
(Mays 1995)

Resource allocation formulae are simplified models of reality, and therefore imprecise, and require interpretation and judgement, a limitation which is not often made explicit. Although used as a means of measuring need, what a statistical model does is establish associations, and a theoretical framework of causality is needed to interpret these relationships and reach judgements as to their relevance. In short 'analysts must forever be vigilant about the limitations of their craft' (Duncan and Smith 1998).

A brief discussion of the regression technique might help the non-specialist at this stage. Regression analysis is widely used in social science research to identify relationships between variables, and in particular, whether one variable (the independent variable) influences another (the dependent variable). In practice, such relationships can be difficult to identify because of the existence of several different factors which could influence outcomes.

In this case, local authority expenditure is used as the dependent variable, on the assumption that variations in expenditure can be explained by variations in socio-economic or demographic factors. The basic aim is to identify the relevant factors, to quantify the size of these influences, and to assess the strength of such relationships through a statistical model, in this case modelling need for local expenditure on services. The regression procedure, in short, seeks to determine the causes of historic expenditure, and, from there, predict what councils ought to have spent on such services. These models will have varying levels of explanation, and normally leave a residual unexplained (Midwinter 1989). The statistical outcome is a correlation coefficient ( $r$ ) which requires to be statistically significant to merit use in GAE; and is expressed as a decimal point less than one. The higher the correlation, the stronger the relationship. We are also interested in the explanatory power of the model, measured as the percentage of variance explained (or  $r^2$ ). In our context this infers that only factors which influence expenditure systematically in a general relationship across the country will be

selected, and that those authorities scoring highly on the independent variable should incur higher expenditure. The relationship should be statistically significant at a 95% confidence level (i.e. we can be 95% confident the relationship we have found is real and not by chance).

So far, so simple. However, the limitations of the technique must be understood, and these limitations apply to the Scottish client group method. The Guide reports that 'the underlying objective of the distribution of AEF is to permit each authority to provide a standard or common level of service to a similar level of efficiency, whilst also setting the same level of council tax' (Para 31). In theory this would require the setting of a standard level of service, followed by a calculation of the costs for each authority of providing it. In practice, standards are left undefined, and the process confined to providing a statistical rationale for sharing out the sums available, based on the size of the client group, the regression coefficient, and the difference between the authority's score on the indicator concerned and the Scottish average. The resultant total is added to or subtracted from the primary effect, and the totals assumed to reflect the cost of a standard service (Midwinter and Monaghan 1993).

Thus:

In practice, by using conventional statistical methods, the Scottish Office is implicitly assuming that the national average response to the chosen indicators of need should form the standard.  
(Smith 1997)

This assumption is particularly problematic in services such as social work or leisure and recreation, where statutory obligations are vague, and discretion high. The problem is that the method assumes that authorities' need is reflected in past expenditure, and what is being measured is average spending, on the assumption this equates with standard services (Duncan and Smith 1998).

The second problem is the reliance on proxy indicators as being constituent of need. This means that a range of potential variables exist for measuring such specific factors as poverty or sparsity, and the choice between them is judgemental, or even political, based on 'looking at the effects of different formulae on the distribution of grant between local authorities' (Foster, Jackman and Perlman 1982, p.255). This point was stressed in a recent paper produced by the Department of the Environment, Transport and the Regions in England. It argued that the 'best formula' is seldom obvious, undermining the objectivity of the exercise. The experience in practice was of several

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alternative formulae which scored similarly on statistical tests, but with significantly different resource consequences (DETR 1999). These then became a matter of judgement, and with authorities in disagreement, the final decision may rest with ministers.

A third problem relates to the underlying statistical assumption that needs variables will be systematically related to variations in expenditure, but not differences in policy and efficiency. The Audit Commission report concluded that, in practice, spending differences reflect all three factors, as authorities with policies of higher spending usually have high levels of need. This argument was put succinctly in the DETR paper referred to above, which noted:

there remains the risk that a formula will be unable to distinguish reliably between variations in spending because of differences in local preferences and efficiency, and variations that are accounted for by matters outside the authority's control, such as the characteristics of the area and its people. For example, it would not be surprising to find a link between high levels of deprivation and high levels of spending. But areas with high levels of deprivation might also give political support to the provision of more extensive public services. It becomes practically impossible to avoid reflecting such local preferences where they coincide with such plausible reasons for variations in spending. A similar point would be relevant in relation to efficiency.  
(DETR 1992, para 10)

Finally, the regression method is used to identify general factors. If a factor only applies to a handful of authorities (e.g. the islands or the cities) it is unlikely that any effect will be revealed by regression analysis. This is already recognised in grant distribution through the special islands needs allowance, made on a judgemental basis. This has also been a concern for academic researchers. For example:

additional expenditure may be necessitated by unique or relatively unusual features, resulting perhaps from geographical location, historical development, or unusual population characteristics. Unless such factors are shared by several places, they are likely to be ignored in the regression model.  
(Flowerdew, et al 1994, p.4)

This discussion of the limitations to regression analysis in measuring needs has highlighted the inevitability of imprecision, and the impossibility of

distinguishing between need, policy and efficiency effects. As regression coefficients are derived mathematically rather than politically, the model has the appearance of greater objectivity than normative approaches (Thomas and Warren 1997, p.26). The application of statistical analysis is underpinned by value judgements, and at best constitutes a rough approximation of needs. There is no denying that most of the indicators considered in the method have some connection with expenditure needs, but this cannot be quantified with precision, particularly where the regression technique is applied to discretionary services in which higher spending reflects political choice rather than statutory obligation. Regression analysis in needs assessment works best in contexts where clear and unambiguous relationships can be identified. It is less contentious in education, where a clearly defined client group exists, and where the impact of discretion can be identified through national staffing standards. In social work, by contrast, the population is a potential client group, although only a minority actually use the service, and access can vary between areas because of differences in local decisions over eligibility. With social work, all the problems of regression analysis are present in needs assessment, and we shall consider these further below.

## **PROBLEMS OF PRACTICE**

In the post-reorganisation period, these technical limitations of regression analysis combined with the consequences of structural reform to create serious problems with needs assessments. The reformed financial system created a system of financial dependency and control. As the Audit Commission observed of the English system:

Imperfections were tolerable if controversial when more than half of local expenditure was covered by local taxation, enabling councils to 'paper over the cracks' of the SSA system using local taxes. But the increase of grants to 80% of expenditure, capping, the tendencies to hypothecation and a performance culture ... all raise questions about the capability of the SSA system.

(Audit Commission 1993, p.14)

This argument would also apply to Scotland. When the client group method was introduced, financial controls were in the early stages of development. The central assumption that spending would vary according to need was more defensible. In the context of expenditure limits, and individual authorities increasingly using service GAEs as benchmarks for resource allocation, then the prospect of feedback loops from the control system is a

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strong one, and the extent to which regression results reflect genuine need relationships is even more questionable (Smith 1997).

Further concerns emerged over what became known as the 'mismatch' problem. Reorganisation was based on questionable financial assumptions (McQuaid 1993) and little consideration was given to the potential disruptive effects of disaggregating the large city regions over local finances. The scale of the potential problem is acknowledged in the Distribution Committee papers (Scottish Office 1995).

The mismatch occurred between the notional budgets of authorities (i.e. likely to be inherited from the outgoing authorities) and the illustrative needs assessments. Whilst for Scotland as a whole this was unproblematic (seventeen authorities inherited budgets below their expected GAEs) for several authorities the mismatch was significant, at over 6%. Those gaps would require substantial savings in addition to the efficiency savings assumed in grant settlements. (See Table 1.)

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**Table 1**  
**Excess of Spending over Needs Assessments in Mismatch Authorities**

	1995-6	2000-1
	%	%
Dundee City	+12.2	+14.2
Glasgow City	+10.9	+15.1
Midlothian	+8.9	+10.4
Inverclyde	+7.5	+10.1
Argyll and Bute	+7.5	+9.8
West Dumbarton	+6.7	+13.4
Clackmannan	+6.5	+9.6
Aberdeen	+6.5	+8.0
Scotland	+1.6	+9.0

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The data shows that these authorities' expenditure remains well in excess of their GAE figures. Since reorganisation, central government has been

reducing its grant contribution to local spending, and has made no provision in its grant for increased pay costs. This fiscal squeeze has served to increase council taxes as the general level of overspending has increased and authorities who inherited surplus positions at reorganisation are now also all in excess. The scale of these differences is such that the Executive's strategy of promoting convergence with GAEs will not be delivered in the foreseeable future. This undermines the credibility of the GAE system. GAEs are now supplemented by special payments for the islands, deprivation, and council tax safety nets, as well as by damping the effect of changes within the GAE system, in order to give councils a spending guideline which is closer to its budgetary position.

The problems within the needs assessments for social work have been compounded. Difficulties arose in the social work assessments due to the failure of the secondary indicators for home care for the elderly (pensioners on income support) and community and residential care for children (children of income support recipients). Doubts about the plausibility of the secondary indicator for residential care for the elderly and the need for a review was agreed. It was argued that because of the absence of expenditure data for the new authorities, there was no satisfactory way of retesting indicators.

In the case of services for the elderly, a conventional client group review had been undertaken, using pensioners on income support, elderly deprived households, pensioners living alone, and pensioners with limiting long-term illness, but no statistical relationships to confirm the plausibility arguments were found. The solution was the development of a composite primary indicator, which was basically population weighted by age, poverty and poor health. These indicators were agreed by a team of academic consultants, and applied in GAE, despite the poverty and poor health measures having failed the standard regression test.

In the case of child care, weightings for poverty and dependency factors were included, again retaining an indicator which failed in regression analysis. The consultants argued that differences in policy would be distorting the regression results, the conventional weakness of regression analysis. The resultant composite indicators were accepted as an interim measure on the basis of a 'negative consensus', pending a further review when expenditure data for the new authorities became available. This further review is now underway, but surprisingly, is only examining the issue of the weights applied to the existing factors (which are equal in an additive model) rather than returning to a conventional client group analysis.

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Expenditure data is now available for the new authorities, although the current review has revealed differences in accounting practices which could influence the regression results. For illustrative purposes, I tested the existing components as potential secondary indicators in the conventional way. Once again, no statistically significant relationships were found, raising concerns about the validity of the existing distribution based on these factors. (See Table 2.) An internal review of the problems concluded that the spending data was unreliable from a number of authorities, and tested the existing factors using only twenty-six of the thirty-two authorities. Most of the indicators continue to fail the regression test, only one of the four indicators passing in services for the home-based elderly, residential care for the elderly; and children in care. In particular, the poverty measures, which have the most significant redistributive effect on grant, failed consistently. Despite this, the status quo was maintained, and allowances continue to be made for factors without the normal statistical validation. The inability of the regression technique to distinguish between need and discretion was cited as the reason for not changing the existing weightings, and remains a real problem in practice, for example, given the discretionary nature of charging for home care services. This discretion also applies to eligibility for services, which make it improper to utilise data on client characteristics as needs indicators, as these reflect local definitions of need, poverty, and interpretation of statute. The social work composite indicators also resulted in major shifts in GAE, which required damping in resource terms.

These problems are insurmountable and will remain contested between authorities. Some urban authorities argue that there is a need to give greater weight to deprivation, but the necessary statistical information is absent. The same position relates to rural authorities and sparsity effects. In discretionary services, the problem can be clearly stated. Secondary indicators are determined on the basis of statistical explanations of expenditure variations. In the absence of such statistical evidence, no such allowance can be made. However, even when such relationships do exist, the question remains whether these reflect need, or local choice (or possibly both) and this cannot be determined objectively. It remains a matter of judgement.

### **REFORM : ARGUMENTS FOR A SIMPLER APPROACH**

The client group approach was relatively uncontentious for its first ten years. Whilst it had weaknesses, there was enough slack in the system to allow authorities to cope with problems of measurement imprecision. Since 1992, the introduction of council tax, the application of universal capping, the

efficiency squeeze, and the reorganisation mismatch effect have all combined to compound the difficulties, increasing the gap between needs assessments and budgets. The annual review process has become a forum for local authority competition, given the importance of GAE for grants and guidelines. Authorities now employ staff and consultants to assist them gain improvements in their GAE, and to challenge other authorities' cases. Discontent with the formula is widespread.

Yet budgetary realism requires the recognition that only incremental change, in a system of financial dependency, will avoid excessive tax increases or severe service reductions. The formula is reviewed, revised, then tweaked, to provide politically acceptable and financially realistic spending targets. Such adjustments are commonplace in government. As Keating (1998) observed

There are immense political difficulties in changing existing patterns of spending to make them conform with whatever formula is chosen. Consequently, efforts to achieve fiscal equalisation typically start with existing spending patterns and seek to change these at the margin. (Keating 1998, p.212)

**Table 2**  
**Summary of Regression Results in Social Work Services**

Home Based Elderly (Spending per Elderly Person)	r
SMR	-0.026
Living Alone Index	0.068
Income Support Index	0.245
Urban Settlement Pattern	0.015
Residential Care for the Elderly (Spending Per Elderly Person)	r
Income support Index	0.158
%Properties in Council Tax Bands A-C	0.305
Living Alone Index (75-84)	0.139
Urban Settlement Pattern	0.206

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Child Care  
(Spending Per Child <16)

	r
Income Support Index	0.001
Single Parent Index	0.019
Urban Settlement Pattern	0.0003

*Note: This table summarises the regression results for the existing components of the social work need index and social work spending per client as recorded in **Rating Review**. These are only indicative, as the data in **Rating Review** may differ from that used in the grant system. However, the absence of any statistically significant relationship is important evidence that the existing indicators and the weights applied to them are matters of concern. Given the absence of any empirical basis in support of them, their continued use in GAE is therefore very contentious.*

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The client group approach seeks to equalise fiscal capacity to provide a standard of service according to a centrally set level of performance, enhancing central control (Boyle 1966; Bennett 1982). In practice, it succeeds in permitting fiscal equalisation if not needs equalisation. (Accounts Commission 1993, p.63). Whilst the statistical methodology gives an air of objectivity to the method, it remains based on questionable assumptions and the need for judgement. The method does not define standard service in any rigorous way, cannot calculate precisely need and cost effects which stem from statutory obligation rather than local preferences or efficiency differences, and requires ad-hoc adjustments to deliver acceptable outcomes, i.e. grants and guidelines which are close to existing spending patterns, and therefore delivering only realistic, incremental allocations.

There is a strong case, therefore for shifting to a simpler system whose central aim is grant stability. Rather than adjusting after-the-event, the grant structure would be similar to at present, with the calculation of an expenditure assessment rather than a needs assessment, and the grant distribution equalising tax levels at the expenditure assessment figure.

This expenditure assessment would work on the same bases as the 'block and formula' approach used for determining the Scottish budget, in a way which recognises that inherited commitments are dominant in the new budget, with the scope for choice at the margins. The block element would be based on authorities' budgets adjusted in line with the GAE provision. The formula element would only apply to changes in expenditure provision, and be based on authorities' relative population shares. This is defensible, as the existing

secondary indicators reallocate less than 2% of GAE, and the effects are broadly in balance. The secondary effects are marginal and, as the Treasury notes, population is the main driver of expenditure needs (HM Treasury 1998).

This would bring grants, GAE and budgets into closer correspondence and eliminate the need for ad-hoc adjustments and, more importantly in political terms, expenditure guidelines. It would promote stability, as GAE would be based on authorities' budgets initially, and then the previous year's GAE thereafter, and authorities would have no incentive to increase spending to attract increased grant. It would continue to reflect needs, through changing population trends at the margins. Overall, stability would be enhanced as in the Barnett formula, through changes being concentrated on the expenditure increments rather than the whole grant. This would eliminate the requirement for extensive consideration of secondary effects which few outside the cognoscenti of the Distribution Committee and its technical advisers understand, and reduce the complexity of the GAE assessment. Authorities would have a degree of certainty which is missing at the moment, and be free to concentrate on maximising efficiency rather than having understandably at the moment to seek to maximise grants.

The end result would be a simple, transparent and objective system of allocating resources. It would deter ministers from making ad-hoc adjustments to grant totals as agreed in the fiscal year 2000-1 with 'special deprivation allowances' in the absence of the necessary tests under the current method, which are open to interpretation of partisanship (under this adjustment, the main beneficiaries were Labour councils in the West of Scotland).

However, these proposals would broadly entrench the current differentials between councils, and this would need monitoring to ensure the pattern of resource distribution remained broadly acceptable.

Implementation of this approach would benefit from a resource context similar to the reform of resource allocation in the NHS. Under this scheme, all health boards and trusts were guaranteed real terms increases, so that the distributional effects did not cause problems of financial management. This would facilitate a smooth change of system, and avoid the disruption to finances which followed reorganisation. Moreover, local government grants have been falling as a share of the Scottish cake, and so the additional monies available through the Comprehensive Spending Review should be applied to assist this reform.

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Ministers are keen to move to a simpler system. This approach would be preferable to one based on fewer indicators, as the problems of selection and weighting would remain. A system based on block expenditure assessments and tax equalisation would have the further merit of being inherently less centralist, and allow authorities freedom to choose their own priorities. Ministers remain under pressure from the Parliament's local government committee to undertake a more fundamental review of local government finance, including alternative forms of taxation. Simplifying grant distribution would be important progress, and the approach advocated here would be more transparent than the client group method, which remains understood by only a minority of specialists.

#### **FOOTNOTE:**

In November 2000 the Executive confirmed their interest to move to a simplified grant system as part of a package of financial reforms, including three-year budgets and the scrapping of spending guidelines. The objective is to develop a Simplified Distribution Formula which will lead to greater stability, although the exact methodology has yet to be agreed. In addition, all councils will receive a minimum guaranteed increase in grant over the period.

(Scottish Executive News Release, 16 November 2000)

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