Managing new financial powers

An update

AUDITOR GENERAL

Prepared by Audit Scotland
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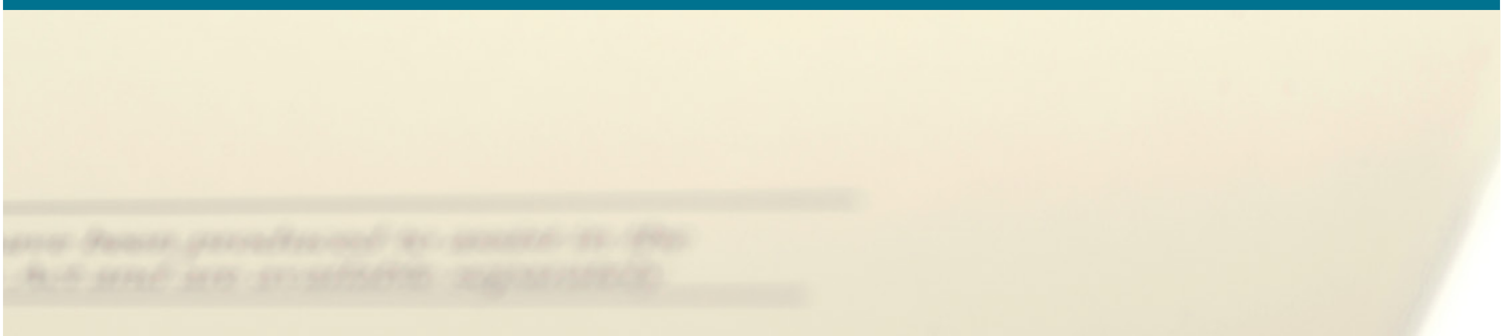

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Key facts

52 per cent

Scottish budget that will be raised directly in Scotland by 2020, compared to 10 per cent in 2014/15

£200 million

One-off transfer from the UK Government to the Scottish Government to support implementing new financial powers

£572 million

Devolved taxes collected by Revenue Scotland in 2015/16

1 April 2017

Scottish Fiscal Commission becomes a statutory body

2.6 million

Number of Scottish income taxpayers

£2.8 billion

Estimated social security spending being devolved to Scotland

Summary

Key messages

1 The Scottish Parliament's financial powers are changing substantially, with new responsibilities for taxes, social security and borrowing through the 2012 and 2016 Scotland Acts. The amount of money raised in Scotland will go up from about £4 billion before the Scotland Acts were introduced, to £22 billion by 2020. The scale of change needed to implement and manage the new financial powers is significant. The Scottish Government is identifying the staff and skills it needs to set up and manage the financial powers, although recruiting enough people with the required skills may prove difficult. The Scottish Government spent £18.5 million up to the end of 2015/16 on programmes to implement the new financial powers. Set-up costs will increase significantly during the next four years, as the Scottish Government implements its social security powers. It is important that the Scottish Government builds a clearer picture of potential future costs and plans how it will fund implementation of the new financial powers over the next four years.

2 The Scottish Government has updated its structures for overseeing the new financial powers and has good programme management processes in place. Arrangements are being put in place to ensure data is shared among relevant bodies to support effective decision-making, financial planning and scrutiny. The transition of the Scottish Fiscal Commission to a statutory body is being managed effectively.

3 Revenue Scotland is collecting two devolved taxes and is making good progress in preparing for further devolved taxes. The National Audit Office (NAO) found that HM Revenue and Customs (HMRC) did not identify 420,000 Scottish taxpayers before the Scottish rate of income tax was introduced. The Scottish Government worked with HMRC to resolve this and work is ongoing to prepare for further income tax powers.

4 The Scottish Government's social security programme is in the early stages. The next stage, in establishing an agency and implementing the new social security system, is an exceptionally wide-ranging and complex task. Once its approach to delivering the social security system is more established, sharing it publicly will support scrutiny of the Scottish Government's proposals and provide the public with more information about the changes. Underpinning this approach with detailed, coordinated project plans will enable oversight of the programme's progress towards delivering the social security powers by the end of the current parliamentary session in 2021.

the scale of change needed to implement and manage the new financial powers is significant

5 The new financial powers require a more strategic approach to Scottish public financial management and reporting, including an overarching medium-term financial strategy underpinned by clear policies and principles. The Scottish Government is developing its approach to financial management. This has included longer-term analysis and assessment to support decision-making. It needs to finalise policies and principles for borrowing and reserves, and further develop its longer-term financial scenario planning. Making these publicly available will enhance financial transparency.

6 The Scottish budget is becoming increasingly complex, with more reliance on forecasting than ever before and more adjustments likely throughout the budget cycle. The Scottish Parliament's Budget Process Review Group is reviewing current arrangements and assessing what is needed to support scrutiny in the future. The Scottish Government is taking steps to enhance financial reporting to provide a more comprehensive picture of Scotland's public finances but more work is required. This will enable the Parliament and wider public to understand and scrutinise the Scottish Government's decisions.

Recommendations

The Scottish Government should:

- monitor regularly how much is being spent on implementing the financial powers in the Scotland Acts against what has been planned. The costs of each individual programme, and the total cost, should be reported regularly through existing governance structures (paragraph 16)
- develop more detailed estimates of how much it will cost to implement the financial powers in the Scotland Acts, and refine them as policy decisions are made about how the powers will be delivered (paragraph 17)
- integrate new approaches to workforce planning, developed through its SG2020 change programme, into its processes at all levels of the organisation (paragraph 24)
- share its approach to implementing the social security powers publicly and underpin this approach with detailed plans for the social security system programme and its projects (paragraphs 68–70)
- develop a medium-term financial strategy setting out (paragraph 83):
  - forecast economic performance and its effect on Scotland's public finances
  - broad financial plans for the next three to five years
  - clear policies and principles for using and managing the new financial powers
  - scenario plans

- finalise principles for using its borrowing powers and the Scotland Reserve as a matter of urgency and make these publicly available (paragraphs 92 and 94)
- demonstrate publicly the progress it is making toward introducing a comprehensive account of Scotland's public finances (paragraph 112)
- explain and better link different parts of the budget, and provide more detailed explanations for differences between the budget and outturn (paragraph 115).

Background

1. The 2012 and 2016 Scotland Acts (the Scotland Acts) devolve a range of powers to the Scottish Parliament. This includes powers over the Crown Estate's economic assets in Scotland, policing of the railways, drink-driving limits and licensing for onshore oil and gas extraction. The Scottish Parliament's financial powers are also changing substantially, with new responsibilities for taxes, social security and borrowing being devolved (Exhibit 1, page 9). This report focuses on these new financial powers.

2. Over the next four years, spending is set to rise from about £38 billion to over £40 billion each year. The amount of money raised in Scotland will go up from about £4 billion before the Scotland Acts were introduced, to about £22 billion.[1] This means that around 50 per cent of devolved spending in Scotland will be met by money raised directly, once the Scotland Act 2016 powers are fully implemented. This compares to around ten per cent before the Scotland Act 2012.

3. Management of the Scottish public finances will fundamentally change as the new financial powers are delivered. Scotland's budget is becoming increasingly complex, and subject to greater uncertainty and volatility than when the block grant from the UK Government was relatively fixed. The new powers give more control over public finances and bring new opportunities and challenges. The Scottish Government will have more choice over tax and spending, and more decisions to make about how and when to use its new borrowing and reserve powers. The performance of the Scottish economy relative to the rest of the UK will have a greater influence on public finances than ever before.

4. In February 2016, the UK and Scottish governments agreed a revised fiscal framework, which sets out the rules for managing the new financial powers in Scotland.[2] This includes the calculations of the grant received from the UK Government, borrowing limits and preparation of fiscal and economic forecasts. It is important that the Scottish Government develops effective arrangements to manage the new financial powers within the fiscal framework. Its financial reporting also needs to be comprehensive, reliable, timely and transparent: that is, clear, easy to find and understandable.

5. Implementing the financial powers in the Scotland Acts is a huge and complex programme of work for the Scottish Government. It involves developing policy and legislation, establishing new public bodies and introducing new processes. The financial powers in the Scotland Act 2012 have all been introduced. Work will continue to implement the powers in the Scotland Act 2016 until at least 2021 (Exhibit 1).

6. On 23 June 2016 the UK electorate voted to leave the European Union (EU). It is too early to say what the vote to leave the EU means for Scotland. It is likely to have implications for the public finances, and changes the context in which the financial powers in the Scotland Acts are being introduced and managed.

About this audit

7. This report looks at how the Scottish Government is managing the range of new, devolved financial powers in **Exhibit 1**. It examines how the Scottish Government, Revenue Scotland and the Scottish Fiscal Commission (SFC) are implementing or preparing to introduce these new powers. It also considers how the Scottish Government is developing public financial management arrangements in the context of the new powers. Our audit assesses progress to February 2017, while acknowledging that substantial activity is ongoing.

8. This report builds on our two previous reports on implementing the financial provisions in the Scotland Act 2012, published in **December 2014** and **December 2015**. We also published a paper in **September 2016** highlighting key issues for the Scottish public finances flowing from the new financial powers. We will continue to report on the progress of the Scottish Government and other public bodies in implementing and managing the new financial powers, through our annual audits and our programme of performance audits.

9. The report is in three parts:

- Part 1 examines the Scottish Government's arrangements for managing the implementation of the new financial powers.
- Part 2 assesses progress in delivering the financial powers in the Scotland Acts.
- Part 3 looks at how financial management and reporting of the public finances are changing as the new financial powers are introduced.

10. Our findings are based on reviewing documents and talking to representatives from organisations involved in implementing the new financial arrangements. The audit methodology for this report is in the Appendix

11. All of our work on the financial powers in the Scotland Acts can be found on our website.

Exhibit 1
Timeline for new financial powers

Scotland Act 2012	From 2015	Land and Buildings Transaction Tax	£507 million	Forecast revenue for 2017/18
		Scottish Landfill Tax	£149 million	Forecast revenue for 2017/18
		Borrowing and cash reserve powers (up to 10% of capital budget each year):		Borrowing can be from: - the National Loans Fund - Commercial banks - Issuing of bonds
		• Revenue borrowing	Overall limit – £500 million	
		• Capital borrowing	Overall limit – £2.2 billion	
		• Cash reserve	Overall limit – £125 million	
	2016	Scottish Rate of Income Tax (SRIT)	£4.9 billion	Estimated revenue for 2016/17
Scotland Act 2016	2017	Control over income tax rates and bands[1]	£11.9 billion	Forecast revenue for 2017/18
		Increased borrowing and reserve powers over:		Extends 2012 Act powers
		• Revenue borrowing	Overall limit – £1.75 billion	Annual limit £600 million
		• Capital borrowing	Overall limit – £3 billion	Annual limit 15% of overall limit
		• Scotland Reserve	Overall limit – £700 million	Annual limit £350 million
	2018	Air Departure Tax[2]	£326 million	Forecast revenue for 2018/19
	2019	VAT: the first 10p of standard rate of VAT (and 2.5p of reduced rate) raised in Scotland will be assigned to Scottish budget	£5.6 billion	Estimated gross assigned revenues based on 2015/16 figures
	By 2021	Responsibility for 11 social security benefits and the power to top-up reserved benefits and create new ones	£2.8 billion	Estimated spending based on 2015/16 figures
		Aggregates Levy	£53 million	Devolution date to be confirmed. Estimated revenues based on 2015/16 figures

Key
£: revenues **£: limits** **£: spending**

Notes: 1. Non-saving non-dividend income tax replaces SRIT. 2. Air Departure Tax replaces UK Air Passenger Duty.

Source: Audit Scotland; *Scottish Government Draft Budget 2017/18,* December 2016, *Government Expenditure & Revenue Scotland 2015-16*, Scottish Government, August 2016

Part 1

Managing implementation

Key messages

1 By the end of 2015/16, the Scottish Government had spent £18.5 million on programmes to implement the financial powers in the Scotland Acts. Set-up costs will increase significantly during the next four years, as the Scottish Government implements its social security powers. It is important that the Scottish Government regularly monitors and reviews how much is being spent against what has been planned. Gaining a better understanding of costs will help it to develop more detailed estimates of potential future costs as policy decisions are made, and plan how it will fund implementation of the new financial powers over the next four years.

2 The scale of change needed to implement and manage the new financial powers has significant staffing implications for the Scottish Government. It is making organisation-wide changes to support the movement of people and funding to meet its priorities. Individual teams are identifying the specific staff and skills they need to set up and manage the financial powers, although recruiting enough people with the required skills may prove difficult.

3 The Scottish Government has updated its structures for overseeing the introduction of the new financial powers and has good programme management processes in place. It is involved in discussions and decisions with the UK Government, the Department of Work and Pensions (DWP) and HM Revenue and Customs (HMRC) on how the new powers will work in practice. Arrangements are being put in place to ensure data is shared among relevant bodies to support effective decision-making, financial planning and scrutiny. The transition of the Scottish Fiscal Commission to a statutory body is being managed effectively.

the scale of change needed has significant staffing implications for the Scottish Government

The cost of implementing new social security powers will increase significantly during the next four years

12. The Scottish and UK governments are incurring costs in implementing and then managing the financial powers in the Scotland Acts. The revised fiscal framework sets out that the Scottish and UK governments will share the cost of implementing the financial powers in the Scotland Act 2016 as follows:

- The UK Government will make a one-off payment of £200 million to the Scottish budget – £100 million of this will be transferred in 2017/18. This is a contribution towards costs rather than reimbursement for specific areas of spending. The two governments will continue discussions in 2017 to agree when the remaining funds will be transferred.

- The UK Government will transfer up to £66 million each year to the Scottish budget to cover ongoing administration costs – £22 million will be transferred in 2017/18.
- The Scottish Government will meet all costs associated with the devolution of income tax, Air Passenger Duty and the Aggregates Levy.
- The Scottish Government will meet all administration and programme costs it incurs in creating new social security benefits or making discretionary payments.
- The Scottish Government will meet all costs associated with establishing the Scottish Fiscal Commission (SFC).
- The Scottish and UK governments will share equally the costs of implementing and administering the assignment of VAT revenues to the Scottish budget.
- The Scottish Government will meet all other net costs necessarily incurred by the UK Government solely as a result of devolution.

13. By the end of 2015/16, the Scottish Government had spent £18.5 million on programmes to implement the financial powers in the Scotland Acts (Exhibit 2, page 12). Most of this was to cover HMRC's costs in setting up and operating the Scottish rate of income tax. The Scottish Government budgeted a further £18 million for 2016/17 and £92 million for 2017/18. The remaining amount will be used to support other work flowing from the Scotland Act 2016, such as employability programmes and the Crown Estate transfer. The draft budget does not provide a detailed breakdown of this amount. Scottish Government departments and public bodies are identifying potential costs of implementing the new financial powers, such as staff and IT systems, to help inform the allocation of the 2017/18 budget.

14. Set-up costs will increase significantly during the next four years, as the Scottish Government implements powers in the Scotland Act 2016. The budget for this work in 2017/18 is over five times more than the previous year, owing to funding to implement the social security powers (Exhibit 2). The Scottish Government expects that implementation will cost more than the £200 million that the UK Government will transfer to the Scottish budget, although it has not identified how much more. The Scottish Government will need to fund the remaining costs alongside existing budget pressures and spending commitments.

Building a clearer picture of future costs will help the Scottish Government plan how it will fund implementation of the new financial powers

15. The Scottish Government has established individual programmes to introduce the financial powers in the Scotland Acts. The costs of these programmes are recorded separately by the organisations and teams responsible for them. Costs are not collated or reported centrally. The programme brief for the fiscal

Exhibit 2

Set up costs for implementing the new financial powers

Most of the costs to date are for implementing the Scottish rate of income tax.

<table>
<tr><th>Programme</th><th>Total cost to 2015/16 (£ million)</th><th>Budget (2016/17) (£ million)</th><th>Draft budget (2017/18) (£ million)</th></tr>
<tr><td>Land and Buildings Transaction Tax and Scottish Landfill Tax</td><td>6.4[1]</td><td>0</td><td>0</td></tr>
<tr><td>Scottish rate of income tax</td><td>12[2]</td><td rowspan="4">16.1</td><td rowspan="4">12</td></tr>
<tr><td>Air Departure Tax</td><td>0</td></tr>
<tr><td>Aggregates Levy</td><td>0</td></tr>
<tr><td>VAT</td><td>0</td></tr>
<tr><td>Social security</td><td>0.1</td><td>0.9</td><td>80[3]</td></tr>
<tr><td>Scottish Fiscal Commission</td><td>0</td><td>1[4]</td><td>0</td></tr>
<tr><td>Total</td><td>18.5</td><td>18</td><td>92</td></tr>
</table>

Notes:
1. This includes programme costs of £5.5 million to 31 July 2015, and £0.9 million paid to HMRC for costs associated with the devolution of Stamp Duty Land Tax, which was replaced by Land and Buildings Transaction Tax.
2. This includes £11.1 million paid to HMRC and £0.87 million paid to the Department of Work and Pensions.
3. This is the budget for Scotland Act 2016 non-tax implementation. The Scottish Government expects most of it will be used to fund the social security programme.
4. This is for the programme to manage the transition of the Scottish Fiscal Commission to a statutory body by 1 April 2017, which was established in June 2016. Figures do not include operating costs or budget. The SFC has a 2017/18 budget of £1.7 million, a small proportion of this is for the transition arrangements.

Source: Audit Scotland using information provided by the Scottish Government, Revenue Scotland and Scottish Fiscal Commission

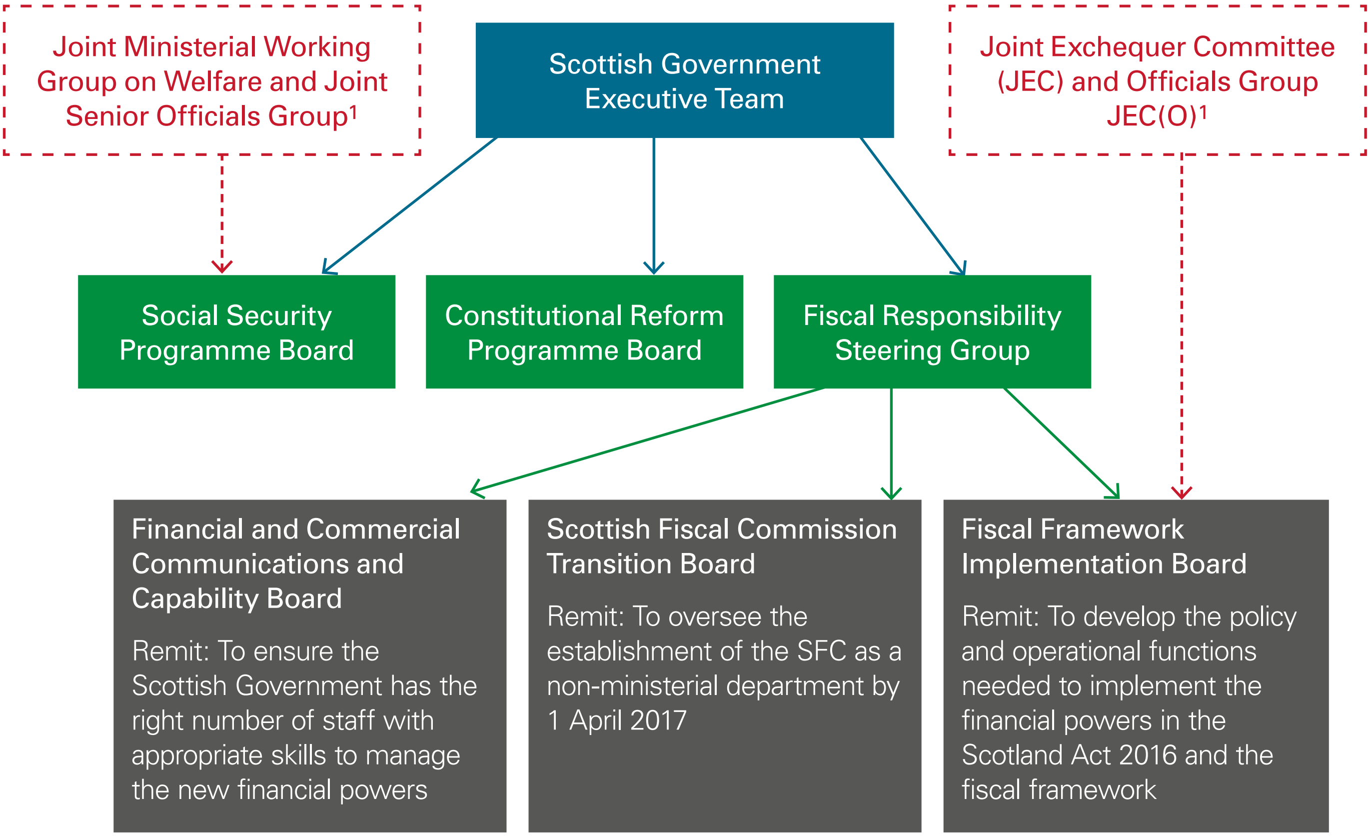
framework implementation programme states that programme costs will be monitored monthly by the Scottish Government finance directorate and reported to the Fiscal Framework Implementation Board (Exhibit 3, page 13). To date, the board has not discussed the programme costs.

16. It is important that the Scottish Government monitors regularly how much is being spent overall on implementing the financial powers in the Scotland Acts against what has been planned. The costs of each individual programme, and the total cost, should be reported regularly through existing governance structures; for example to the Fiscal Responsibility Steering Group or Scottish Government Executive Team (Exhibit 3). This will help ensure that there is an awareness of spending across all programmes at a senior level and that programme teams are accountable for their spending. It will also contribute to a better understanding of set-up costs, which will help the Scottish Government to develop cost estimates for future activity.

Exhibit 3

Arrangements to manage the introduction of the new financial powers

There are clear structures in place for overseeing the introduction of the new financial powers.



Note: 1. This is a joint UK and Scottish government forum, with indirect links to the Scottish Government programme boards.
Source: Audit Scotland

17. Building a clearer picture of potential future costs will help the Scottish Government to plan how it will fund implementation of the new financial powers over the next four years, within its budget. Given the scale of the programme to implement the powers, accurately identifying potential costs is complex. The Scottish Government will need to develop more detailed cost estimates and refine them as policy decisions are made about how to implement and deliver certain powers. For example, how individual social security powers will be administered, when and by whom. Having a better understanding of what has been spent to date may help with this.

18. Alongside the cost of implementing and administering the new financial powers, the Scottish Government will need to consider the impact of specific policies on its budget. For example, ministers need to know how much a decision to increase Carer's Allowance by a certain amount would cost overall, so long-term budget implications can be fully understood. The Scottish Government is starting to model the costs of the social security powers to help inform policy decisions.

The scale of change needed to implement and manage the new financial powers has significant staffing implications for the Scottish Government

19. The Scotland Acts introduce additional responsibilities for the Scottish Government, such as developing new policy and legislation, establishing new public bodies and introducing new processes. The scale of the change needed to implement and manage the new financial powers has significant staffing implications. There will be substantial changes in the type and volume of work the Scottish Government will do. For example, when the social security powers are in place, it expects to process as many transactions in a week as it currently does in a year.

20. The Scottish Government also needs to deliver its current business and respond to the potential impact of the UK leaving the EU. At the end of March 2016, the core Scottish Government directly employed 5,152 full-time equivalent (FTE) staff. This is a reduction of six per cent from 5,491 FTE staff at the end of March 2010. Successfully implementing and managing the new financial powers will require enough staff with the right knowledge and skills. Recruiting staff with the technical experience required, for example in finance and programme management, may prove difficult. The Scottish Government recognises that it needs to adapt to meet the demands and challenges it faces, including making best use of existing money and people.

21. The Scottish Government has an ongoing change programme called SG2020. It aims to change the way the Scottish Government works to ensure it can continue to deliver ministerial priorities and take on additional responsibilities within limited resources. SG2020's 'matching resources to priorities' workstream aims to create a more flexible and responsive workforce by reallocating people and money to new or increased priority areas. This includes ensuring that necessary resources are available to support work as a result of new powers, including tax, social security and employability, to manage the implications of the EU referendum, and to help build economic growth.

22. The Scottish Government is making organisation-wide changes to support the movement of people and funding to meet these priorities. It has revised its promotion policy, developed policies and systems to support more flexible deployment, and is assessing opportunities for redeploying and retraining staff.

23. Individual directorates and programmes are also identifying the staff and skills they need to implement and manage the financial powers in the Scotland Acts. In doing this, it is important that the Scottish Government considers both the staff needed to set up the new powers and those needed to manage them in the longer term. The finance team is reviewing its role, structure and functions to allow it to deliver additional responsibilities resulting from the new financial powers through to 2020. Additional budget has been allocated to develop the size and skills of the finance team.

24. The Scottish Government recognises the significant staffing implications of the new financial powers and the challenges it faces in recruiting staff with the skills it needs. It has started to reallocate existing staff and recruit new people to meet immediate pressures. The Scottish Government now needs to implement longer-term solutions to ensure it has the staff and skills in place to deliver its current priorities and new responsibilities. It will be important that it integrates new approaches to workforce planning, developed through SG2020, into its processes at all levels of the organisation.

The Scottish Government has updated its structures for overseeing the introduction of the new financial powers

25. We previously reported that the Scottish Government had developed clear structures for overseeing the introduction of new financial powers.[3] The Scottish Government revised these structures during 2016 to reflect the Scotland Act 2016 and fiscal framework (Exhibit 3, page 13).

26. Each of the programme boards under the Fiscal Responsibility Steering Group has established good programme management arrangements. The remit of the boards and how they interact is clearly documented. Each has its own risk register that is regularly discussed at the relevant programme board. Where necessary, the boards escalate risks for inclusion in the corporate risk register, which is reviewed by the Scottish Government Audit and Assurance Committee. The programmes are also independently reviewed at key stages.

27. The social security programme is in its early stages (Part 2) and it has refined its programme governance arrangements. This included reviewing membership of the programme board during the second half of 2016 to ensure it had the right people and skills to fulfil its decision-making role for the next stage of the programme. The board approved its terms of reference at its meeting in January 2017.

28. Decisions on individual programmes are made by the relevant board, and the Fiscal Responsibility Steering Group and Scottish Government Executive Team oversee the programme boards. Cross-representation of officials across the boards helps to ensure they are well informed on the different strands of work. For example, the social security director is a member of both the Social Security Programme Board and the Fiscal Framework Implementation Board.

The Scottish Government is working with other organisations to implement the powers in the Scotland Acts

29. The Scottish and UK governments co-chair joint-government forums that are responsible for agreeing how aspects of the Scotland Act 2016 and fiscal framework will operate in practice:

- **The Joint Exchequer Committee** (JEC) governs implementing, operating and reviewing the fiscal framework. Through the JEC, ministers from both governments discuss how to implement the powers in the Scotland Acts. The JEC is supported by the **Joint Exchequer Committee: Officials** (JEC(O)) group, which includes officials from both governments, the DWP and HMRC.

- The **Joint Ministerial Working Group on Welfare** is responsible for the policy and legislative aspects of devolution of social security powers. It is supported by the **Joint Senior Officials Group**, including officials from both governments, Scotland Office and DWP.

30. The JEC met ten times between July 2015 and February 2016 to discuss revisions to the fiscal framework. It has met once more, since the fiscal framework was agreed in February 2016, in November 2016. At this meeting ministers agreed how to apply the block grant adjustment and the amount of administration and implementation funding to be transferred for 2017/18. They also discussed progress on further income tax powers and how to assign money raised from VAT. The JEC is due to meet again in early 2017 to discuss further technical details in advance of powers being transferred. The Joint Ministerial Working Group on Welfare was established in February 2015. It has met seven times since then, most recently in February 2017, to discuss how the two governments will manage the transfer of social security powers and progress to date.

31. Ensuring a smooth transition of powers from the UK Parliament to the Scottish Parliament requires officials in the bodies involved to build and maintain effective working relationships. Memorandums of understanding (MOUs) have been agreed between the Scottish Government and DWP and HMRC, setting out their respective responsibilities and how they will work together to implement specific powers. Officials from these organisations are represented on groups that support the joint-government forums (paragraph 29) and on each other's programme boards. For example, DWP is represented on the Scottish Government's Social Security Programme Board, and the Scottish Government sits on HMRC's programme board that oversees changes to Scottish income tax. This helps to ensure that senior officials have an awareness of relevant activity in other bodies and are involved in discussions and decisions where appropriate.

Information and data-sharing arrangements are being put in place

32. The UK and Scottish governments have agreed to put in place appropriate and reciprocal information-sharing arrangements. This will help both governments, and other relevant bodies, undertake their respective roles in implementing and managing the new financial powers. The Scottish Government had access to all the information it needed to produce the 2017/18 draft budget, and is now taking steps to formalise these arrangements.

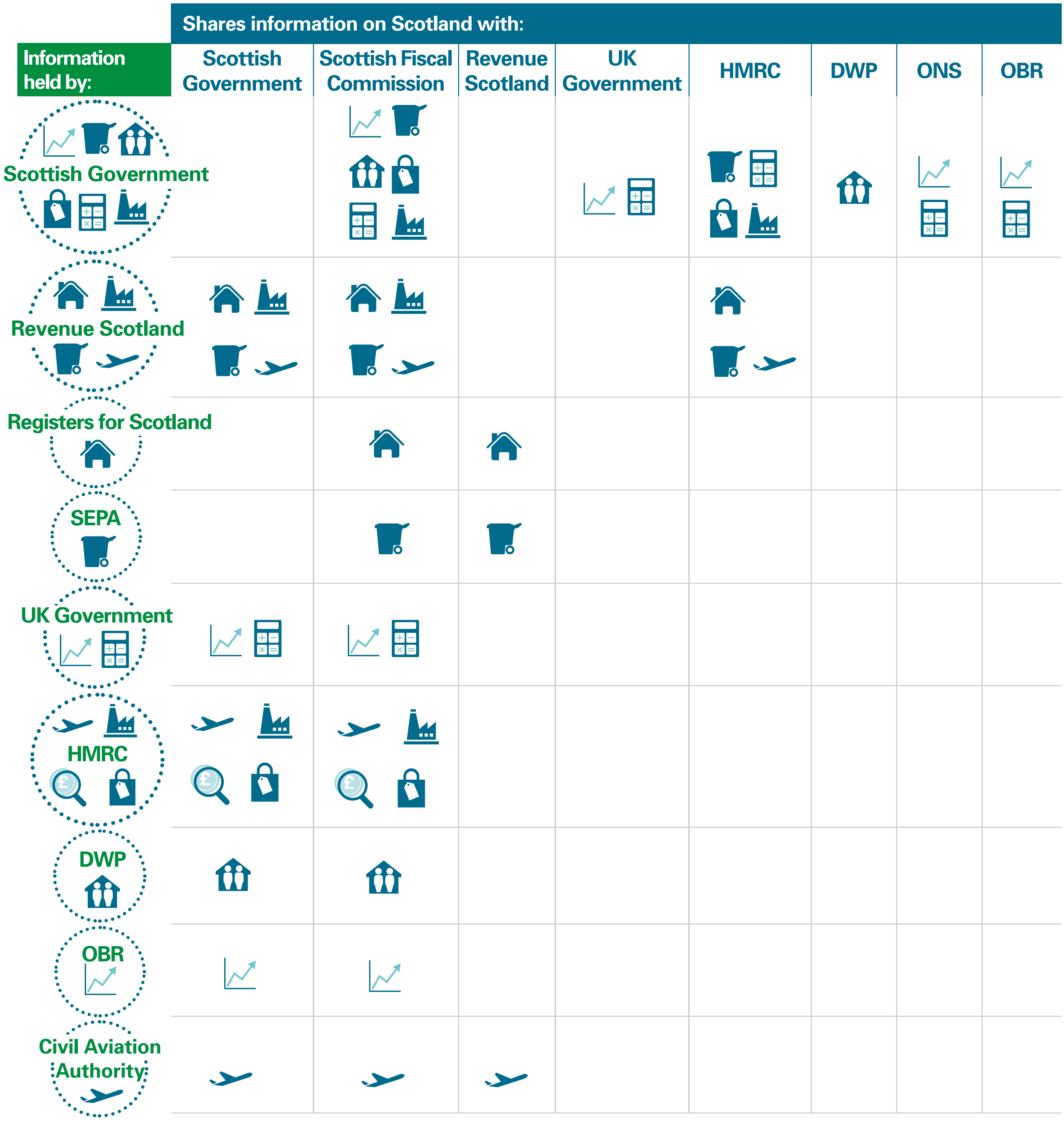
33. A variety of information and data will need to be shared between UK and Scottish public bodies to help:

- identify Scottish taxpayers and social security claimants
- inform individuals and organisations and prepare them for implementation of the new financial powers
- prepare economic, tax and spending forecasts to help prepare the budget and set block grant adjustments
- develop policies on tax and spending and assess if policies are achieving the government's objectives and desired outcomes
- consider taxpayers' behaviour responses to policy changes
- design and build the supporting IT systems and administrative procedures.

34. (Exhibit 4, page 17) shows the wide and complicated network of public bodies that need to share information and data to support the new financial powers. MOUs will be developed and refined as powers are transferred and policy choices made. It will be important that in sharing this data careful consideration is given to data protection and security.

35. Economic, tax and spending data will be used by more than public bodies. For example, information will be scrutinised and used by independent forecasters. Having more independent forecasts and information available will lead to better informed policy choices and aid budget scrutiny. Independent forecasters and commentators have an important role to play in assessing the reliability

Exhibit 4
Sharing data between government bodies



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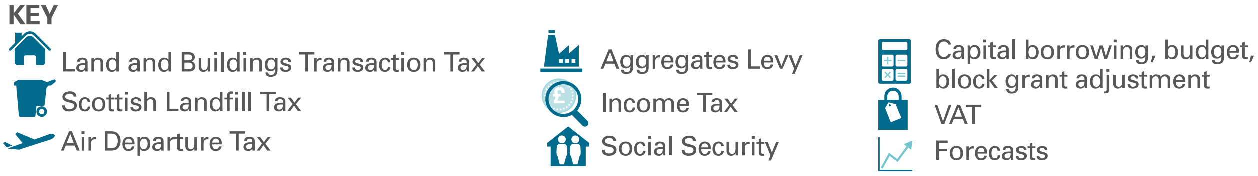


Notes: 1. This exhibit only captures some of the new arrangements that will be needed for the Scotland Acts and does not show existing arrangements between other UK public bodies. 2. SEPA is the Scottish Environment and Protection Agency, OBR is the Office for Budget Responsibility, ONS is the Office for National Statistics.

Source: Audit Scotland

and robustness of economic forecasts and the sustainability of the Scottish Government's policy decisions (Part 3). This will be important given the inherent uncertainty of forecasting.

36. It is also important that the public has access to clear, reliable and easily understandable economic and financial information. This helps to underpin wider scrutiny and public understanding of budget decisions. The Scottish Government currently makes economic and financial data available through its Government Expenditure and Revenues Scotland (GERS) reports. The Scottish Government announced its Open Government National Action Plan in December 2016 reinforcing its commitment to data sharing, transparency and involving the wider public in decisions.

The transition of the Scottish Fiscal Commission to a statutory body is being managed effectively

37. The role of the Scottish Fiscal Commission (SFC) will become increasingly important as new financial powers are introduced. Since 2014, the SFC has operated on a non-statutory basis and its role has been to independently assess the Scottish Government's forecasts of devolved tax revenues. It reported on the forecasts in the Scottish Government's draft budgets for 2015/16 through to 2017/18.

38. Under the Scottish Fiscal Commission Act 2016, the SFC will be established as a statutory body from 1 April 2017. Its responsibilities will expand to include:

- preparing five-year forecasts of devolved tax revenues, non-domestic rates and Scottish income tax
- preparing five-year forecasts of demand-led social security spending, once devolved
- preparing forecasts of Scotland's onshore gross domestic product (GDP)
- assessing the reasonableness of Scottish ministers' borrowing projections.

39. The SFC's statutory functions are similar to that of the UK's Office for Budget Responsibility (OBR) and in line with good practice outlined by the Office for Economic Cooperation and Development (OECD) for independent fiscal institutions.[4] The main difference is that there is no requirement for the SFC to provide an assessment on the financial sustainability of public finances.

40. From April 2017, the SFC will be responsible for preparing forecasts for inclusion in the Scottish Government's draft budget and Budget Bill. The first of these will be the draft budget for 2018/19. The SFC expects to have a joint protocol with the Scottish Government in place from 1 April 2017, setting out the forecasting and assessment process. It will be up to the Scottish Government to decide if it uses the forecasts from the SFC or its own forecasts.

41. The SFC established a transition programme to put in place the systems, processes, staff and skills needed for the SFC to operate as a statutory body. The programme has clear plans for this transition. It has a particular focus on establishing the SFC's independence, recruiting staff with appropriate technical skills and securing access to the data it needs to perform its functions. The programme is on track for SFC to have everything necessary in place to operate as a statutory body from 1 April 2017.

42. One of the biggest challenges facing the transition programme is the recruitment of enough staff with the right skills. Recruitment campaigns that ran from September to December 2016 did not fill all posts on a permanent basis, including the chief executive. The SFC implemented its contingency plans and is satisfied that it has the right staff in place to deliver its remit in 2017. The SFC is identifying lessons learned from its recruitment campaigns to help inform recruitment activity during 2017. It expects to appoint a permanent chief executive by summer 2017. The interim chief executive will remain in post until the SFC is operating as a statutory body. The SFC appointed an interim deputy chief executive in February 2017 to provide leadership through to the appointment of a permanent chief executive. It is important that the SFC keeps under review the staff and skills it needs to carry out its functions effectively.

Part 2

Delivering new financial powers

Key messages

1 Revenue Scotland is collecting two devolved taxes and successfully introduced the Additional Dwelling Supplement in response to a policy change. It is making good progress in preparing for the introduction of Air Departure Tax from April 2018.

2 The National Audit Office (NAO) found that HMRC did not identify 420,000 Scottish taxpayers before the Scottish rate of income tax (SRIT) was introduced in April 2016. While this had no direct impact on taxpayers or the Scottish budget in 2016/17, an accurate taxpayer base is critical for devolved income tax to operate effectively. The Scottish Government worked with HMRC to resolve this issue. They continue to work together to further refine the taxpayer base and prepare for further income tax powers from April 2017.

3 The Scottish Government's social security system programme is in its early stages. It has been taking time to create the environment needed to successfully deliver the social security system. The next stage, establishing an agency and implementing the new social security system is an exceptionally wide-ranging and complex task. Once its approach to delivering the social security system is more established, sharing it publicly will support scrutiny of the Scottish Government's proposals and provide the public with more information about the changes. Underpinning this approach with detailed, coordinated project plans will enable oversight of the programme's progress towards delivering the social security powers by the end of the current parliamentary session in 2021.

implementing the new social security system is an exceptionally wide-ranging and complex task

Devolved taxes

The Scotland Act 2012 devolved two taxes to Scotland – Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax (SLfT) on 1 April 2015. LBTT is paid on land and property purchases and SLfT is paid on waste going to landfill. Revenue Scotland collected £425 million in LBTT and £147 million in SLfT in 2015/16.

The Scotland Act 2016 devolves two further taxes to Scotland – Air Departure Tax (charged on passengers flying from Scottish airports) and Aggregates Levy (a tax on importing or extracting sand, gravel or rock from the ground or sea). The Scottish Government estimates £326 million will be collected in Air Departure Tax and £53 million in Aggregates Levy when they are devolved.

Revenue Scotland is collecting two devolved taxes and is making good progress preparing for further devolved taxes

43. We reported in 2015 that Revenue Scotland had successfully implemented LBTT and SLfT, and began collecting both from 1 April 2015. It collected £572 million in devolved taxes in 2015/16 on behalf of the Scottish Government. From April 2018, Revenue Scotland will also collect the replacement for Air Passenger Duty, Air Departure Tax (ADT).

44. In December 2015, the Scottish Government announced in its 2016/17 draft budget an additional tax on buying second and additional homes in Scotland. Revenue Scotland would collect this Additional Dwelling Supplement (ADS) on the Scottish Government's behalf from April 2016. This announcement came a month after the UK Spending Review and Autumn Statement announced a similar tax on buy-to-let properties and second homes in the rest of the UK. Revenue Scotland set up a project team to prepare for the new tax in January 2016 (Case study 1). It successfully made the adjustments necessary to collect ADS from April 2016.

Case study 1

Revenue Scotland's preparation for the Additional Dwelling Supplement (ADS)

Revenue Scotland established a project in January 2016 to implement ADS from 1 April 2016. In doing this, it drew on its experience of implementing LBTT and SLfT. It organised its work into three teams – communication, IT and operational design. Revenue Scotland held roadshows, webinars and produced guidance to ensure that stakeholders, such as solicitors, were aware and prepared for the tax change.

Revenue Scotland worked closely with its IT provider to adapt its IT system for ADS. Stakeholders who use the IT system took part in testing to check not only that the new module worked well but also that the changes did not affect other parts of the IT system.

Following the closure of the project, Revenue Scotland completed a lessons-learned exercise to inform its future projects. It has made this available in the Scottish Government's Programme and Project Management Centre of Expertise to share its learning more widely. There were 63 lessons for future projects across the themes of governance, project management, collaboration, stakeholder engagement, policy development and resource management. This identified what had been done well and learning points for improvement. The learning is contributing to the Air Departure Tax project.

Source: Audit Scotland

Revenue Scotland is making good progress in preparing for Air Departure Tax by April 2018

45. The Scotland Act 2016 devolves Air Passenger Duty levied on passengers flying from Scottish airports from April 2018. The Scottish Government consulted on replacing the tax in March 2016 and introduced its Air Departure Tax (Scotland) Bill in December 2016.

46. Revenue Scotland has made good progress in putting the arrangements in place to prepare for implementing the new tax. It has established a programme structure and recruited to its four projects: programme management and transition, IT, communications and operational design. Their work is overseen by a programme board. Revenue Scotland and HMRC are developing criteria for reviewing their readiness to devolve responsibility for the tax. The programme will begin reviewing its progress against the criteria from March 2017.

47. The new tax will be administered through Revenue Scotland's existing online tax payment system. As this is a change from HMRC's current paper-based payment system, Revenue Scotland is actively engaging the airline industry in designing the new tax return and in the development of systems, processes and guidance. It plans to open its online system before the new tax is introduced to ensure the industry is prepared for the change.

48. Revenue Scotland is expected to be responsible for implementing and collecting the Aggregates Levy once it has been devolved. A date for this is still to be decided as outstanding legal challenges to the UK-wide levy are still to be resolved.

Shared and assigned taxes

The Scotland Act 2012 gave the Scottish Parliament the power to set a Scottish rate of income tax (SRIT) from April 2016. The main UK rates of income tax are reduced by ten pence for each tax band for Scottish taxpayers, and replaced by the SRIT. The Scottish Government estimates £4.9 billion will be collected in SRIT in 2016/17. The Scotland Act 2016 gave the Scottish Parliament the power to set the rates and band thresholds for all non-savings non-dividend (NSND) income tax paid by Scottish taxpayers. The Scottish Government estimates it will collect £11.9 billion in Scottish income tax from 2017/18.

Through the Scotland Act 2016, a share of the VAT collected in Scotland will be assigned to the Scottish budget from April 2019. This will be the first ten pence of standard rate VAT and 2.5 pence of reduced rate VAT. The Scottish Government estimates £5.6 billion of VAT collected will be assigned to the Scottish budget.

The Scottish Government is working with HMRC to improve the identification of Scottish taxpayers

49. The Scottish rate of income tax (SRIT) was introduced on 6 April 2016. HMRC is responsible for implementing, collecting and administering the SRIT. This includes identifying Scottish taxpayers, to whom the Scottish rate of income tax applies. The Scottish Government is responsible for paying HMRC for implementing and operating the SRIT and ensuring this represents value for money.

50. The National Audit Office (NAO), which audits HMRC, reported in December 2016 on progress in implementing the SRIT.[5] It reported that an error in the design of HMRC's taxpayer identification exercise in December 2015 meant that 420,000 potential Scottish taxpayers did not receive a letter notifying them of the change in income tax arrangements. The NAO reported that HMRC did not have effective controls in place to immediately recognise that the full intended population had not received a Scottish taxpayer notification letter. HMRC was notified quickly that some taxpayers had not received notification letters by taxpayers, employers and the Scottish Government. In January 2016 it engaged its IT supplier to determine the scale of the issue and in April 2016 it confirmed the total number of people affected. An interim solution was put in place by June 2016 followed by a permanent IT solution in October 2016 as part of HMRC's biannual IT update.

51. There were no direct financial consequences for the Scottish Government or taxpayers as a result of this error. Identifying Scottish taxpayers is fundamental to effectively operating the SRIT and further devolved income tax from April 2017. The Scottish Government sought and received assurance from HMRC that the error in identifying taxpayers had been resolved through a series of meetings. It tested this against the taxpayer status of those on the Scottish Government payroll. Work continues to further refine the taxpayer population, for example by sampling the payrolls of other large employers. The Scottish Government has worked with HMRC to develop an action plan for this work, and it receives assurance through regular meetings with HMRC. The NAO will assess and report on the effectiveness of this action plan later this year.

52. Maintaining a correct record of Scottish taxpayers relies on people notifying HMRC of a change of address. The NAO reported that there remains a risk that taxpayers do not update their address details. This could result in taxpayers paying the incorrect amount of income tax. Keeping information up to date will only become established taxpayer behaviour through effective communication. No further spending on SRIT-specific communications was planned from 2016/17 onward. HMRC will continue to communicate through its usual channels with agents and employers to reinforce the importance of keeping address details up to date.

The estimated costs of implementing the SRIT have been revised down

53. The Scottish Government is responsible for meeting HMRC's costs in setting up and operating the SRIT. To March 2016, the Scottish Government paid £11.1 million to reimburse HMRC for costs incurred implementing the SRIT, £8.4 million of which was in 2015/16.[6]

54. As implementation of HMRC's SRIT project progresses, the estimated set-up costs continue to be revised downwards. In June 2016, HMRC revised its estimate for implementation costs to £30 million, £5 million less than it estimated in March 2015 (Exhibit 5, page 24). It now expects IT costs to be more than non-IT costs because the costs of communicating with taxpayers were significantly less than estimated. HMRC used the Scottish Government's communication contracts for radio and newspaper advertising as they provided better value for money, which contributed to reduced publicity costs.

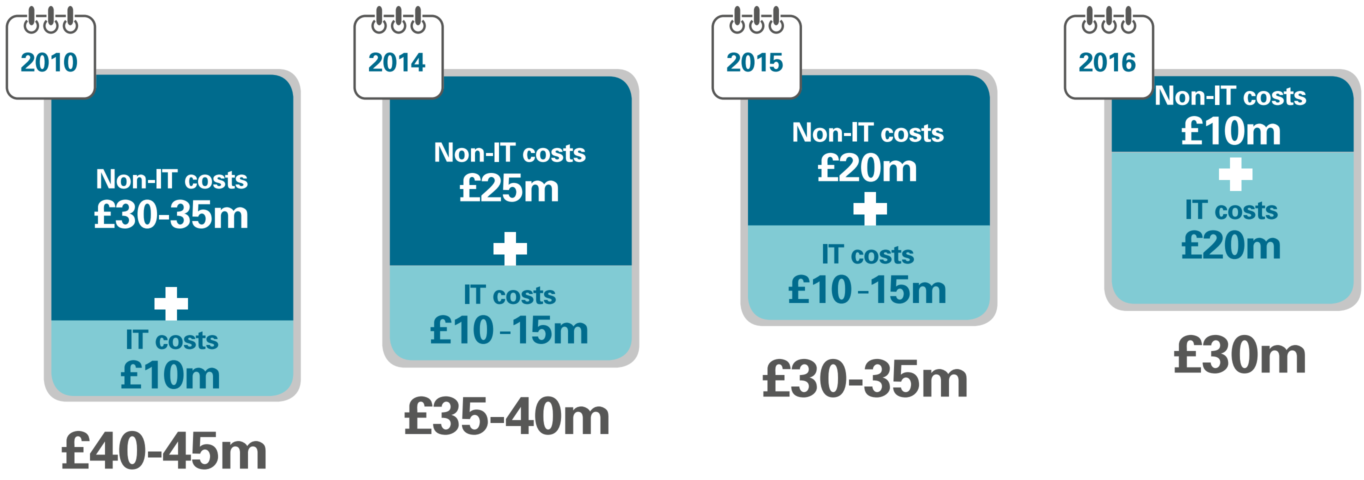
55. There will be further project costs in 2016/17 to amend HMRC's IT systems. The Scottish Government will also pay an estimated £1.5 million to HMRC in 2016/17 for administering the SRIT.[7] HMRC has estimated that annual running costs will increase to around £5 million if the Scottish rate of income tax is different from the rest of the UK.[8]

56. DWP has adjusted its systems and guidance to accommodate the introduction of the SRIT. It estimates this will cost £1.7 million.[9] DWP charged the Scottish Government £870,000 for this work in 2015/16, and expects further costs in 2016/17.

Exhibit 5

Estimated set-up costs for the Scottish rate of income tax

Overall estimated set-up costs continue to be revised downwards, although IT cost estimates have increased.



Note: Total estimated set-up costs are for the seven years from 2012/13 to 2018/19.
Source: *Third annual report on the implementation and operation of part 3 (financial provisions) of the Scotland Act 2012,* UK Government, March 2015; *The administration of the Scottish rate of income tax 2015/16,* National Audit Office, December 2016

HMRC and the Scottish Government are preparing for further devolution of income tax powers

57. HMRC has set up a new project to implement the Scotland Act 2016 income tax powers. It reports into existing project and programme structures, which the Scottish Government is part of.

58. In December 2016, the Scottish Government and HMRC revised the MOU previously agreed for the SRIT to ensure that it reflects the further devolution of income tax powers. They are also working to agree how Scottish income tax will be administered by April 2017, including:

- identifying and maintaining the taxpayer base
- compliance procedures for Scottish income tax
- information to allow the Scottish Government to hold HMRC to account for its performance in administering Scottish income tax
- data for monitoring and forecasting tax receipts.

The methodology for assigning a share of VAT to the Scottish budget is still to be agreed

59. A share of VAT collected in Scotland will be assigned to the Scottish budget from 2019/20. Scottish and UK ministers are still to agree how this will be calculated. HMRC will continue to collect VAT in Scotland. Given the complexity of the work to agree the methodology for assigning VAT to the Scottish budget, it will be important that the Scottish Government and HMRC maintain effective working relationships.

60. HMRC has established a project looking at possible methodologies. It reports through the same structure as its SRIT programme, which the Scottish Government participates in, and will provide recommendations to the JEC. The cost of this project will be shared equally by the two governments. Effective monitoring and scrutiny of project plans and milestones will be needed to ensure implementation in 2019/20.

Social security

The Scotland Act 2016 devolves a number of areas of social security to Scotland. These cover 11 benefits totalling £2.8 billion of spending in Scotland. This equates to 15 per cent of all social security spending in Scotland. The Scottish Government is committed to delivering the 11 social security benefits by the end of the current parliamentary session, in 2021.

The Scottish Government's social security system programme is in its early stages

61. The Scotland Act 2016 devolves responsibility of specific areas of social security spending to Scotland. These include benefits for people with a disability or health condition, carers, parts of the regulated social fund and discretionary housing payments (Exhibit 6, page 26). DWP and HMRC will continue to deliver reserved benefits and tax credits.

62. The Scottish Government's social security system programme is in its early stages. It has been taking the time to create the environment needed to successfully deliver the social security system. To ensure it gets this right the programme is developing its understanding of the process of managing social security, what will be needed to manage the system well, and modelling costs. For example, the programme is exploring what different users' needs are to help identify:

- what processes and IT systems might be required
- the interdependencies between different benefits and existing systems
- the skills needed to deliver and test any new systems.

63. The Scottish Government is also taking steps to learn lessons from the experience of others. For example, Revenue Scotland has shared its experience of setting up a new body and IT system and the programme team is learning from DWP's experience of using its systems. This knowledge base is helping the programme team to understand the practical challenges and opportunities of managing a social security system.

Exhibit 6
Social security powers being devolved through the Scotland Act 2016

September 2016

Powers to:

- create new benefits in devolved areas
- change employment support
- make discretionary payments and assistance
- make changes to Universal Credit for the costs of rented accommodation, recipients and timing of payments
- top up reserved benefits.

Claimants and spending: 1 April 2017

- **Discretionary Housing Payment** – additional support for housing benefit recipients having difficulty paying rent.
- Transitional year for devolving employability services. Fully devolved from April 2018.

116,000
£49m

Claimants and spending: Timing to be agreed

- **Disability Living Allowance (DLA)** – provided to people with a disability or health condition. See **PIP**.

303,000
£1.4bn

- **Attendance Allowance** – to help people over 65 years with a physical or mental disability to pay for personal care.

128,000
£487m

- **Personal Independence Payment (PIP)** – introduced to replace DLA for people aged 16-64 years.

78,000
£318m

- **Carer's Allowance** – for people over 16 years who spend at least 35 hours a week looking after someone with substantial care needs.

68,000
£222m

- **Winter Fuel Payment** – for people born on or before 5 July 1952 to help pay for heating bills.

1,061,000
£181m

- **Industrial Injuries Disablement Benefit** – for people who are ill or disabled as a result of an accident or disease at work or while on employment training scheme or course.

26,000
£87m

- **Severe Disablement Allowance** – for working age people unable to work owing to illness or disability. Closed to new entrants.

8,000
£51m

- **Cold Winter Payment** – paid to certain benefit recipients to help with heating costs when it is on average 0°C or below for seven days.

136,000
£3m

£2.8 billion
in social security spending to be devolved to Scottish Parliament

£3m

£4m

Spending: Timing to be agreed

- **£4m: Funeral Payment** – paid to certain benefit recipients to help with the cost of arranging a funeral.
- **£3m: Sure Start Maternity Grant** – one-off payment to help towards the cost of a first child for certain benefit recipients.

Note:
1. The figures represent 2015/16 spending. The number of recipients for DLA, PIP, Attendance Allowance, Carer's Allowance, and Severe Disablement Allowance is at February 2016. The number of recipients for Industrial Injuries Disablement Benefit is at March 2016. Winter Fuel Payment, Cold Winter Payment and Discretionary Housing Payment are total payments, 2015/16. The number of grants for Scotland for funeral payments and the Sure Start Maternity Grant is not available for 2015/16.

Source: Audit Scotland using figures from DWP and Scottish Government

64. The scope of the work to devolve the social security powers is exceptionally wide-ranging and complex. In March 2016, the Scottish Government set out its vision and principles for social security alongside the first stage of an options appraisal.[10, 11] This identified setting up an agency to deliver social security as the preferred option. Between July 2016 and October 2016 it carried out a consultation to gather the public's opinions on the devolved benefits and how they should be delivered. It published the findings of the consultation in February 2017. This, and its planned work with panels of current claimants, will contribute to the Scottish Government developing its policies and programme.

65. The Scottish and UK governments have agreed to split the transfer of the legislative and operational responsibilities for social security. This means the Scottish Parliament will be able to legislate on devolved social security areas but take responsibility for administering them in a phased way. The transfer of the legislative responsibilities is expected by summer 2017, when the Scottish Government intends to have introduced its Social Security Bill. Transfer of the operational responsibilities is anticipated by April 2020. The Scottish Government is exploring with DWP how to enable the Scottish Parliament to implement some social security changes, such as increasing Carer's Allowance, sooner. It is also consulting on regulations giving people the options to alter the frequency of their Universal Credit payments and to pay the housing element directly to their landlord. Implementing these changes may involve using DWP systems in the interim, which could incur costs. The fiscal framework states that the Scottish Government will meet any additional costs directly associated with the use of its powers to vary elements of Universal Credit. The Scottish Government and DWP will need to agree how this applies in practice.

66. We have previously made recommendations on managing ICT programmes in central government.[12] These recommendations are relevant to the social security system programme. Any new IT systems will need to work with existing systems to ensure they meet user needs and pay benefits accurately and fairly. The programme recognises the importance of IT to successfully delivering the new social security powers. It has appointed a Chief Digital Officer and located specialists from the Scottish Government's digital team within the social security directorate to ensure closer working with operation and policy colleagues.

67. The Social Security Programme Board oversees the work of the programme (Exhibit 3, page 13). Its membership includes representatives from other Scottish Government directorates including digital, finance and procurement, and DWP also observe board meetings.

68. The programme will be delivered through a number of projects that report to the board. They are being established as decisions are made about how the social security powers will be implemented. Each project should be underpinned by detailed plans setting out the key tasks, milestones and interdependencies. Coordinating the project plans into an overarching programme plan will support the board's oversight and scrutiny of progress towards delivering the social security system by the end of the current parliamentary session, 2021.

69. Devolution of social security powers comes at a time when DWP is implementing a number of reserved policies such as Universal Credit. The Scottish Government is working with DWP to ensure its programme of work is achievable alongside DWP's work programme. Building and maintaining good working relationships will be essential to ensuring the plans are successfully delivered.

70. The programme team is undertaking the next stage in the options appraisal process which will inform the Scottish Government's approach to delivering the social security system. At the same time it is carrying out additional work to model more detailed costs and develop plans and timescales. The Scottish Government should share its approach to delivering the social security system with the Scottish Parliament in due course. Doing so will help provide the public with more information about the changes and support scrutiny of the Scottish Government's proposals.

71. 2017 will be a critical year for the programme as it moves into the delivery phase with the introduction of legislation and the use of its new social security powers for Universal Credit flexibilities. This step-change will significantly increase the amount of work undertaken by the programme team. We will continue to report on the Scottish Government's progress in delivering the social security powers as the programme develops.

Employability transitional service plans are well advanced

72. Devolution of employability services under the Scotland Act 2016 begins from April 2017. The Scottish Government has announced its plans to replace DWP's Work Choice and Work Programme services with two new employability services, Work First and Work Able. These aim to help up to 4,800 people with a disability or long-term health condition into employment. The arrangements are transitional for 12 months, before the services are fully devolved in 2018. Skills Development Scotland has procured Work Able and will manage the contract. The Scottish Government has completed procurement of Work First and agreed to use DWP IT systems for the service. The Scottish Government is already planning for the fully devolved service and will begin its procurement in 2017. Effectively managing the contracts and monitoring their performance will help ensure service providers achieve positive outcomes for their clients.

Part 3

Public financial management and reporting

Key messages

1. The new financial powers require a more strategic approach to Scottish public financial management and reporting. This includes an overarching, medium-term financial strategy underpinned by clear policies and principles for managing the financial powers. The Scottish Government is developing its approach to financial management within the fiscal framework. This has included longer-term analysis and assessment to support decision making. It now needs to finalise policies and principles for borrowing and reserves, and further develop its longer-term financial scenario planning. Making these publicly available will enhance financial transparency.

2. The Scottish budget is becoming increasingly complex, with substantial changes to key components including the block grant from the UK Government. The budget will be more reliant on forecasting than ever before and more adjustments are likely to be needed throughout the budget cycle. The Budget Process Review Group is reviewing current arrangements and is assessing what is needed to support Parliamentary scrutiny in the future.

3. Clear reporting on all parts of the budget cycle is important; from the budget itself to reporting on outturn and performance. The Scottish Government is taking steps to enhance financial reporting to provide a more comprehensive picture of Scotland's public finances but more work is required. This will enable the Parliament and wider public to understand and scrutinise the Scottish Government's decisions.

the Scottish Government is developing its approach to financial management and reporting

The new financial powers require a step-change in public financial management and reporting

73. Public financial management involves maintaining a sustainable fiscal position, and effectively raising revenues and allocating resources to ensure the efficient delivery of public goods and services.[13] It covers all parts of the budget cycle from planning and preparation to reporting on outturn, performance and the achievement of outcomes. The Scottish Government has a central role in managing Scotland's public finances and operates as a devolved administration within a wider UK context. In doing so, it has to manage its finances within the agreed fiscal framework (paragraph 4).

74. The Scottish Government and the Scottish public sector more generally have a good record of financial management and reporting.[14] The new tax raising and spending powers represent a significant shift in emphasis for the Scottish Government. As a result public financial management and reporting is fundamentally changing. From a position which mainly involved managing expenditure within budgets, the Scottish Government now manages increasingly complex budgets alongside more volatile revenues from taxes.

75. The new financial powers provide opportunities for different approaches to managing public finances. This includes more choices on raising revenues and spending, and the balance between these elements. The performance of the Scottish economy relative to the rest of the UK will have a direct bearing on Scotland's public finances. This exposes Scotland's public finances to increased risk of volatility and uncertainty compared to the position before the new powers came into effect. In particular, tax revenues and social security spending may be more or less than forecast and this will have to be managed within the budget cycle and the fiscal framework.

76. Effective management of public finances will increasingly rely on robust economic and financial forecasting and modelling. Forecasts need to be based on unbiased and reliable data, using sound methodologies and the SFC will have a key role in this (paragraphs 37 to 40). Forecasts are by their nature uncertain. There will always be forecasting errors – in time, forecasts will prove to be pessimistic or optimistic – and errors will differ in scale and size. What is important is that the Scottish Government identifies and manages the variations through its budget proposals and by applying its new borrowing and reserve powers over the medium- to long-term as it considers necessary.

77. The change from a spending budget to a tax-raising and spending budget is significant and requires a close understanding of the underlying factors that affect each element and how they interact. It also requires enhanced reporting. The International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) highlight the importance of medium- and longer-term plans and frameworks to provide an overview of long-term policy objectives, projected revenues and spending, economic forecasts and assumptions, and how all these are aligned. They also highlight the importance of comprehensive, reliable and timely reporting on past, present and the longer-term state of public finances for effective financial management and accountability.[15, 16]

78. The Scottish Parliament requires good-quality information to enable effective scrutiny of the Scottish Government's budget proposals. More generally, the Scottish Parliament and taxpayers need good financial information, to understand and assess the health of Scotland's public finances and the Scottish Government's progress in achieving its priorities and desired outcomes.

79. Engaging with public bodies and taxpayers can help with making informed decisions about public finances and prioritisation of resources. An important part of this process will be outlining multi-year financial plans which will also help public bodies take a longer term view and consider financial sustainability.

80. This part of the report considers the impact of the new financial powers on public financial management and reporting and assesses the Scottish Government's progress in these key areas.

The Scottish Government is further developing its approach to financial management

A longer-term approach supports decision-making and financial sustainability

81. As noted in (paragraph 77) global standards for public financial management highlight the importance of longer-term approaches. In the UK, the Chartered Institute of Public Finance and Accountancy (CIPFA) has highlighted the importance of long-term or strategic planning to aid decision-making, and in providing a framework upon which budgets should be produced.[17] A longer-term approach to finances provides a context for current decisions and, along with a clear set of financial strategies and principles, creates an overall framework for financial decision-making and sustainability.

82. The Scottish Government acknowledges the benefits of taking a longer-term view and has been developing its processes to reflect the fiscal framework. It undertakes longer-term analysis and assessments to support financial decision-making. This has included, for example, modelling scenarios to assess the potential impact on tax raising and spending projections. It has not yet finalised an overarching approach for managing Scotland's public finances which reflects its new financial powers.

83. (Exhibit 7, page 32) sets out the main components of strategic financial management. A key element is a medium-term financial strategy setting out the expectations and broad financial plans for the next five years. This should be underpinned by clear policies and principles for using, managing and controlling the available financial powers. Scenario planning based on economic forecasts and financial information will be increasingly important in assessing the range of potential impacts on the Scottish budget and will in turn aid financial planning, management and decision-making.

84. The new financial powers add more dimensions to scenario planning and modelling involving a wider range of variables and assumptions. Publishing medium and longer-term models, projections and plans as they are more fully developed will provide the Parliament, public sector bodies and the wider public with the information they need to have a fuller understanding of the overall financial position.

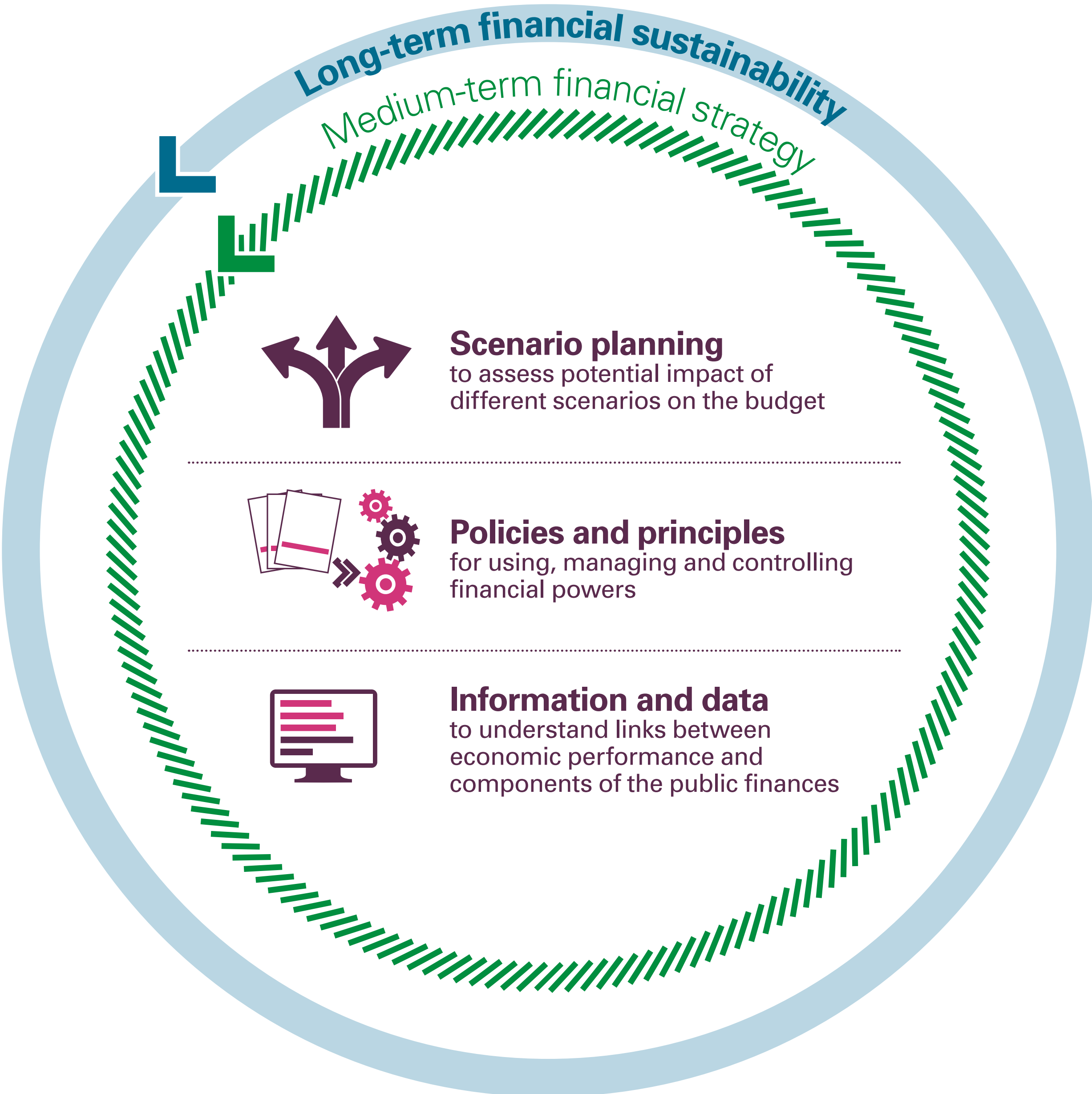
85. The Scottish Government will need to assess and keep under review the long-term sustainability of Scotland's public finances, drawing on the key aspects set out in (Exhibit 7). This includes considering the longer-term implications of policy decisions and how these sit alongside existing commitments and anticipated changes in the economy, revenues and spending.

Fiscal policies and principles support public financial management and longer-term sustainability

86. The fiscal framework sets out agreed rules and limits within which the Scottish Government will manage its finances and the related economic and funding risks. They include rules for block grant adjustments, annual and overall limits for borrowing and the Scotland Reserve. The Scottish Government and HM Treasury are finalising details of how borrowing and the Scotland Reserve will be applied in practice.

87. More detailed, well-reasoned fiscal principles support day-to-day financial management and decision-making as well as the response to specific events. For example, in addition to those prescribed in the fiscal framework, the Scottish Government could set out high-level targets or limits for key measures. This might include limits for the level, type and timing of borrowing. It could also

Exhibit 7
Key components of strategic financial management



Source: Audit Scotland

include principles for the operation of the Scotland Reserve and how it will be maintained to support planned spending over time and in the event of forecasting errors, or unexpected economic or fiscal events.

88. The Scottish Government has applied such an approach for its infrastructure and investment programme since 2011. To provide assurance that its capital financing commitments on future revenue budgets are affordable and sustainable it set a limit to ensure that its payments for Private Finance Initiatives (PFI), non-profit distributing (NPD) schemes and borrowing do not exceed five per cent of

Borrowing and reserves

The Scotland Act 2016 and accompanying fiscal framework increased the Scottish Government's capital and revenue borrowing powers to help it manage the increased risk and volatility its budget is now exposed to. The Scottish Government to date has not borrowed any money. But it has estimated it will need £30 million in 2017/18 to start repaying what it plans to borrow in 2016/17 (see table).

The Scotland Act 2016 also changed the rules in relation to reserves. The Scotland Reserve replaces both the Scotland Act 2012 cash reserve and the Budget Exchange Mechanism from 2017/18.

	Annual limit[1] (£ million)	Overall limit [1] (£ million)	Planned 2016/17 (£ million)	Annual limit 2016/17 (£ million)	Planned 2017/18 (£ million)	Annual limit 2017/18 (£ million)
Capital borrowing	15% of overall borrowing limit	3,000	333	333	450	450
Revenue borrowing	600	1,750	TBD[2]	200	TBD	600
Scotland Reserve	350	700	TBD	125	TBD	350

Notes: 1. The Scotland Act 2016 increases the annual limits. For capital borrowing it increases from 10% of its capital budget in the Scotland Act 2012 to 15% of its borrowing limit in the Scotland Act 2016 from 2017/18. 2. TBD = to be determined. All decisions on borrowing and use of reserves will be taken over the course of the year as circumstance change and develop.

its resource budget. This principle was re-examined for the 2017/18 draft budget reflecting on the additional borrowing powers. The Scottish Government will keep this approach under review.

The Scottish Government has not finalised policies and principles for managing its borrowing and reserve powers

89. Borrowing can be used for capital purposes (to create assets such as schools, hospitals, roads and bridges) and for revenue purposes (to deal with unexpected shortfalls in revenues from taxation). Creating assets can help boost the economy by providing jobs which in turn can increase the money raised from taxation. All borrowing decisions have consequences for future budgets as repayments have to be made. This reduces the amount of money available for priorities in future budgets.

90. The fiscal framework sets an annual limit for capital borrowing of 15 per cent of the overall limit of £3 billion. The framework also allows the Scottish Government to borrow up to £600 million each year for revenue purposes within an overall limit of £1.75 billion for:

- in-year cash management
- forecasting errors in relation to taxes and demand-led social security spending that affect the block grant adjustment

- a Scotland-specific 'economic shock'.[18]

91. In December 2015, we recommended that the Scottish Government progress its strategy for capital borrowing, setting out details of decision-making processes and procedures for borrowing.[19] Since then CIPFA and the Fraser of Allander Institute have also called for a clear borrowing strategy setting out how the Scottish Government will use its powers and what it will use them for.[20]

92. The Scottish Government is refining its longer-term analysis (paragraph 82) and is developing high-level principles for capital and revenue borrowing covering key aspects such as affordability, sustainability and transparency. It is considering whether the principles should include other caps or limits. The Scottish Government needs to finalise these as a matter of urgency to support the management of its finances within the fiscal framework and to inform the preparation of the 2018/19 draft budget. These will need to be kept under review as circumstances arise.

93. Making the principles and related information publicly available represents an important contribution to financial transparency. This will facilitate the Parliament's and taxpayers' understanding of public financial management and the parameters by which the Scottish Government operates for example, setting out:

- under what conditions the Scottish Government will use capital and revenue borrowing
- how the Scottish Government will demonstrate decisions are affordable and sustainable
- what processes the Scottish Government will put in place to assess and respond to forecasting errors or a Scotland-specific 'economic shock'
- how the Scottish Government will report borrowing and use of its reserve against the limits set in the fiscal framework
- any additional limits or targets, other than those in the fiscal framework, the Scottish Government puts in place to ensure there is scope to deal with unexpected economic events.

94. Reserves involve setting aside money for future financial periods, in anticipation of future spending or to smooth the effects of peaks and troughs in tax revenues or unanticipated spending. The Scottish Government has initially decided that it will manage the Scotland Reserve within the rules of the fiscal framework, throughout the budget cycle as events arise and to support Scottish Government priorities. As indicated in paragraph 86, the details of how the Scotland Reserve will be applied and operate in practice have yet to be finalised. It will be important to establish clear policies, principles or parameters for the management of reserves within the fiscal framework limits to underpin future financial decision making.

The Scottish budget is more complex than ever before

95. The Scottish budget is becoming increasingly complex, with more components such as revenues from taxes and new expenditure such as social security payments. While the block grant from the UK Government remains a key component, the Scottish Government will have more options available to it – including its approach to taxation, borrowing and use of reserves – in bringing forward budget proposals, and as it implements and manages the budget.

96. The complexity and the interrelationships between elements of the budget is illustrated by considering the block grant and Scottish tax receipts. The block grant is the funding that the Scottish Government receives from the UK Government every year.

97. The fiscal framework states that the Barnett formula will continue to be used to calculate the overall block grant.[21] It is based on the previous year's grant plus or minus any changes, or 'consequentials' calculated using this formula. As each of the new financial powers is implemented a further adjustment needs to be made to the block grant, known as a block grant adjustment (BGA). Exhibit 8 summarises, in general terms, how funding for the Scottish Government's budget is now calculated.

Exhibit 8
How the funding for the Scottish budget is determined

Source: Audit Scotland

98. BGAs represent tax revenues foregone, or spending power no longer available to the UK Government. The fiscal framework sets out how the initial baseline adjustment will be made in each case for the year the tax or benefit is devolved. For taxes, it will be based on forecast Scottish tax revenue in the year prior to devolution. For all social security spending, except for cold weather payments, it will be based on forecast equivalent spending in Scotland.

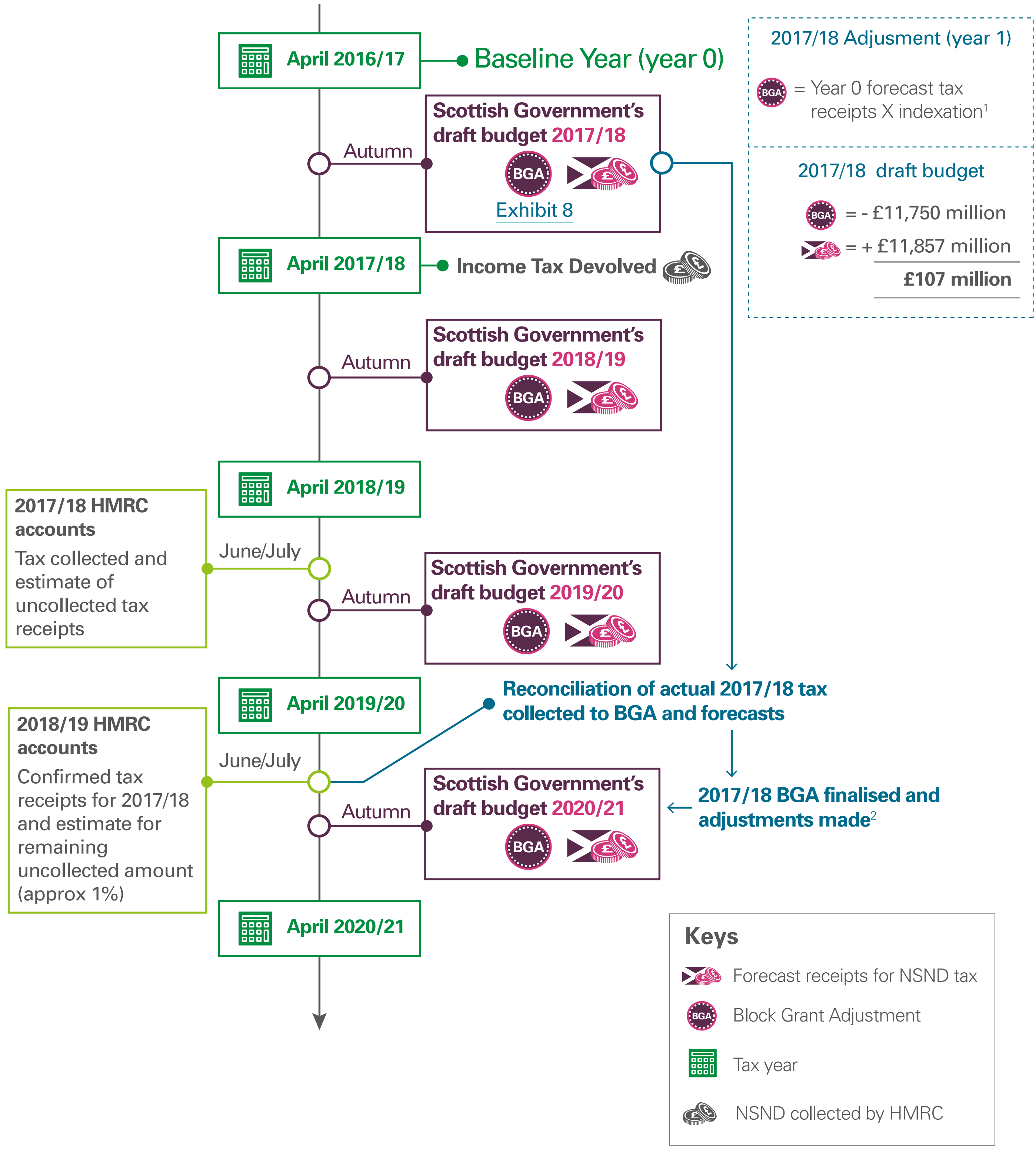
99. As the initial BGAs will be based on forecasts an adjustment may be needed if the actual revenues collected or spending is less than forecast. In some cases actual revenues will not be known until nearly two years after the initial BGA was made. As an example, (Exhibit 9, page 36) summarises how the process will work for non-savings non-dividend (NSND) income tax.

100. All this adds to the complexity of the budget process with a number of adjustments and reconciliations going on in any one year as actual receipts and spending are reconciled to the BGAs. For example, if actual revenues are less than forecast, the BGA in the following year will be adjusted accordingly. The Scottish Government would then have to decide whether to use revenue borrowing, or the Scotland Reserve to cover any shortfall or to adjust spending plans.

The Scottish Parliament's budget process is under review

101. In view of the far-reaching changes to public finances flowing from the new financial powers, it was widely recognised that the budget process would need

Exhibit 9
Block grant adjustment process for non-savings non-dividend income tax for 2017/18



Notes:
1. The fiscal framework sets out the indexation methodology until 2020/21.
2. If the Scottish Government's draft budget is introduced less than two months after the reconciliation, this adjustment can be deferred until the following year.

Source: Audit Scotland

reviewed. In September 2016, the Scottish Parliament's Finance and Constitution Committee announced a fundamental review of the budget process, taking into account the devolution of further powers. It set up the Budget Process Review Group (BPRG) consisting of Scottish Parliament and Scottish Government officials and external experts, including the Auditor General for Scotland.

102. The BPRG is considering the budget timeline as well as what type of reports and information would be most effective for scrutiny. The BPRG is also considering the impact on the Scottish budget process of changes to the timing of UK Government budget statements. The group is expected to report its proposals to ministers and the Finance and Constitution Committee later this year.

The Scottish Government is providing more financial information and is committed to enhanced financial transparency

103. The Scottish Parliament approves the Scottish Government's proposed spending plans and tax rates before the start of each financial year. Effective parliamentary scrutiny is critical to ensure that budget proposals are thoroughly tested and independently reviewed. This improves decision-making and contributes to public trust in government.

104. The Scottish Parliament's role in scrutinising the Scottish Government's policies, budgets and performance has never been more important. To fulfil its role, the Parliament requires reliable and timely information about the Scottish Government’s objectives, plans and progress. This includes comprehensive information about how it intends to use the money available to it, how it was spent and what was achieved as a result.

105. The Scottish Government's draft budgets have included a separate chapter on devolved taxes since 2015/16. The draft budget for 2016/17 also included information on the SRIT. The actual devolved tax receipts for 2015/16 were reported in the Devolved Taxes Account published by Revenue Scotland for the first time in September 2016. Scottish income tax receipts will be disclosed in HMRC's accounts from 2016/17 onwards.

Clear and comprehensive reporting on all parts of the fiscal framework is needed

106. It will be critical for the Scottish Government to provide clear information on how all parts of the fiscal framework operate in practice including the basis of its decisions on key aspects of public financial management and a clear overall picture of Scotland's public finances. This will help to determine how sustainable Scotland's public finances are. This includes reporting clearly on:

- how anticipated spending is funded from anticipated revenues
- movements in the Scottish block grant arising from the application of the Barnett formula, baseline adjustments and indexation for each element of the block grant
- revenue and spending forecasts, and reconciling these to actual amounts when they are known
- actual spending against budget and the reasons for variations

- the impact of any capital and revenue borrowing, and movements and balances in the Scotland Reserve
- what has been achieved from public spending
- other commitments, guarantees or potential liabilities that may impact on future budgets.

107. The Scottish Government reports this information in a variety of documents including budget documents, audited annual accounts, and economic and performance reports. It is important this information is presented in such a way that is easy to understand and navigate. This provides a basis for ongoing engagement with taxpayers and helps the Parliament to build a comprehensive picture of Scotland's public finances. This allows the potential consequences of policy choices and decisions on long-term financial sustainability to be better understood.

The Scottish Government provided additional information to support the 2017/18 draft budget

108. The Scottish Government set out its commitment to enhancing transparency and to clearly explain how public finances work in its Open Government Partnership National Action Plan in December 2016.[22] It published additional financial, economic and performance information alongside the publication of its 2017/18 draft budget. This included:

- a short guide to Scotland's public finances explaining how the budget is funded, what money is spent on, the fiscal framework and the timeline for new tax and spending powers [23]
- a report explaining the methodologies and assumptions relating to the devolved tax forecasts underpinning the draft budget. This included details of actual tax revenues to date and a medium-term assessment of devolved tax revenues and forecasts over a five-year period to 2021/22 [24]
- an update setting out how the Scottish Government is performing against national outcomes and performance indicators.[25]

109. In addition, the taxation chapter within the draft budget document was expanded to include an explanation of the new tax powers and fiscal framework. Information on tax forecasts, block grant adjustments and borrowing were also included.

110. Overall, the 2017/18 draft budget contains most of the information listed at paragraph 106, although there is scope to enhance the amount of detail and to make the explanations easier to understand. As the budget becomes increasingly complex it will be important for the Scottish Government to further develop this document. For example, it needs to clearly explain and link the different sections of the budget so it is more transparent and understandable. For example:

- While the total Departmental Expenditure Limit (DEL) funding and total DEL spending plans are clearly set out, there are some adjustments that are not fully explained and any carry forwards from the previous year are not separately identified.[26] This makes it difficult to understand how the total funding covers spending plans.
- An annex to the budget states that the full amount of capital borrowing will be used for investment in infrastructure and how capital repayments have

been modelled. It does not show the effect of the proposed borrowing against the overall limit of £3 billion in the fiscal framework.

- There is no commentary on the use of reserves other than an explanation of the rules as set out in the fiscal framework.

111. While the draft budget provided tax revenue forecasts for the next five years and total funding for the next three years, there is not yet a medium-term financial strategy (Exhibit 7, page 32) which would provide a longer-term context for the annual budget. No commentary or explanations are provided beyond 2017/18.

The Scottish Government is committed to further developing financial reporting

112. Continuing work is needed to build a comprehensive picture of Scotland's public finances. As the Auditor General for Scotland has previously reported, this includes a more rounded account of the Scottish Government's overall performance.[27] It needs to be clearer what spending is aiming to achieve and how this contributes to the Scottish Government's overall purpose and specific outputs and outcomes.

113. The Scottish Government is further developing its financial reporting in the context of the new powers, addressing commitments it has made previously. A short guide to public finances (paragraph 108) and annual Scottish Administration outturn information, which were both published in December 2016.[28] The short guide to Scotland's finances covered 2016/17 spending plans and key facts about the Scottish Administration at a budget level, with helpful infographics. The outturn statement provided high-level information on actual spend across the Scottish Administration in 2015/16. Further work to consolidate balance sheet information, a snapshot of what is owed and owned, which is important for understanding the overall financial position, is underway.

114. The Scottish Government also intends to publish a 'tailored for Scotland' 2016/17 consolidated account to show a more aggregated picture of the Scottish public finances.[29] The scope, format and content of the accounts is currently under consideration with a commitment to agree this by April 2017. The Scottish Government should demonstrate publicly the progress it is making toward introducing these accounts, even where all the required information is not immediately available. This may include, for example, trial runs involving groups of public sector bodies and individual key elements of public finances that will in time be reflected in consolidated public accounts.

115. As part of its ongoing work to further enhance financial reporting, the Scottish Government continues to review its annual accounts to identify opportunities for improvements. In its 2015/16 accounts it explained how the Scottish budget as a whole is funded and it made links with other relevant accounts. There is scope for more detailed and consistent explanations for differences between budgets and outturns. This would assist understanding of key developments such as the impact of in-year changes and other factors that affect the budget, and the Scottish Government's response. It would also facilitate understanding and scrutiny in key areas of spending, including in education and health.

116. In summary, the Scottish Government continues to develop its financial reporting making a number of welcome improvements and by providing evidence of its commitment to enhanced financial transparency. Delivering on this is critical to develop understanding, build confidence and support effective scrutiny at this time of unprecedented change to Scotland’s public finances.

Endnotes

1 *Government Expenditure and Revenue Scotland 2015/16*, Scottish Government, August 2016.

2 *The Agreement between the Scottish government and the United Kingdom government on the Scottish government's fiscal framework*, February 2016; and *Operation and Governance of the Scottish Government's Fiscal Framework*, March 2016.

3 *Implementing the Scotland Act 2012: An update*, Audit Scotland, December 2015.

4 *Recommendation of the Council on Principles for Independent Fiscal Institutions*, OECD, February 2014.

5 *The administration of the Scottish Rate of Income Tax 2015/16*, National Audit Office, December 2016.

6 Ibid.

7 *Scottish Government Fourth Annual Report on the Implementation and Operation of Part 3 (Financial Provisions) of the Scotland Act 2012*, Scottish Government, March 2016.

8 Committee evidence from HMRC on the Draft Budget, Finance and Constitution Committee, 14 December 2016.

9 *Scottish Government Fourth Annual Report on the Implementation and Operation of Part 3 (Financial Provisions) of the Scotland Act 2012*, Scottish Government, March 2016.

10 *A New Future for Social Security in Scotland*, Scottish Government, March 2016.

11 *Scottish Social Security, Options Appraisal Part 1: The strategic case for change and the governance of social security in Scotland*, Scottish Government, March 2016.

12 *Managing ICT contracts in central government: An update*, Audit Scotland, June 2015.

13 *Public Financial Management and its Emerging Architecture*, International Monetary Fund, April 2013.

14 *Update on developing financial reporting*, Audit Scotland, March 2015.

15 *Fiscal Transparency Code*, International Monetary Fund, 2014.

16 *Best Practices for Budget Transparency*, OECD, 2002.

17 *Looking forward: Medium-term financial strategies in the UK public sector*, CIPFA, October 2016.

18 The fiscal framework defines a Scotland specific 'economic shock' as being *'triggered when onshore Scottish GDP growth in real terms is forecast to be below one per cent on a rolling four quarter basis and at least one percentage point below actual or forecast UK GDP growth in real terms over the same period.'*

19 *Implementing the Scotland Act 2012: An update*, Audit Scotland, December 2015.

20 *Scotland's Budget 2016*, Fraser of Allander Institute, September 2016.

21 The Barnett formula is a mechanism used by HM Treasury to automatically adjust the amounts of public expenditure allocated to the devolved administrations of Northern Ireland, Scotland and Wales to reflect changes in spending levels allocated to public services in the UK.

22 *Open Government Partnership Scottish Action Plan*, Scottish Government, December 2016.

23 *Scotland's Finances: Key Facts and Figures*, Scottish Government, December 2016.

24 *Scottish Budget - Draft Budget 2017-18 Devolved Taxes Methodology Report,* Scottish Government, December 2016.

25 *Scotland Performs Update*, Scottish Government, December 2016.

26 Departmental Expenditure Limit is the element of the Scottish budget that covers programme expenditure and running costs.

27 *The 2015/16 audit of the Scottish Government Consolidated Accounts*, Audit Scotland, September 2016.

28 The Scottish Administration is the Scottish Government, its executive agencies, Crown Office and Procurator Fiscal Service, NHS territorial and special boards, and Statutory Office Holders.

29 Scottish Government written response to the Scottish Parliament Public Audit and Post Legislative Committee, 2 November 2016. The commitment to 'tailored-for Scotland' accounts was on the proviso that 'non-departmental bodies and local authorities commit to data-sharing for this purpose and that their accounts are fully compliant with International Financial Reporting Standards.

Appendix

Audit methodology

We reviewed a range of information during our audit, including the following:

- Papers and official reports of the Scottish Parliament Finance and Constitution Committee and Social Security Committee
- The Scottish and UK Governments' fourth annual reports on progress in implementing the Scotland Act 2012
- The Fiscal Framework and accompanying technical annex
- OECD Principles for Independent Fiscal Institutions
- Scottish Government Draft Budget 2017/18
- Papers and minutes from the Scottish Government Audit and Assurance Committee
- Papers and minutes from the Fiscal Framework Implementation Programme Board and programme management documentation
- Programme management documents of the Scottish Government's Social Security Programme and the Scottish Fiscal Commission Transition Programme
- Minutes of the Joint Ministerial Working Group on Welfare
- Papers and minutes from the Revenue Scotland Board and Audit and Risk Committee
- Revenue Scotland Annual Audit Report and devolved taxes and resource accounts 2015/16.

We spoke to representatives from:

- Scottish Government
- Revenue Scotland
- Scottish Fiscal Commission.

We considered the National Audit Office's planning and approach to its audit work on the Scottish rate of income tax.

We reviewed the NAO's documentation and the basis for its findings and conclusions. In particular, we considered:

- the NAO's approach to identifying the key risks to successfully implementing of the SRIT
- the NAO's audit working files, with particular focus on the audit evidence underpinning the key findings and conclusions in its report
- the NAO's arrangements for ensuring the quality of the audit work and reporting.

Managing new financial powers

An update

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