

# Scotland's new financial powers

Key issues for the Scottish public finances



 AUDIT SCOTLAND

Prepared for the Auditor General for Scotland  
September 2016



# Auditor General for Scotland

The Auditor General's role is to:

- appoint auditors to Scotland's central government and NHS bodies
- examine how public bodies spend public money
- help them to manage their finances to the highest standards
- check whether they achieve value for money.

The Auditor General is independent and reports to the Scottish Parliament on the performance of:

- directorates of the Scottish Government
- government agencies, eg the Scottish Prison Service, Historic Environment Scotland
- NHS bodies
- further education colleges
- Scottish Water
- NDPBs and others, eg Scottish Police Authority, Scottish Fire and Rescue Service.

You can find out more about the work of the Auditor General on our website:

[www.audit-scotland.gov.uk/about/ags](http://www.audit-scotland.gov.uk/about/ags) 

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively.

## Introduction

**1.** The Scottish Parliament's financial powers are changing substantially, with new responsibilities for taxes, social security and borrowing ([Exhibit 1, page 4](#)).

Over the next five years, spending is set to rise from about £38 billion to over £40 billion and the amount of money raised in Scotland will go up by about £17 billion to £22 billion. This means that the amount of devolved spending in Scotland met by money raised directly will increase from around ten per cent prior to the Scotland Act 2012, to over 50 per cent once the Scotland Act 2016 powers are implemented ([Exhibit 2, page 5](#)).

**2.** 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 relative strength of the Scottish economy will have a greater influence on public finances than ever before. The budget process will become increasingly complex, and subject to greater uncertainty and volatility than when the block grant from the UK Government was relatively fixed. As a result, forecasting will become more important.

**3.** The Smith Commission agreed that the Scottish Parliament should seek to expand and strengthen the independent scrutiny of Scotland's public finances in recognition of the additional variability and uncertainty that further tax and spending powers will introduce to the budgeting process. The Parliament also has a vital role in scrutinising the implementation of the new powers.

**4.** Audit Scotland provides independent assurance that public money is spent properly and is providing value for money. We are committed to supporting the Parliament as the new powers are implemented. Drawing on our audits to date and our input to the Scottish Parliament's work in Session 4, we have produced this short paper to highlight for Parliament some key issues for the Scottish public finances flowing from the new financial powers.

## Managing the new financial powers

**5.** The UK and Scottish governments have agreed a fiscal framework and it sets out how the new financial powers will work in practice.<sup>1</sup> This includes how the grant received from the UK Government is calculated, the amount of money the Scottish Government can borrow and how fiscal and economic forecasts will be produced in future.

**6.** The fiscal framework is underpinned by the wider system for Scottish public finances, for example, the budget process and financial reporting. It is essential that this system is further developed to reflect increased fiscal responsibility. There will be greater complexity, uncertainty and volatility affecting Scottish public finances. Effective arrangements will be needed across government and the Parliament to manage this, within the limits of the new fiscal framework. These are required to make sure the new financial powers operate effectively and that the financial health of the devolved Scottish public sector is maintained.

**7.** The Scottish Government will deliver the new financial powers in partnership with other parts of the Scottish and UK public sectors. For example, the Scottish Fiscal Commission will be responsible for preparing forecasts to help inform the budget process and scrutiny, and Her Majesty's Revenue and Customs (HMRC) will administer the Scottish income tax provisions.

---

1 The fiscal framework is an agreement between the UK and Scottish governments setting out the rules by which the new financial powers will be managed.

---

**Exhibit 1****Timeline for new financial powers**

			Estimate <sup>1</sup>	Notes
Scotland Act 2012	From 2015	 Land and Buildings Transactions Tax	£416 million	Actual 2015/16: £425 million
		 Scottish Landfill Tax	£147 million	Actual 2015/16: £147 million
		Borrowing and cash reserve powers (up to 10% of capital budget each year):  <ul style="list-style-type: none"> <li>Revenue borrowing</li> <li>Capital borrowing</li> <li>Cash reserve</li> </ul>	Overall limit – £500 million Overall limit – £2.2 billion Overall limit – £125 million	Borrowing can be from: - the National Loans Fund - Commercial banks - Issuing of bonds  £74m added to reserve from 2015/16 receipts
2016	 Scottish Rate of Income Tax (SRIT)	£4.3 billion		
Scotland Act 2016	2017	 Control over income tax rates and bands	£11.2 billion	
		Increased borrowing and reserve powers over:  <ul style="list-style-type: none"> <li>Revenue borrowing</li> <li>Capital borrowing</li> <li>Scotland Reserve</li> </ul>	Overall limit – £1.75 billion Overall limit – £3 billion Overall limit – £700 million	Extends 2012 Act powers Annual limit £600 million Annual limit 15% of overall limit Annual limit £350 million
		2018	 Air Passenger Duty	£275 million
Scotland Act 2016	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	
		 Aggregates Levy	£53 million	Devolution date to be confirmed
		Social security 	Responsibility for 11 social security powers ranging from Disability Living Allowance to winter fuel payments	£2.7 billion

Note: 1. Estimates for taxes are taken from *Government Expenditure & Revenue Scotland 2015-16*, Scottish Government, August 2016.

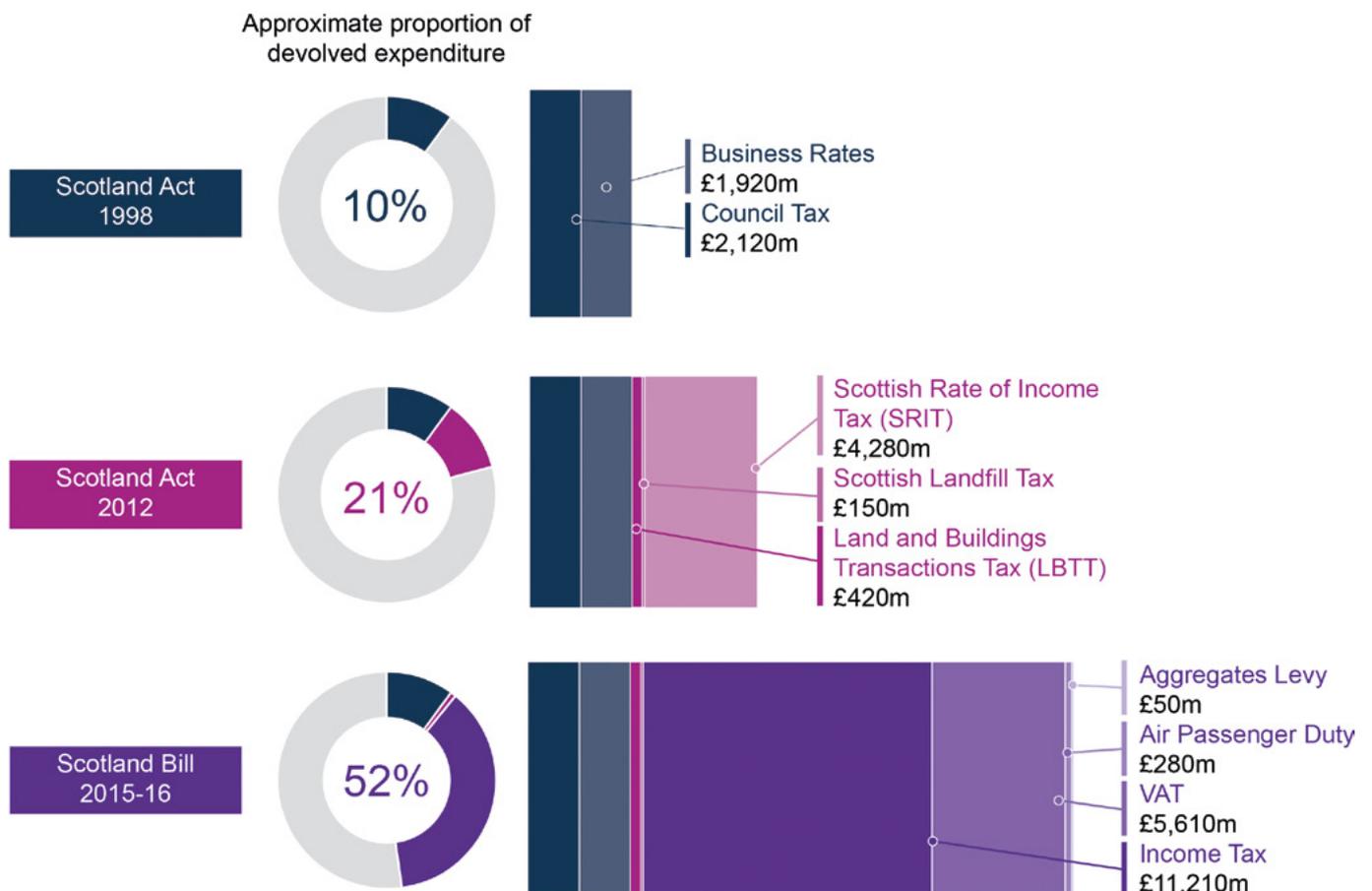
Source: Audit Scotland

We have produced a [Supplement](#) alongside this paper to provide a high-level view of the new landscape showing how funds flow through the system and which organisations are involved.

8. The EU referendum in June 2016 has added a further dimension to discussions about the changing face of Scotland's public finances. It is too early to say what the vote to leave the EU means for Scotland but it is likely to have significant implications for public finances, and it changes the context in which the new financial powers are being implemented.

## Exhibit 2

### Taxation as a share of spending



Note: Figures are rounded to nearest £10 million.

Source: Scottish Parliament Information Centre Financial Scrutiny Unit, August 2016

## Key issues

**9.** Effective Parliamentary scrutiny is critical to ensure that decisions being taken by government are thoroughly tested and independently reviewed. This improves decision-making and contributes to public trust in our democratic system of government. As the Scottish Government implements the new financial powers, the Parliament's role in scrutinising its policies, budgets and performance has never been more important. To fulfil this role, the Parliament must get comprehensive, reliable and timely information about the Scottish Government's objectives, plans and progress.

**10.** The following paragraphs contain some key areas and related questions which we think are likely to be important for the Scottish Parliament as it deals with business connected with the new financial powers.

### Budget process and scrutiny

**11.** The new powers do not change the requirement for the Scottish Government to balance the budget.<sup>2</sup> The Scottish block grant from the UK Government will continue to be determined by the Barnett formula, adjusted to reflect the new tax and social security powers. Alongside this the budget will increasingly depend on forecasted tax revenues.

**12.** Budgetary procedures will need to consider the revenue side of budget setting as well as spending. Good quality information on planned spending and how it will be funded, including the potential sensitivities of forecasts, will be crucial. Clearly linking spending proposals to Scottish Government outputs and desired outcomes will also be important.

**13.** The new powers signal the need for a step change in budget scrutiny to ensure proper oversight of the Scottish Government's spending plans and new tax powers. To that end, the Parliament is leading a tri-partite review of the budget process, involving the Finance Committee, the Scottish Government and external financial experts.

---

<sup>2</sup> A balanced budget is where planned spending and anticipated revenues are matched. Planned spending must not be greater than the combined 'funding' of the UK block grant, devolved and assigned taxes, net borrowing and use of financial reserves.

---

## Key questions



- How will the budget process support effective scrutiny of the Scottish Government's financial plans and how is it using the new financial powers?
  - What information will the Scottish Parliament need to scrutinise budget proposals?
  - How clearly are tax and spending proposals linked to the Scottish Government's stated purpose and its desired outputs and outcomes? How will it show what is being achieved?
  - What information will be available about the expected long-term effects of policy and budget decisions?
-

### Financial sustainability

**14.** The performance of the Scottish economy relative to the rest of the UK will have a direct impact on Scotland's public finances and the Scottish budget. One of the key challenges will be managing the greater volatility of revenues from taxation and demand-led spending, ensuring the public finances remain in good health. Long-term planning and forecasting will become more important in securing sustainable public finances. Forecasting will become more complex as more taxes and demand-led spending are introduced over the next five years.

**15.** If the Scottish economy performs well, then more revenue from taxation than anticipated will be collected. This will provide opportunities for increasing or accelerating spending, reducing taxation, adding to the Scotland reserve or reassessing decisions about borrowing.

**16.** If the Scottish economy performs less well, revenues from taxation will be lower than anticipated and demand-led spending, such as on social security, may increase. This means less money will be available to invest in public services. In response, the Scottish Government may decide to borrow, draw on reserves, cut controllable spending or to address the position using a combination of these actions.

---

## Key questions



- How will policy decisions affect the Scottish economy and financial sustainability in the short, medium and long term?
  - How will all the elements and sensitivities of tax and spending forecasts be clearly and comprehensively explained and reported?
  - How will variability in revenue from tax and demand-led spending be managed?
  - What information will be available on borrowing and the impact of borrowing on future budgets?
- 

### Financial management

**17.** The fiscal framework is critical to how the new powers work. It provides specific rules for a number of elements of the system, including the block grant adjustment mechanism, borrowing and the new Scotland reserve. It will continue to be important for the Scottish and the UK governments to work well together as the new devolved powers and the fiscal framework are implemented. This will include sharing relevant information and a clear shared understanding of how things will work in practice.

**18.** The financial powers include new options for the Scottish Government to help it manage public finances. Existing borrowing limits to bridge any unplanned gap between budgeted and actual tax revenues have been increased ([Exhibit 1, page 4](#)), with new powers to manage a Scotland specific economic shock. The Scottish Government can use reserves to smooth the impact of any variability in tax revenues. Borrowing and use of the cash reserve will have to be managed within the limits and other rules set out in the fiscal framework.

**19.** Clear strategies, for example setting out how and when borrowing will be used, will be important for managing and controlling the new powers. Robust financial management processes will be important to deal with the potential volatility of revenues and demand-led spending.

---

## Key questions



- How will the Parliament know if the funding mechanisms, including block grant adjustments are working effectively?
  - How well are the Scottish and UK governments working together to share information and put in place detailed arrangements for implementing the fiscal framework?
  - What borrowing and cash management strategies are being put in place?
  - What information will be available about the principles the Scottish Government is applying to decisions on borrowing and the use of the Scotland reserve?
- 

### Transparent financial reporting

**20.** Underpinning all these areas is a need for transparency to enable the Parliament and the wider public to see and understand the basis on which decisions are made. It will also be important for everyone to be able to understand the assumptions underlying changes in revenues and spending from one year to another, and how forecasts are reconciled to outturn once actual information is available.

**21.** It will be critical for the Scottish Government to report clearly and objectively on how all parts of the fiscal framework operate in practice. This includes, clearly reporting on movements in the block grant, block grant adjustments, movements and balances in the Scotland reserve, relevant revenue and expenditure forecasts, and the impact of borrowing. It will also be important for the government to demonstrate that anticipated expenditure can be funded from anticipated revenues.

**22.** A complete understanding of how much money has been committed across government to long-term investment such as borrowing, public private partnerships and public sector pensions is important when taking decisions about future tax and spending. It is also important to have a good awareness of the full range of potential financial commitments which depend on events in the future, such as contingent clinical negligence claims.

**23.** The Scottish Government already publishes a range of financial and economic information and is working to further develop financial reporting. It is increasingly important to have comprehensive, transparent, and timely financial reporting to support decision-making and scrutiny. As we have previously highlighted, a key element of this is an overall account of the revenues, spending, assets (what is owned) and liabilities (what is owed) of the Scottish public sector as a whole, including the need for a Scottish equivalent to the Whole of Government accounts for the UK. The Permanent Secretary has committed to developing proposals to further enhance financial reporting in Scotland. The timescales for this have still to be set out.

---

## Key questions



- Are all material elements of the Scottish Budget clearly and objectively reported? For example, are block grant adjustments, movements and balances on the Scotland reserve and borrowing clearly reported and understood?
  - What information will be available to support a clear understanding of the overall position of Scotland's public finances?
  - What steps is the Scottish Government taking to improve and enhance financial reporting?
- 

### Implementation of the new financial powers

**24.** Managing the implementation of, and transition to, the new financial powers is a complex task. Having the right skills, knowledge and capacity to manage the new powers will be important. It is also important that there is the capacity across government to manage new developments alongside continuing to manage day-to-day operations. Given the scale of the task, it is vital to have the right people in place at the right time.

**25.** It is equally important to build and maintain effective working agreements and relationships with the UK Government and its departments closely connected with the new powers, such as HMRC and the Department for Work and Pensions (DWP).

---

## Key questions



- What steps is the Scottish Government taking to ensure it has the skills and capacity to deliver the new financial powers?
  - Are all the necessary arrangements being put in place to manage all aspects of the new financial powers?
  - What information is available to the Scottish Parliament to assess working relations between the Scottish and UK governments?
-

## The audit role

**26.** Public audit provides independent assurance that public money is spent properly and is providing value for money. This helps create a strong and effective system of accountability and transparency which supports the best use of public money in the public interest. Taken together with effective public and parliamentary scrutiny, this contributes to strong and transparent oversight of public funds.

**27.** Audit Scotland works closely with the Auditor General for Scotland and the Accounts Commission (which audits local government). The joint paper [Public audit in Scotland](#)  sets out the shape, principles and themes of public audit. It reflects the changing context for our work, including the new financial powers coming to Scotland. We work together to play a full part in their successful implementation.

**28.** We are committed to supporting the Parliament in developing world-class arrangements for holding government to account and improving the use of public money. We will continue to work with its committees to strengthen the Parliament's oversight of the government in line with the recommendation of the Smith Commission and to support scrutiny of the implementation of the new powers.

**29.** We do this by contributing our views on the arrangements as they are further developed and through our audit work. To date, we have published a number of reports and provided submissions to the Scottish Parliament's committees on the new financial powers and related topics. A list of these is provided in [Appendix 1](#). In doing so, we continue to work with the UK's National Audit Office, to ensure joined-up and effective public audit.

**30.** If you would like more information about Audit Scotland's work on the new financial powers, please contact Mark Taylor, assistant director at [mtaylor@audit-scotland.gov.uk](mailto:mtaylor@audit-scotland.gov.uk) .

# Appendix 1

## Summary of Audit Scotland reports and submissions covering the new financial powers



During the course of 2014 and 2015, the Auditor General for Scotland (AGS) published two reports on managing the implementation of the new financial powers:

- [\*Preparations for the implementation of the Scotland Act 2012\*](#) , December 2014
- [\*Implementing the Scotland Act 2012: an update\*](#) , December 2015.

The AGS will publish a report on [\*Managing new financial powers\*](#)  in spring 2017.

The AGS has published two reports on financial reporting in Scotland:

- [\*Developing financial reporting in Scotland\*](#) , July 2013
- [\*Update on developing financial reporting\*](#) , March 2015.

The AGS and Audit Scotland have provided written evidence to the Finance, Public Audit and Devolution committees of the Scottish Parliament between April 2015 and March 2016:

- In April 2015, Audit Scotland [submitted a response](#)  to the Finance Committee's call for evidence on Scotland's fiscal framework.
- In June 2015, Audit Scotland [submitted a response](#)  to the Public Audit Committee's call for evidence on audit, accountability and the further devolution of powers.
- On 21 August 2015, the AGS [wrote](#)  to the Public Audit Committee in response to the Committee's issues paper on audit, accountability and the further devolution of powers.
- In October 2015, Audit Scotland [submitted a response](#)  to the Finance Committee's call for evidence on the Scottish Fiscal Commission Bill.
- On 4 March 2016, the AGS [wrote](#)  to the conveners of the Devolution and Finance Committees (copied to the Public Audit Committee) offering observations on the fiscal framework and highlighting the important role of public audit in the implementation of new financial powers.

# Scotland's new financial powers

## Key issues for the Scottish public finances

This report is available in PDF and RTF formats, along with a podcast summary at:

[www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk) 

If you require this publication in an alternative format and/or language, please contact us to discuss your needs: 0131 625 1500

or [info@audit-scotland.gov.uk](mailto:info@audit-scotland.gov.uk) 

For the latest news, reports and updates, follow us on:



Audit Scotland, 4th Floor, 102 West Port, Edinburgh EH3 9DN

T: 0131 625 1500 E: [info@audit-scotland.gov.uk](mailto:info@audit-scotland.gov.uk) 

[www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk) 

ISBN 978 1 911494 07 2