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FINANCIAL DEVOLUTION AND CONSTITUTIONAL CHANGE UPDATE

Purpose

1. This paper provides an update on key developments surrounding financial devolution and constitutional change.

Background

2. We provided an update to the Accounts Commission in February 2019 on financial devolution and the UK's withdrawal from the EU. Significant developments since then include:

    - HMRC published the first set of outturn data for Scottish income tax (for 2017/18), which showed that forecasts were optimistic about how much income tax would be raised in Scotland and the rest of the UK. The way that the fiscal framework works means that there will be a £204 million reduction in the Scottish budget for 2020/21, to address the difference between forecast and outturn figures.

    - Social Security Scotland has started delivering the remaining two elements of the Best Start Grant (early learning and school age) and Best Start Foods payments. It is now delivering five devolved benefits. The Scottish Government has set out provisional timescales for the phased introduction of further devolved benefits and some new Scottish benefits through to the end of 2022. It expects all existing claims to transfer from the Department for Work and Pensions (DWP) to Social Security Scotland by 2025.

    - The date that the UK is due to leave the EU moved from 29 March to 31 October 2019. There have been major changes to the UK Government cabinet, including a new Prime Minister, and preparations for leaving without a withdrawal agreement are intensifying. The annual audit reports for 2018/19 will include assessments of how local authorities and other public bodies are preparing for EU withdrawal and responding to any emerging risks.

    - Crown Estate Scotland announced the four projects that will be taken forward to the final stages of its pilot scheme to encourage local authorities and other bodies to manage Scottish Crown Estate assets. They include projects involving Orkney Islands Council, Shetland Islands Council and Comhairle nan Eilean Siar.

Managing the public finances

3. Scotland's new financial powers, including tax raising, borrowing and reserve powers, have introduced much greater complexity, volatility and uncertainty into the Scottish budget. Forecasts now play a significant part in setting the block grant for Scotland. The Office for Budget Responsibility forecasts the revenues foregone by the UK Government as a result of devolving income tax (deducted from the block grant) and the Scottish Fiscal Commission forecasts the tax revenues raised in Scotland (added to the block grant). Once the actual amounts raised (outturn) are known, the Scottish budget is adjusted to account for the differences between the forecasts on which the original

budget was based and the outturn. These adjustments are known as reconciliations. Final outturn data on income tax is not published until over a year after the end of the tax year, and so these reconciliations are reflected in future year's budgets.

4. In July, HMRC published outturn data on income tax for 2017/18, which was the first year that powers over tax rates and bands were devolved. The outturn data showed that the forecasts that determined the Scottish block grant for 2017/18 were optimistic about how much income tax would be raised in Scotland and the rest of the UK. The difference between forecasts and outturns for 2017/18 will be reconciled in the Scottish budget for 2020/21. The net reconciliation effect will be a £204 million reduction in the Scottish Government's funding for that year. Reconciliations are part of the new fiscal arrangements and will happen each year. They may not always be negative, although the Scottish Fiscal Commission has forecast shortfalls totalling £1 billion over the next three budget cycles (to 2022/23). The Scottish Government will need to manage the impact of negative reconciliations on its budget, for example through borrowing, use of the Scotland Reserve, cutting back on spending or increasing taxes.

5. The Scottish Government published its second medium-term financial strategy on 30 May 2019.[1] The document, which is an element of the revised Scottish budget process, is intended to set out the challenges and opportunities facing the public finances and the Scottish Government's broad financial plans and projections for the next five years. The Budget Process Review Group recommended the annual publication of the strategy, to help inform detailed budget proposals by providing a medium-term perspective on the public finances.

6. The UK's departure from the EU continues to cause uncertainty over the UK and Scottish budgets. In August, the Chancellor announced a one-year spending review to set UK Government departmental budgets for 2020/21. This is expected to be completed in September. The UK Government announced that a full multi-year spending review will be held in 2020, once the UK has left the EU. The Scottish budget would normally be published within three weeks of the UK budget but, at the time of writing, timing has not been confirmed. In its medium-term financial strategy, the Scottish Government anticipated that it will publish its budget in December 2019, including a three-year settlement for local government. It noted that it plans to undertake a review of spending beyond 2020/21 "irrespective of the UK Government's decision about its Spending Review", although it also states that this "may not be possible if we do not have sufficient clarity from the UK Government on its spending plans at that stage".

7. The complexity, volatility and uncertainty associated with the Scottish Government's budget raises financial planning challenges for local authorities as they consider their own budgets for future years.

8. As further devolved tax and spending powers start to be implemented, the Scottish budget will become increasingly complex. There are further responsibilities to be implemented, although it is not yet clear when this will happen:

    - The Scottish and UK governments agreed that a share of VAT revenues would be assigned to the Scottish budget from 2020/21 after a transition year in 2019/20. This would be the second largest source of tax revenue for the Scottish Government (around £5.7 billion) after income tax (around £11.7 billion). It is currently not possible to identify how much VAT is raised in Scotland, so the amount of VAT assigned to Scotland would be based on estimates. The Scottish Government has concerns about the methodology for producing these estimates, which it is developing jointly with HMRC and HM Treasury, and the level of

[1] https://www.gov.scot/publications/scotlands-fiscal-outlook-scottish-governments-medium-term-financial-strategy-2019/

volatility and risk they could introduce to the Scottish budget. In May, the Scottish Government proposed delaying the implementation of VAT assignment until the approach can be reviewed alongside the fiscal framework in 2021.[2]

- The Scottish Government originally intended to replace the UK-wide Air Passenger Duty with a Scottish Air Departure Tax in April 2018. It has delayed introduction of the tax beyond April 2020 because of EU state-aid rules relating to the tax exemption for flights departing Highlands and Islands airports. In May 2019, the Scottish Government announced that its policy to cut and eventually scrap the tax to encourage economic development was incompatible with its climate change policies and that it would no longer seek to reduce the tax rates.

- The Scottish Government has not yet set a timetable for the devolution of Aggregates Levy. The UK-wide levy has been subject to EU and UK legal proceedings around EU state-aid rules, and the Scottish and UK governments agreed that it wouldn't be devolved until these issues had been resolved. The legal proceedings concluded earlier this year and the UK Government is now reviewing the levy, including ensuring its design is suitable for devolution. The UK Government expects to report the findings of the review and next steps by the end of 2019.

9. Understanding the risks that the new financial powers and operation of the fiscal framework present to the Scottish budget, and monitoring how they are unfolding, is critical to the effective oversight of the Scottish public finances. The team leading on our work in this area has agreed a year-round programme of work to assess and report on this. The focus of its work is on scrutinising how well the Scottish Government directs and manages public money to deliver financial sustainability and support overall outcomes for the people of Scotland.

Social security powers

10. Social Security Scotland, which began operating in September 2018, currently delivers five devolved benefits (Carer's Allowance Supplement; Best Start Foods; and three Best Start Grant payments for pregnancy and baby, early learning, and school age). A further two benefits are expected to be introduced during 2019 (Funeral Support Payment and Young Carer Grant). Social Security Scotland will take on fiscal responsibility for all remaining devolved benefits in April 2020. This means that, although the majority of claimants will continue to receive payments from DWP at that point, all devolved benefit payments will appear in Social Security Scotland's accounts. The Scottish Government has set out provisional timescales for the phased introduction of devolved social security benefits and some new Scottish benefits through to the end of 2022. It expects all existing claims to transfer from DWP to Social Security Scotland by 2025.

11. The Scottish Government recently announced that it was introducing a new benefit payment, the Scottish Child Payment, earlier than originally planned. The payment, which will be administered by Social Security Scotland, will be introduced for children under six in early 2021 and rolled out to all eligible children under 16 by the end of 2022. The timings for the introduction of other benefits has changed to accommodate the earlier introduction of this new payment. Social Security Scotland and DWP are assessing the likely risks and impacts of this new payment for their work and the wider Scottish social security programme.

12. At the end of July, Social Security Scotland launched a campaign to recruit 100 new staff to its Glasgow office. This is to support its delivery of the seven benefits that will be in

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[2] https://www.parliament.scot/S5_HealthandSportCommittee/General%20Documents/20190515_-_Derek_Mackay_to_CST_-_VAT.pdf

place by the end of 2019 and to prepare for the remaining benefits that are still to be introduced. Social Security Scotland expects to employ over 1,900 people once it is fully operational. This includes around 400 people to deliver social security services at a local level and provide one-to-one support to people entitled to devolved benefits, such as helping them to complete applications and supporting them through the process. Social Security Scotland has appointed a local delivery lead for each council area and plans to build client support teams of up to five people in each area by the end of the year. Social Security Scotland is working with local partners, including councils, health and social care partnerships and third sector organisations, to identify opportunities to locate these local delivery services in existing public buildings.

13. Audit Scotland is the appointed auditor for Social Security Scotland and the payments that it administers. The first annual audit of Social Security Scotland is currently underway and will be completed by the end of September 2019. We also report on how the Scottish Government is managing the delivery of the devolved social security powers through our performance audit programme. The latest report was published in May 2019.

14. We are changing our approach to our housing benefit performance audit work, following discussions with the Accounts Commission. We are taking a more strategic, risk-based and proportionate approach to this work. We plan to publish two thematic reviews (on overpayments and resourcing models) and two reviews of individual councils during 2019/20. We will also publish the latest annual update on the housing benefit performance audit in late 2019.

EU withdrawal

15. At the time of writing, there remains significant uncertainty about when and how the UK will leave the EU. In March 2019, the UK Government and European Commission agreed to extend Article 50 (the legal process for leaving the EU) until either 22 May, subject to the UK Parliament approving the withdrawal agreement, or 12 April. Following the UK Parliament’s rejection of the withdrawal agreement for a third time on 29 March (the day the UK was originally meant to leave the EU), the Prime Minister requested a further extension. The European Commission agreed to extend Article 50 to 31 October 2019, at the latest, on the condition that the UK participated in European Parliament elections in May. Since then, there has been a Conservative Party leadership contest and the new Prime Minister took office in July. The political environment around EU withdrawal has shifted and grown more volatile, with the UK Government stating that they are willing to leave the EU on 31 October without a withdrawal agreement if necessary.

16. We are continuing to monitor issues as they develop and identify potential risks to the bodies we audit and implications for our work. Any relevant issues are reflected in the public sector audit risk register and our work programme. As part of the annual audits for 2018/19, auditors assessed how public bodies (including councils and integrated joint boards) are preparing for EU withdrawal and responding to any emerging risks. We are also reporting on this in our performance audits, where relevant, such as our audits on local government in Scotland (challenges and performance), NHS workforce planning, and higher education finances.

17. We are supplementing our audit work with ongoing engagement with key stakeholders. We hosted two roundtable sessions in August, which gave people from a range of sectors the opportunity to discuss the short and longer-term risks presented by EU withdrawal and how they are responding to them. Attendees included representatives from COSLA, Scotland Excel, Society of Chief Officers of Environmental Health in Scotland, and Coalition of Care and Support Providers in Scotland. Key immediate risks for councils include continuity of food supplies and, in particular, impact on vulnerable groups. In addition, there are concerns about impact on local economies especially

where particular sectors are dependent on workers from elsewhere in the EU and, critically, on the social care sector.

18. The impact of EU withdrawal will feature in our audit work for the foreseeable future. We will continue to share information from our work in this area both internally and externally, for example through briefing papers, blogs and presentations. We currently plan to publish an output on behalf of the Accounts Commission and Auditor General in early 2020 that highlights ongoing issues and potential risks for the public sector. At this stage, we plan to bring a draft paper to the Accounts Commission meeting in December 2019, although the format and timing of any output is subject to change depending on external developments. We are discussing our approach with the Accounts Commission sponsors and AGS and a proposal will be taken to the Performance Audit Committee for consideration in September.

Crown Estate Scotland

19. The Scottish Crown Estate Act, which received Royal Assent in January 2019, sets the framework for the long-term management of the Crown Estate in Scotland. It provides for the devolution of management of assets from Crown Estate Scotland to local authorities, public bodies, Scottish harbour authorities and community organisations.

20. Crown Estate Scotland launched a pilot scheme in June 2018 to encourage local authorities and other bodies to manage Scottish Crown Estate land and property rights in their local area. After assessing applications, Crown Estate Scotland announced the four projects that will be taken forward to the final stages in May 2019. The projects are being led by Orkney Islands Council, Shetland Islands Council, Comhairle nan Eilean Siar and Galson Estate Trust (joint proposal), and Forth District Salmon Fishery Board.

21. The projects will see the applicants take responsibility for more decisions relating to the management of the Scottish Crown Estate. They are designed to give communities and local authorities more say and influence in decisions that impact the seabed, coastline and land in their local area. The proposals submitted by councils are as follows:

    - **Orkney Islands Council** – decisions to lease seabed assets around Orkney will be taken within the local community through a new Marine Planning Partnership. The Partnership will help to engage local stakeholders and the wider community in the development of a statutory regional marine plan and seabed leasing decisions, taking account of local circumstances. The Council aims to take a lead role in the Partnership, supported by an advisory group of stakeholders representing local economic, environmental and community interests.

    - **Shetland Islands Council** – a master planning process is being developed to assess the potential for future developments within the Sullom Voe Harbour Area and ensure that any development is sustainable and meets with community aspirations. The aim is to develop, promote and enhance local management and decision making, including developing a planning process with local control over leasing of seabed assets and ensuring extensive public, community and industry consultation.

    - **Comhairle nan Eilean Siar and Galson Estate Trust** – the council and community landowner will make decisions on leases for renewable and non-renewable energy developments in the Galson sea area. They will be advised by a new Outer Hebrides Marine Development Partnership. The Partnership will comprise representatives of relevant local agencies and will provide expert advice on areas such as the marine environment, socio-economic factors and fisheries.

Audit reporting

22. The AGS published a performance audit report on implementing the devolved social security powers on 2 May 2019.[3] The report was considered by PAPLSC on 16 May and by the Social Security Committee on 30 May. The report outlined the challenges of delivering such a complex programme of work. The key messages from our report were as follows:

- The Scottish Government has done well to establish a new agency and start making benefit payments. It has also undertaken important groundwork needed to deliver future benefits in line with its overall policy direction. But the high pace of delivery and the complexity of the social security system has been a significant challenge and meant that the Scottish Government found delivering on its initial commitments harder than expected.

- Implementing the second wave of benefits is more difficult as the complexity and amount of work increases further. This means a significant change for the implementation programme. The processes and systems currently being used to plan and support implementation have worked well to date. But they will not be enough to support the delivery of the second wave.

- The programme team is aware of these challenges and is doing the right things, revising arrangements to try to address them. Continuous short-term pressures mean that it is difficult for the team to pause and refocus activity, presenting risks to overall delivery. Many decisions about future benefits and how they will be delivered in the long term are still to be made.

- The Scottish Government does not yet have a clear understanding of the key things needed to deliver all remaining benefits in the way it intends. This includes not monitoring and reporting on how much it will cost to fully implement all the benefits. It is currently developing financial and workforce plans to support its implementation timescales. It is critical that these are agreed and aligned to the intended outcomes for service users.

23. We will be reporting on the Scottish Government's management of the public finances over the next few months. In late September, the AGS will publish a section 22 report on the 2018/19 audit of the Scottish Government consolidated accounts. In early October, the AGS will publish a section 22 report on the 2018/19 audit of Social Security Scotland's accounts. Later this year, we plan to publish a second briefing on the operation of the fiscal framework, building on the issues identified in the paper we published in October 2018.[4]

24. A new budget process was introduced for the 2019/20 Scottish budget, which promotes a year-round approach to budget setting, scrutiny and evaluation, with increased emphasis on outcomes and what spending is achieving. In March, we hosted two workshops with parliamentary officials and auditors to reflect on the first year of the new budget process and discuss what more we can do to help embed and improve the process. Our parliamentary engagement lead is coordinating our ongoing engagement with committees and working with colleagues across the organisation to identify how our audit work can help to support improved budget scrutiny.

[3] https://www.audit-scotland.gov.uk/report/social-security-implementing-the-devolved-powers

[4] https://www.audit-scotland.gov.uk/uploads/docs/report/2018/briefing_181016_financial_powers.pdf

Conclusion

The Commission is asked to note the content of this report.

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2 September 2019