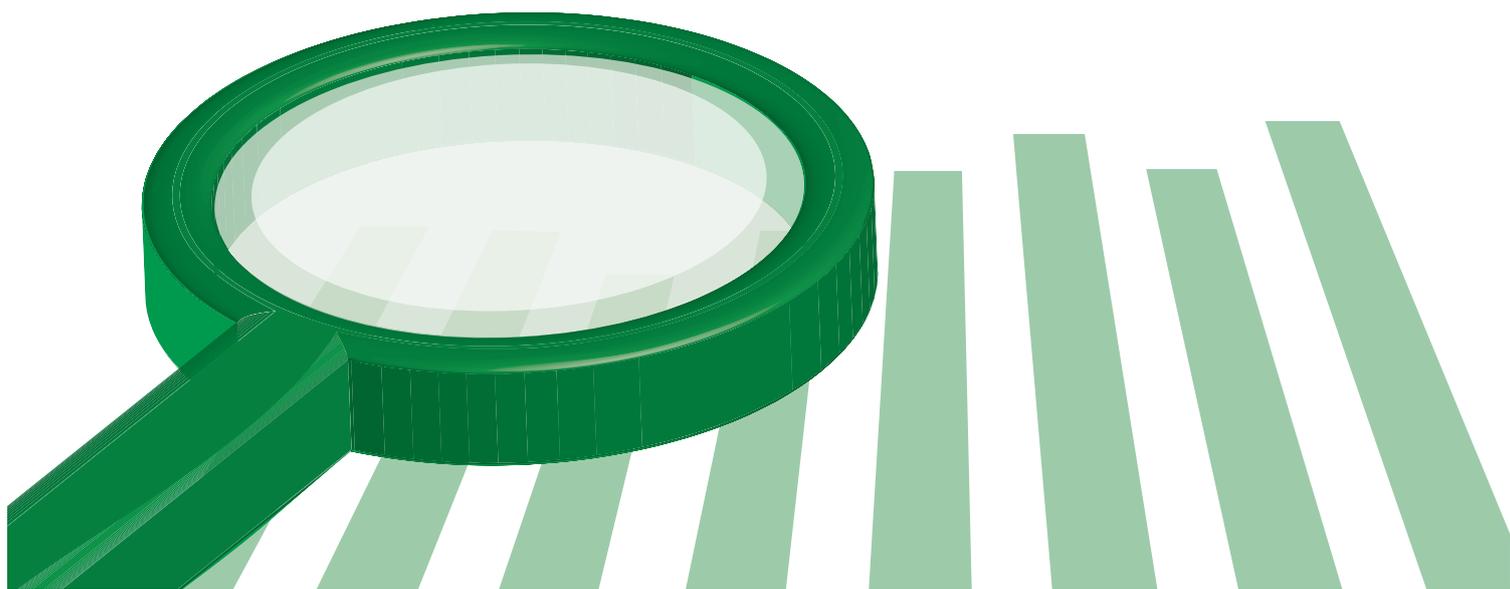


Briefing

Scotland's new financial powers

Operation of the Fiscal Framework 2018/19



 AUDIT SCOTLAND

Prepared for Auditor General for Scotland
October 2019

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Introduction

1. The Scottish Parliament's new financial and social security powers and responsibilities from the 2012 and 2016 Scotland Acts are fundamentally changing the Scottish public finances. Alongside continuing taxation powers, the 2018/19 Scottish budget included demand-led social security assistance for the first time. This will grow significantly, with social security spending rising to around £3.6 billion annually from 2020/21.
2. The Scottish budget is becoming increasingly complex. It is subject to greater uncertainty and volatility than when the majority of its funding was relatively fixed through the block grant from the UK Government. The way the Scottish economy performs relative to the rest of the UK now has a greater influence on public finances than ever before. The Scottish Government has more choice over tax and spending, and more decisions to make about how and when to use its financial powers. The Scottish Government is pursuing its own tax and social security policies, that are increasingly diverging from those of the UK Government. The first Scottish income tax outturn data was published in July 2019, which will impact on the 2020/21 budget.
3. The Scottish Parliament's revised budget process aims to respond to these new fiscal challenges. Understanding the opportunities and risks associated with the operation of the Fiscal Framework, and how these are unfolding, is critical to the effective oversight of the Scottish public finances.
4. This paper provides a briefing for Parliament on how the Fiscal Framework is operating in practice and how the Scottish Government has used the powers available to it. It reflects on experience during 2018/19, describes the range of risks that are now affecting the Scottish budget and outlines how the Scottish Government is managing these.
5. The briefing is in three parts:
 - Part 1 is an overview of how the Scottish budget operated during 2018/19. We recap the main elements of the budget, outlining available funding and spending during the year.
 - Part 2 summarises how the main components of the Fiscal Framework operated in year, and how each is affecting the Scottish budget.
 - Part 3 provides an update of the how the main risks that affect the Scottish budget are emerging, and what these mean for the management of the Scottish public finances.
6. Detailed information about the budget, tax revenues and public spending is provided in a number of financial reports published by the Scottish Government and individual public bodies. We have drawn from this published information and audit reports throughout this briefing.

Part 1. Overview of the Scottish budget in 2018/19

7. The 2018/19 financial year was the second year of operation of the devolved income tax, borrowing and reserve powers contained in the 2016 Scotland Act. The two devolved taxes introduced by the 2012 Scotland Act, Land and Buildings Transactions Tax and Scottish Landfill Tax, continued to be administered by Revenue Scotland. Some demand-led social security spending was incorporated into the Scottish budget for the first time, with the devolution of carers allowance and the introduction of the Best Start Grant pregnancy and baby payment administered by Social Security Scotland.

The block grant and block grant adjustments

8. In 2018/19, the majority of the Scottish budget continued to be funded by grants from the UK Government. This is known as the block grant. UK Government departmental spending plans affect the Scottish block grant via the Barnett formula. The Barnett formula changes the block grant by a Scottish population share of changes in the comparable spending in England (or England and Wales in some cases).
9. The Fiscal Framework states that the Barnett formula will continue to be used to calculate the overall block grant, but it also introduces new sources of revenue and spending. As each of the new financial powers is implemented the block grant is amended to reflect this, with each change known as a block grant adjustment (BGA) ([Exhibit 1](#)).

Exhibit 1

How the funding for the Scottish budget is determined

The block grant is now adjusted to reflect powers devolved to Scotland



Source: Audit Scotland

10. BGAs represent tax revenues foregone or spending power no longer available to the UK Government. When the Scottish budget is determined, it is unknown how much tax will be collected, and how much welfare spending will be required, for both Scotland and the rest of the UK. Adjustments to the block grant are included in the budget based on forecasts. When outturn information is available, the next budget is adjusted to account for this through a process of reconciliation.

The Fiscal Framework and the 2018/19 Scottish budget

11. The Scottish Government is required to operate a balanced budget, matching its spending to available funding each year. The Scottish Government has scope to manage its spending within the broad headings approved by the Scottish Parliament, responding to changes in the funding available and spending pressures.
12. The Scottish Government's financial decisions affect both the total HM Treasury budget for the year and Scottish budget limits. From 2018/19, the UK Government reclassified Scottish Government Departmental Expenditure Limit (DEL) expenditure in its budgeting framework to Annually Managed Expenditure (AME). This is to better reflect Scotland's new financial powers. While this means that the Scottish Government no longer refers to DEL in its budget, the existing firm budget limits relating to its resource and capital spending still apply.
13. The Scottish Government's management of the budget focuses on fiscal resource (excluding non-cash) and capital as a measure of real spending power. Other elements of traditional AME expenditure are still in place and are not covered by the Fiscal Framework. This includes demand-led spending in areas such as NHS and Teachers' pensions. The Fiscal Framework relates to all other spending, making up nearly 80 per cent of the Scottish budget (£34,228 million out of a total budget of £42,199 million). The elements of the Scottish budget governed by the Fiscal Framework are set out in [Exhibit 2](#).

Exhibit 2

Types of fiscal resource and capital spend

Type of Funding	Sub-type	How it is used
Fiscal resource	Cash resource	Spending on the operating costs for public services
	Non-cash resource	Can only be used to meet capital charges that reflect the consumption of physical assets (that is, depreciation) and other items that are treated as non-cash in technical accounting terms. It cannot be carried forward
Capital	General capital	Investing in capital projects, such as new hospitals or schools
	Financial transactions	Making loans to, or investments in, companies or individuals.

Source: Audit Scotland

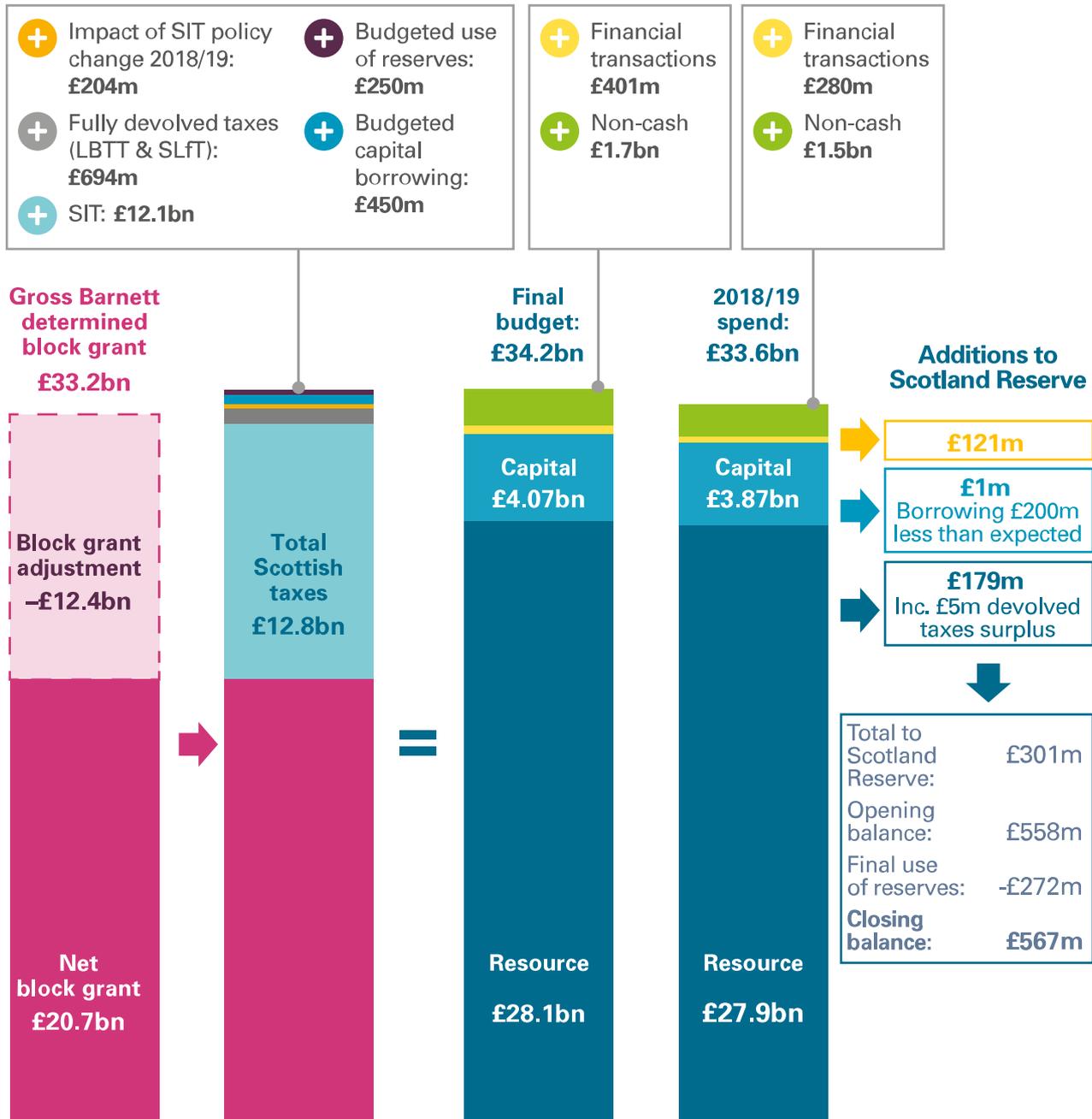
Performance against budget in 2018/19

14. The Scottish Government managed overall spending within budget in 2018/19 and within the limits set in the Fiscal Framework. A summary of the final HM Treasury budget and the actual amount of public spending is set out in [Exhibit 3](#). Total Fiscal Resource and Capital expenditure was £33.6 billion, £621 million less than the final budget of £34.2 billion.

A £301 million surplus was carried forward within the Scotland Reserve. The largest driver in this is the underspend against the Transport, Infrastructure and Connectivity Portfolios.¹

Exhibit 3

Provisional HM Treasury budget performance, 2018/19



Source: Scotland Office Supplementary Estimates 2018/19; Scotland Office Accounts, 2018/19; Provisional Outturn, 2018/19; Economic and Fiscal Forecasts, SFC, May 2019; Audit Scotland Analysis

Note: Some figures may not add due to rounding

¹ Scottish Government Consolidated Accounts 2018/19, Scottish Government, September 2019.

15. The final budget includes amendments that are made to the budget at two points during the year (autumn and spring budget revisions) under the provisions of the annual budget act. This enables the Scottish budget to be updated to reflect UK funding changes, alongside technical changes affecting AME and non-cash DEL budgets, and transfers between Scottish Government portfolios and spending programmes. These are considered by the Finance and Constitution Committee as part of the budget revision process.

Use of key financial powers available through the Fiscal Framework

16. The Scottish Government has used key financial powers available to it through the Fiscal Framework to change Scottish budget levels. The Scottish Government's 2018/19 tax policies reflected in Scottish Fiscal Commission forecasts and included in the overall budget for the year included:
- A new five band Scottish income tax system was implemented in 2018/19, through the introduction of two new bands (a Starter Rate and an Intermediate Rate). The Scottish Government raised the higher rate threshold to £43,430, which compared to a higher rate in the UK of £46,351.
 - For 2018/19, the rates and bands for land and buildings transaction tax changed for non-residential properties, and the Additional Dwelling Supplement was increased from three per cent to four per cent. In June 2018, the threshold for first time buyer's relief was increased from £145,000 to £175,000.
 - For Scottish landfill tax, rates rose with inflation in 2018/19.
17. The Scottish Government now receives a block grant addition from the UK Government to fund the Carer's Allowance social security benefit. This is an addition to the block grant, as opposed to tax powers, where a block grant adjustment is subtracted from it.
18. The Scottish Government now bears the risks and opportunities associated with this devolved benefit in a similar way that it does for devolved and partially devolved taxes. While Carer's Allowance itself is paid in line with the UK-wide benefit, the Scottish Government's future budgets will move up or down depending on whether this demand-led spending in Scotland is higher or lower than the block grant addition.
19. The Scottish Government implemented a Carer's Allowance supplement in 2018/19. This is in addition to the UK-wide Carer's Allowance, and the cost of this is borne entirely by the Scottish Government. Other aspects of devolved social security operating in-year (Best Start Grant, Employability Services and Discretionary Housing Payments) do not have block grant additions associated with them but are funded through the block grant indexed using the Barnett formula. The Scottish Government received £34 million in transfers to support these benefits in 2018/19.

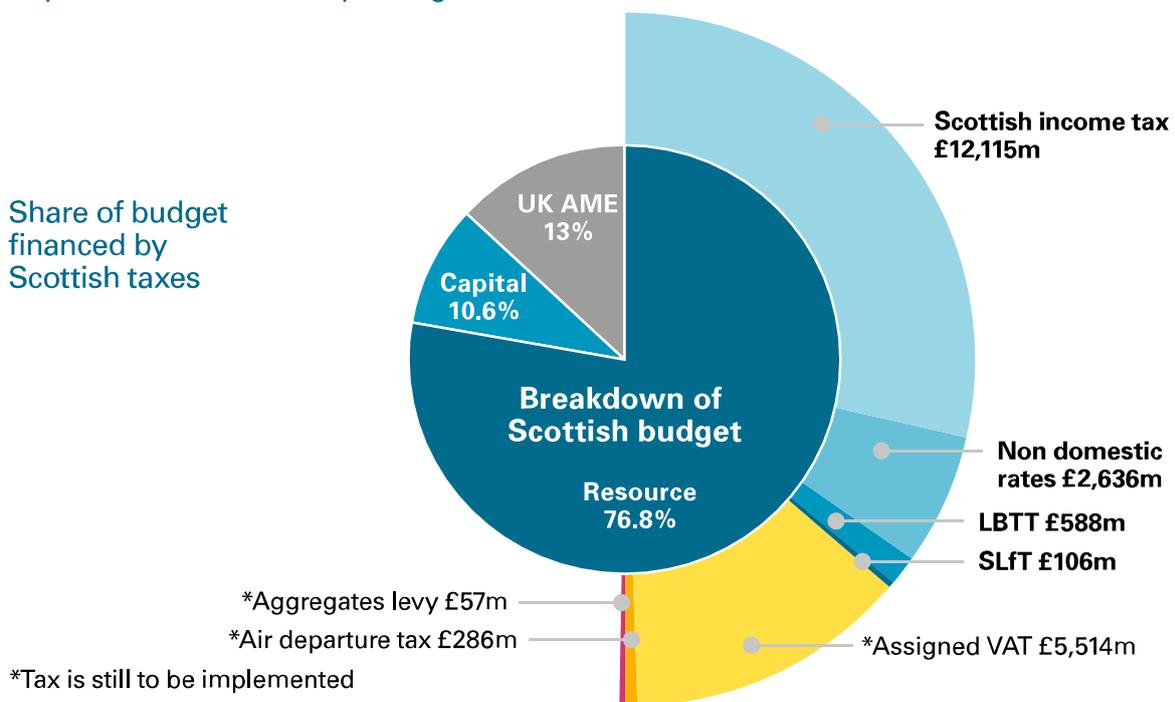
Part 2. Operation of devolved powers in 2018/19

20. Once all taxes included in the Fiscal Framework have been devolved or assigned, revenue raised in Scotland will be around £21 billion. This is over 50 per cent of the total budget funding, and around 65 per cent of the resource funding available to the Scottish Government. The remainder will continue to be funded through the block grant. ([Exhibit 4](#)).
21. The initial budget for taxes and social security benefits is based on forecasts. The Scottish Fiscal Commission (SFC) forecasts Scottish tax revenues and devolved social security benefits spending. The Office for Budget Responsibility (OBR) forecasts of UK Government tax and spending drive the calculation of the associated block grant adjustments.
22. In the 2018/19 budget, Scottish income tax, land and buildings transaction tax and Scottish landfill tax were forecast to generate £12.8 billion, or 30 per cent of the budget. The majority of this (£12.1 billion, 32 per cent of the budget) relates to Scottish income tax. The Local Government spending is also supported by Non-Domestic Rates, forecast to be £2.636 billion.

Exhibit 4

Scottish budget tax revenues as share of devolved expenditure

Devolved and assigned tax revenues will support up to 50 per cent of the Scottish budget – but 65 per cent of Resource spending



Source: Scotland Office Supplementary Estimates 2018/19; Scotland Office Accounts 2018/19; Economic and Fiscal Forecasts, SFC, May 2019; Scottish Government; Audit Scotland Analysis

Note: NDR is included here as a tax raising power. NDR is not covered by the Fiscal Framework.

23. Social Security Scotland was established in September 2018 and is now responsible for Carers Allowance, Carers Allowance Supplement and the Best Start Grant pregnancy and baby payment. The budget for spending in these areas during 2018/19 was £192.9 million.
24. The Scottish budget is adjusted to correct for the difference between forecast and actual tax revenues and social security spending levels (known as outturns) as these become known (in a process known as reconciliation). These reconciliations differ in terms of size, and the timeliness of the outturn information meaning 2018/19 outturn information will impact budgets across a number of budget years (Exhibit 5).

Exhibit 5

Key points in how outturn adjustments are applied in 2018/19

	Fully devolved taxes Scottish landfill tax and land & buildings transaction tax	Large welfare benefits Carer's Allowance in 2018/19	Scottish income tax
Collected/ distributed by	Revenue Scotland	Currently DWP for Carer's Allowance; SSS for Carer's Allowance Supplement	HMRC
Baseline year (year prior to devolution of the tax/benefit)	2014/15	2017/18	2016/17
Nature of block grant adjustment	Taxation collected in the baseline year is indexed by the change in the total amount of the equivalent UK tax since then (on a per head basis)	Benefit spending in the baseline year is indexed by the change in the total amount of the equivalent UK benefit since then (on a per head basis)	Taxation collected in the baseline year is indexed by the change in the total amount of equivalent UK tax since then (on a per head basis)
When UK 2018/19 outturn position is known	Autumn 2019	Autumn 2019	Summer 2020
When Scottish outturn position is known	September 2019	September 2019	Summer 2020
Approximate budget share (as shown in Exhibit 3)	2.0%	0.5% (in 2018/19, not full year)	35%
Year of adjustment to the budget	BGA reconciled and adjusted largely in the budget year itself, and again in the following year after UK outturn position is known.	BGA reconciled once in the budget year itself, and again in the following year after UK outturn position is known	Budget is adjusted in the budget year after the outturn information is known. In effect this means that the budget adjustment is three years after the original budget year.

Source: Audit Scotland

Fully devolved taxes

25. Scottish landfill tax and land and buildings transaction tax make up a relatively small proportion of the Scottish budget. The outturn figures are known quickly, shortly after year end. This means that budget adjustments must be managed in part during the budget year itself, with an adjustment required to the following year's budget. The risks to the Scottish budget from fully devolved taxes are therefore relatively small and are managed over a short horizon.
26. The fully devolved taxes increased the available 2018/19 budget by £53 million and will reduce the 2020/21 budget by £5 million, as shown in [Exhibit 6](#).

Exhibit 6

Provisional adjustments required to budgets for fully devolved taxes for 2018/19

Adjustment	Block grant addition	Scottish tax	Net effect
Original budget figures	£694 million	£694 million	£0 million net effect on budget
In-year adjustment impacting the 2018/19 budget	Block grant addition decreases by £45 million	Scottish devolved taxes increase by £8 million	Scottish budget increases by £53 million
Future adjustment impacting the 2020/21 budget	Block grant addition increases by £5 million	No change	Scottish budget decreases by £5 million
Net effect of 2018/19 outturns on budgets	Block grant addition decreases by £40 million	Scottish devolved taxes increase by £8 million	Scottish budget increases by £48 million
Provisional outturn figures	£654 million	£703 million	+£48 million net effect on budget

Source: Fiscal Framework data annex, as updated October 2019.

Note: Some figures do not add due to rounding.

Social security spending

27. The Scottish Government now has the responsibility for the spending and cash management of some demand-led benefits.
28. The Carer's Allowance Supplement is a new benefit applicable only in Scotland, and therefore has no block grant addition associated with it. The Carer's Allowance Supplement cost £34.9 million in 2018/19.
29. The Best Start Grant transferred from DWP through Machinery of Government transfers to the Scottish budget, meaning that it is funded through the Barnett formula. This is expected to be

the case for most of the smaller benefits as they are devolved. This affects the way funding is indexed. The Scottish Government received a funding transfer of £1 million from the UK Government for Best Start Grant in 2018/19 and spent £4.3 million.

30. A block grant addition for Carer's Allowance contributes to the funding for this benefit. The process of applying block grant adjustments for Carer's Allowance is very similar to the process applied to fully devolved taxes (Exhibit 7). Carer's Allowance operated for seven of the 12 months in 2018/19, meaning there was no in-year block grant addition adjustment made. Such adjustments are anticipated from 2019/20, based on UK Government benefits spending.

Exhibit 7

Provisional adjustments required to budgets for Carer's Allowance for 2018/19

Adjustment	Block grant addition	Scottish CA	Net effect
Original budget figures	£157 million	£157 million	£0 million net effect on budget
In-year adjustment impacting the 2018/19 budget	Not in operation in 2018/19	Scottish CA spending £5 million less than budgeted	Scottish spending decreases by £5 million
Future adjustment impacting the 2020/21 budget	Block grant addition changes by £0 million	No change	Scottish budget changes by £0 million
Net effect of 2018/19 outturns on budgets	Block grant addition changes by £0 million	Scottish CA spending £5 million less than budgeted	Scottish spending decreases by £5 million
Provisional outturn figures	£157 million	£152 million	+£5 million net effect on budget

Source: Audit Scotland; Fiscal Framework Outturn Report, September 2019

Scottish income tax

31. During 2018/19 there was no adjustment to the budget for Scottish income tax outturns and the budget available remained as determined by revenue and BGA forecasts for the year. Unlike fully devolved taxes, there is approximately a 15-month delay in receiving outturn figures and then a further period until any adjustments are applied to subsequent budgets. HMRC continues to collect income tax across the UK and is responsible for separately identifying the amounts that relate to Scottish taxpayers. Outturn figures for 2018/19 will be published by HMRC in July 2020 and will be reconciled through the 2021/22 budget.
32. Outturn figures for 2017/18, the first year that Scottish income tax operated, were published in July 2019 alongside outturn income tax information for the rest of the UK and the final BGA.

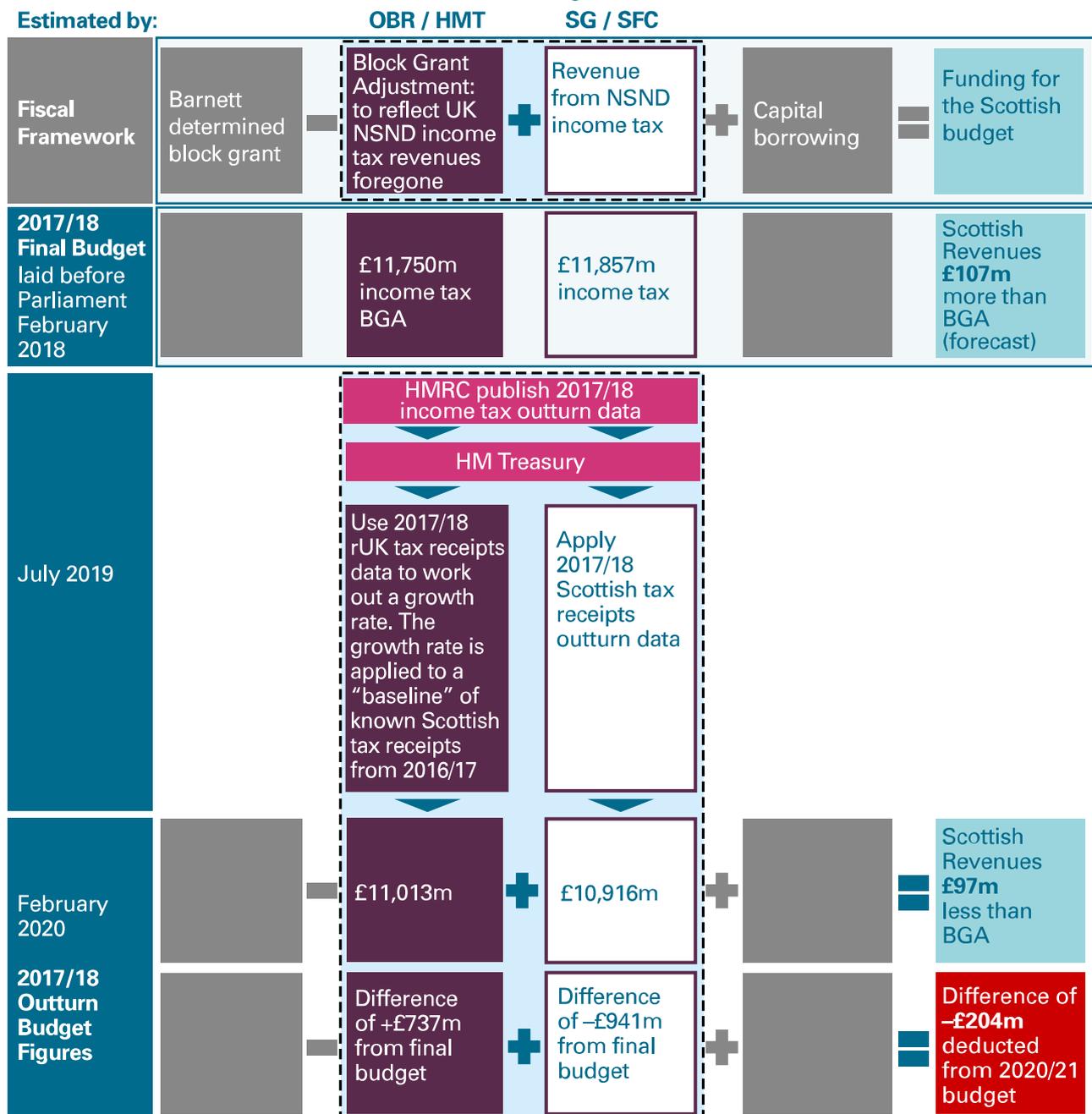
The net difference between outturns and the forecasts used to determine the 2017/18 budget will be corrected (reconciled) by reducing the 2020/21 budget by £204 million (Exhibit 8).

- 33. Scottish income tax makes up a considerable proportion of the Scottish budget. As it is a larger tax, small percentage differences in outturn figures to forecast jnts can make a large difference to future budgets. The Scottish Government must manage this over time.

Exhibit 8

How the 2017/18 NSND Scottish income tax budget adjustment was calculated

£204 million will be deducted from the 2020/21 budget as a result of the 2017/18 tax outturn



Note: Final budget refers to the figures following the Spring Budget Revision.

Source: Audit Scotland. Figures used are from the Fiscal Framework Outturn Report, September 2019

Reserves and borrowing powers used in 2018/19

The Scotland Reserve

34. The Scotland Reserve was introduced in 2017/18, allowing the Scottish Government to carry forward fiscal resource and capital funding to future years. A maximum of £250 million of Resource and £100 million of Capital can be drawn from the Scotland Reserve in any year to be applied as part of the Scottish budget, either to fund commitments or as a buffer mechanism to manage increased volatility in the Scottish budget between years. The Reserve is capped at £700 million in total.
35. In 2018/19, the Scottish Government drew on £250 million of Resource and £22 million of capital from the Scotland Reserve ([Exhibit 9](#)). The Scottish Government added £301.5 million to the Scotland Reserve during the year. The balance as of the end of 2018/19 within the Reserve was £567.5 million. All amounts were within the Fiscal Framework limits.

Exhibit 9

Breakdown of reserves between revenue and capital

The Scotland Reserve operated within the limits set in the Fiscal Framework in 2018/19

	Resource	Capital	Financial transactions	Total
Scotland Reserve at 31/3/18	440.1	86.5	11.4	538.0
2018/19 drawdowns	-250.0	-22.0		-272.0
Additions to reserve during 2018/19 (Exhibit 3)	179.3	0.8	121.4	301.5
Closing balance at 31/3/19	369.4	65.3	132.8	567.5

Note: the annual limit for capital applies to both capital reserves and Financial transactions capital reserves

Source: Audit Scotland

36. There was some flexibility in 2018/19 about how the Scottish Government and UK Government applied the rules of the Fiscal Framework in respect of the Scotland Reserve. Barnett consequentials totalling £148 million were received late in 2018/19. The Scottish Government agreed with HM Treasury that it was not required to carry this funding forward through the Scotland Reserve, rather this will be held within UK reserves and re-allocated to the Scottish Government in 2019/20.
37. While this funding could have been added to the Scotland Reserve while staying within the £700 million limit (as [Exhibit 10](#) shows), this would have had implications for budgeted spending in 2019/20. Because the £148 million is not included in the Scotland Reserve but instead added to the 2019/20 block grant, the Scottish Government can spend this funding in 2019/20 as well as drawing down £250 million the Scotland Reserve. If the amounts had been carried in the Scotland Reserve, the Scottish Government would only have been able to draw down the £250 million, with the £148 million effectively left tied up in the reserve for use in future years.

38. It is not clear the extent to which the Scottish and UK Governments might agree similar flexibilities in the future. The OBR noted in its Fiscal Risks report in July 2019 that fiscal pressure from a devolved administration could lead to spending allocations being topped up. It states there are “early signs that this might be true for Scottish and Welsh devolution, despite the fiscal frameworks”.²

Capital borrowing

39. The Scottish Government has been able to undertake capital borrowing since 2015/16. This borrowing is limited to £450 million each year and total borrowing stock (the total amount of borrowing across years, less repayments made) to £3 billion.
40. In 2017/18 the Scottish Government borrowed the full £450 million. In 2018/19 the Scottish Government budgeted to draw down £450 million but drew down £250 million in-year. The Scottish Government reported that this was due to additional capital funding confirmed in year, and lower than expected demand for funding from projects in the 2018/19 budget. The £250 million borrowed in 2018/19 is to be repaid over 10 years, the normal term of the Fiscal Framework. Borrowing in 2017/18 was over 25 years, following agreement from HM Treasury.
41. As of the end of 2018/19, the Scottish Government has 58 percent of its borrowing limit still available as per the Fiscal Framework. ([Exhibit 10](#))

Exhibit 10

Scottish Government capital borrowing

£ million	2015/16	2016/17	2017/18	2018/19	Total
Borrowing					
Notional borrowing	283	333			616
Cash borrowing 2017/18 onwards			450	250	700
Total borrowing					1,316
Repayments					
Reduction in notional borrowing		9.4	20.5	20.5	50.4
Borrowing repayments				7.1	7.1
Total repayments					57.5
Net borrowing					1,258.5
Borrowing remaining under limit					1,741.5
Borrowing remaining as share of limit					58%

Source: Fiscal Framework Outturn report; Audit Scotland.

Note: Notional borrowing was not cash borrowing for capital purposes as envisaged in the Fiscal Framework. It is borrowing agreed with HM Treasury to offset the technical impact of ONS reclassification of Non-Profit Distributing investment projects as public-sector projects.

² Fiscal Risks Report, Office of Budget Responsibility, July 2019

Resource borrowing

42. Under the Fiscal Framework, the Scottish Government can choose to borrow to bridge short-term gaps in its resource budget through resource borrowing. This can be used for in-year cash management, forecast error, and following any Scotland-specific to economic shock (this only applies under certain economic conditions and cannot be used to stimulate the economy). Limits apply to the use of each resource borrowing power. There is an annual limit to resource borrowing of £600 million, and an overall limit of £1,750 million.
43. These provisions are designed to help smooth the increased volatility that arises from the range of tax and spending provisions included in the 2016 Act. They do not enable the Scottish Government to operate a fiscal deficit to stimulate economic demand or to maintain underlying spending beyond the level supported by the available funding. No resource borrowing was undertaken in 2018/19, and this facility has not been used at all to date.

Main components yet to be implemented

44. While many of the provisions of the 2012 and 2016 Acts are now in place as set out above there remain a number of critical components that remain to be implemented, including:
 - **VAT assignment:** receipts from the first 10p of the standard rate of VAT and the first 2.5p of the reduced rate of VAT in Scotland are due to be assigned to the Scottish Government from 2020/21. This assignment is to be based on a methodology that will estimate expenditure in Scotland on goods and services that are liable for VAT. In May 2019, the Cabinet Secretary for Finance, Economy and Fair Work wrote to the Chief Secretary to the Treasury proposing that it be delayed and considered further at the time of the review of the Fiscal Framework in 2021. In October 2019, the Cabinet Secretary for Finance, Economy and Fair Work told the Finance and Constitution Committee that a response from the UK Government on this issue was imminent.³
 - **Air departure tax:** The Air Departure Tax (Scotland) Act 2017 made provision for air departure tax (ADT) to be Scotland's replacement for UK Air Passenger Duty. In June 2018 it was announced that, the introduction of ADT would be deferred beyond April 2019, so that a solution can be found to the issue of Highlands and Islands State Aid exemption. In April 2019, this was delayed until after April 2020.⁴
 - **Aggregates levy:** The devolution of the aggregates levy had been delayed by ongoing European and domestic legal questions regarding the UK levy. In 2018/19, a consultancy reviewed options for a Scottish specific aggregate levy, which reported to the Scottish Government in March 2019. The legal issues around the UK aggregates levy have now been resolved. The Scottish and UK Governments are in discussions about a review of the UK levy and its implications for the timing of the devolution of the tax.⁵

³ *Official Report, Finance and Constitution Committee*, Scottish Parliament, 2 October 2019.

⁴ *Third Annual Report on the Implementation of the Scotland Act 2016* Scottish Government, 2019.

⁵ *Third Annual Report on the Implementation of the Scotland Act 2016* Scottish Government, 2019.

Part 3. Managing risks to the Scottish budget

Understanding and managing budget risk

45. The Scottish budget now faces a widening range of risks, with a growing proportion of public spending directly funded from taxes raised in Scotland and the devolution of aspects of social security. Understanding these risks and responding effectively is critical to ensuring the affordability of spending decisions and the longer-term sustainability of Scotland's finances.
46. These budget risks affect the level of resources available to enable policy choices about tax and spending. This is often seen in solely negative terms, but over time there may be either downside or upside outcomes. Downside risks increase the pressure on the available public resources, limit the range of tax and spending policy choices available and curtail the effectiveness of the public spending programmes being pursued. Upside risks reduce the pressure on resources, enable a greater range of policy choices and extend the effectiveness of spending programmes.
47. Budget risk also affects the extent to which unexpected changes in available resources may impact on their economic, efficient and effective use. For example, if available funding is significantly less than planned in any financial year, the spending reductions necessary to accommodate this in-year might cause significant disruption to the spending programmes and public bodies affected or lead to unintended consequences. Equally, if available funding is unexpectedly greater than planned this could lead to public money being spent quickly without full value for money being achieved. In both cases the risk of poor value for money decreases the further ahead a change in funding or spending can be anticipated.
48. The Scottish Government is responsible for managing these risks as an integral part of its wider financial management of the Scottish budget. This includes deciding on how to use the tax and spending powers available to it, and how to use the available borrowing and reserve provisions set out in the Fiscal Framework.
49. Risks that arise from the operation of the fiscal framework must be considered alongside the risks that arise from the Scottish Government's wider approach to budget management and spending choices. For example, where the Government plans to use the Scotland Reserve to carry forward significant amounts of budget and spending power from one financial year to the next, this will limit the extent to which the reserve is able to operate as a buffer against unplanned budget pressures. Similarly, the Government may be more reliant on the reserve and borrowing provisions within the fiscal framework to manage volatility where its spending programmes are relatively inflexible.

Forecasting risk

50. Independent forecasts by both the Scottish Fiscal Commission (SFC) and the Office for Budget Responsibility (OBR) are now central to the Scottish budget process. They determine the tax revenues and social security expenditure and corresponding block grant adjustments (BGAs) initially built into each year's budget. Together with the block grant, these forecasts provide the basis for the Scottish Government's spending plans.
51. Forecast error is the difference between what was forecast and what happens. The uncertainties inherent in the forecasting process mean that the actual amounts ('final outturns') will always differ from the initial forecasts, and the Scottish budget will be adjusted to reflect final outturns. The net effect will depend on forecast errors for both devolved revenues (or expenditure) and the corresponding BGA.
52. Critically the effect of forecasting risk will be limited where SFC and OBR forecast errors are correlated, offsetting one another, and significantly greater where they move in opposite directions, amplifying one another.
53. Both SFC and OBR forecasts will inevitably change over time. These changes will reflect updated assessments of anticipated economic performance, updated judgements about impact of Scottish and UK government tax and spending policies, and improved data or methodology in forecast models.

Income tax forecast errors

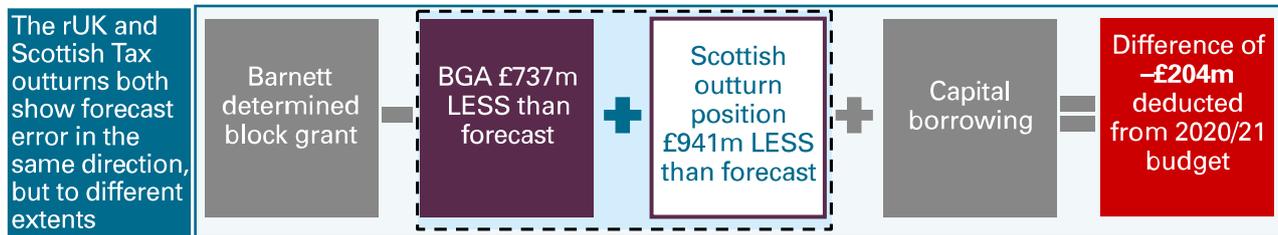
54. In July 2019 HMRC published Scottish income tax outturn data for 2017/18. As detailed in part 2 of this briefing, this will result in a £204 million reduction to the 2020/21 budget to adjust revenues and block grant funding to reflect the tax collected. In September 2019 the SFC reported its assessment of the causes of forecast error.⁶ The BGA and Scottish income tax forecasts errors partially offset each other, mitigating the overall budgetary impact.
55. In May 2019 the SFC updated its income tax forecasts for 2018/19 and 2019/20. Over the three-year period, it is currently expected that revenues included in the Scottish budget will have been overstated by £1,613 million. The BGA is also expected to have been overstated during this time, but by a smaller amount at £613 million ([Exhibit 11](#)). The net effect of this would be to reduce the Scottish budget by £1 billion over the three years from 2020/21 to 2022/23. Outturns for 2018/19 and 2019/20 income tax revenues are still unknown, meaning that these reconciliations to future budgets may be larger or smaller than anticipated. They will be updated when the 2020/21 budget is published.

⁶ *Forecast Evaluation Report*, Scottish Fiscal Commission, September 2019.

Exhibit 11

Tax and BGA forecast errors partially offset each other, limiting budget reconciliations

2017/18 forecasts both overstated income (based on outturns)



2018/19 forecasts both expected to overstate income (based on latest forecasts)



2019/20 forecasts both expected to understate income (based on latest forecasts)



Source: Audit Scotland

Improved taxpayer data

56. Data about the number and income levels of Scottish taxpayers is critical to the accuracy of income tax and BGA forecasts. The original forecasts of the baseline for Scottish income tax in 2016/17 were based on data from the Survey of Personal Incomes (SPI). This is a one to two per cent sample of HMRC's personal tax records. In its May 2018 forecast publication the SFC noted the limitations of using SPI data in the absence of complete Scottish taxpayer outturn information.⁷
57. In summer 2018 the HMRC published outturn data for Scottish taxpayers in 2016/17. This showed:
- the total number of Scottish taxpayers was lower than the previous SPI data had indicated and the revenues from Scottish taxpayers were lower than the SPI estimates had suggested in each taxpayer band
 - the previous overestimation was particularly notable in percentage terms for higher rate and additional rate taxpayers (4.7 percent and 14.2 per cent overestimated respectively).

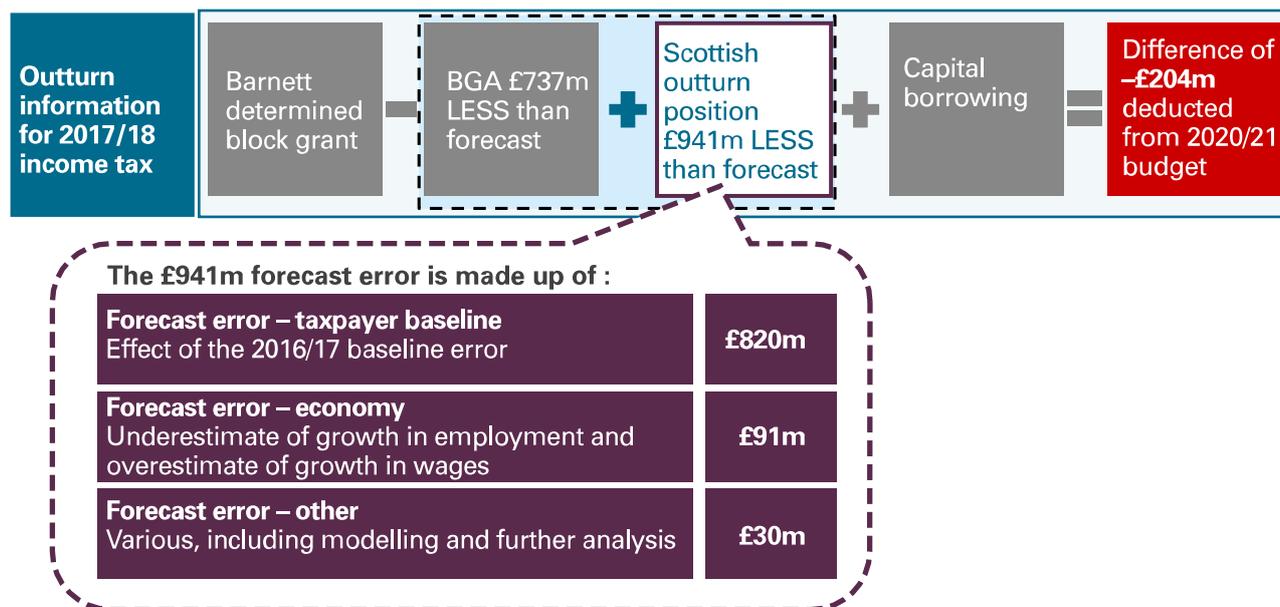
⁷ Scotland's Economic and Fiscal Forecasts, Scottish Fiscal Commission, May 2018.

Relative to the rest of the UK, basic rate taxpayers make up a slightly greater proportion of the taxpayer base compared to SPI estimates.

58. Using the available data, HMRC has calculated that the final outturn for 2016/17 on this basis would have been £10.70 billion, as opposed to the original forecast of £11.5 billion. The SFC stated that this contributed around £820 million to the February 2017 Scottish income tax forecast error for 2017-18 taxes.⁸ Both the 2017/18 and 2018/19 budgets were set using SPI data because these forecasts were prepared before HMRC outturn numbers were published. From 2019/20 the budget has been based on the updated taxpayer baseline.
59. This correction of the Scottish taxpayer baseline was the biggest cause of error for both the forecast of Scottish income tax receipts for 2017/18 and the corresponding BGA. The SFC breaks down the 2017/18 forecast error in its Forecast Evaluation Report. This shows that its original forecast also overstated the position due to economic and methodology factors. (Exhibit 12).

Exhibit 12

Breakdown of the Scottish income tax forecast error for 2017/18



Source: Audit Scotland, based on Forecast Evaluation Report September 2019, Scottish Fiscal Commission

60. SFC forecasts from the 2019/20 budget onwards are based on updated taxpayer base data. Its forecasting models reflect a taxpayer base which includes fewer higher and additional rate tax payers, and proportionately more basic rate taxpayers. The SFC noted in its May 2019 forecast update that significant changes to income tax forecasts since then reflect the number of people in employment and earnings growth.⁹

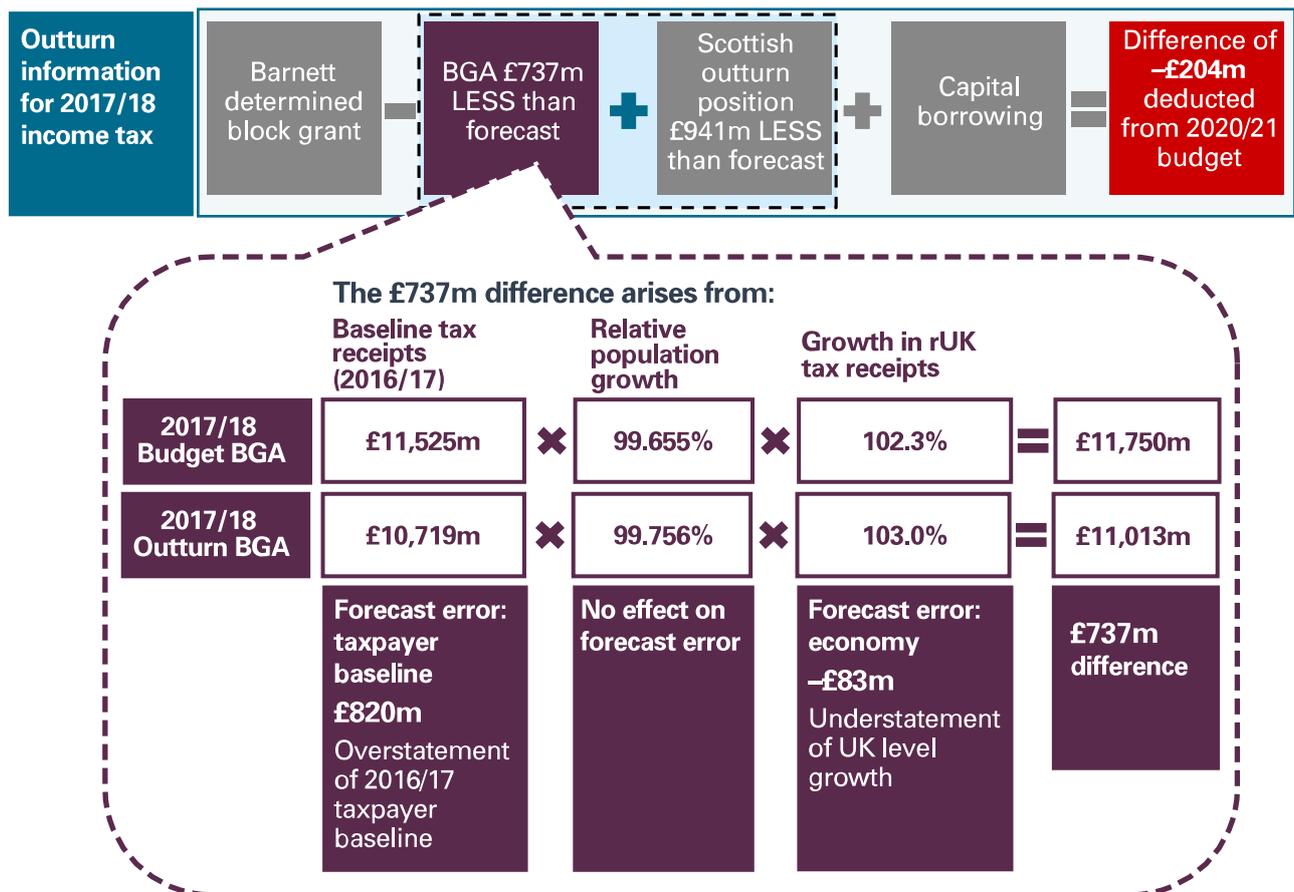
⁸ Forecast Evaluation Report, Scottish Fiscal Commission, September 2019.

⁹ Scotland's Economic and Fiscal Forecasts, Scottish Fiscal Commission, May 2019.

61. Improved taxpayer data will also affect how the SFC forecast the impact of future policy changes across the different tax bands, for example:
- the amount of additional revenue that would be generated by any increase in higher rate taxpayer band's tax rates
 - the reduction in revenue from basic rate payers that would result from changes to personal allowance rates.
62. The correction of the Scottish taxpayer baseline also affected the BGA forecast error, entirely offsetting the effect of the error in revenues on the Scottish budget. The net reduction in the BGA was less because growth in UK Government tax receipts was initially underestimated (Exhibit 13). The overall reduction to the 2020/21 budget of £204 million resulting from 2017/18 income tax outturns is therefore largely because:
- The growth in Scottish tax receipts was less than originally forecast
 - The growth in UK level tax receipts was greater than originally forecast.

Exhibit 13

Breakdown of the BGA forecast error for 2017/18



Source: Block Grant Transparency, HM Treasury, December 2018; Scottish Income Tax Experimental Statistics, HMRC, July 2019; Audit Scotland

Developments in approach to forecasting

63. A key aspect of the process is for forecasters to be able to evaluate their forecasts, learn from this and refine their methodologies and judgements. This can be expected to improve forecasts and reduce this aspect of forecasting risk over time. In the current period of significant economic uncertainty forecasting is inherently more challenging, and the risk of significant forecasting errors increases. It is also very difficult for forecasters to anticipate structural changes to the economy, such as those caused by the 2008 financial crisis.
64. In its 2019 Forecast evaluation report the Scottish Fiscal Commission comment that “now that we can base our forecasts on outturn data, our forecast accuracy has improved significantly”. It also highlights other areas where forecast error has been improved through better data and information, such as forecasts of job outcomes and other analysis of forecasting methodology.
65. In its Statement of Data Needs for 2019 the SFC highlights “encouraging improvements in both the range and quality of Scottish economic data available” including better breakdowns of Scottish GDP and household income from Scottish Government and a revised Memorandum of Understanding (MoU) with HMRC formalising some of its latest data requirements. All of this helps in developing improved forecasts but forecast error can never be eliminated. For example, the OBR’s average two-year ahead forecast error is 5.8 per cent.¹⁰
66. While the forecasting risk related to established taxes might be expected to reduce over time, forecasting risk for newly introduced aspects of the Fiscal Framework is likely to remain significant. In particular VAT assignment and expansion of devolved social security benefits will bring significant forecasting risk, as a result of absence of historical data and the difficulty in making judgements about the costs of Scottish Government policy reforms to benefits.
67. VAT receipts will be assigned on an estimated basis and the methodology is yet to be finalised. VAT presents unique difficulties for forecasting, because actual outturn figures of Scottish VAT cannot be produced; the estimates themselves will be updated and used for future reconciliations. The SFC has commented on the limited forecast history and information available to analyse VAT assignment estimates, which they view as a risk to the Scottish budget.¹¹
68. HMRC published its initial VAT assignment estimate for 2011 to 2016 in May 2019,¹² which the SFC included in its May forecasts. The SFC did not include VAT assignment in its September 2019 Forecast Evaluation Report, because of the limited forecast history and data available up to its last forecast and ongoing uncertainty about when VAT assignment will be implemented.
69. Devolved social security benefits spending will grow substantially between now and 2020/21. As set out in part 2 of this paper, reconciliations for benefits powers had a limited effect in the 2018/19 year, but the potential impact will increase significantly as further powers are

¹⁰ *Forecast Evaluation Report*, Scottish Fiscal Commission, September 2019.

¹¹ *Scotland’s Economic and Fiscal Forecasts*, Scottish Fiscal Commission, May 2019.

¹² *Scottish VAT assignment Experimental Statistics*, HMRC, May 2019.

devolved. The SFC note that current forecasts are based on limited historical data, with uncertainty about future policy plans. It has requested more detailed information to support forecasts.

Economic performance risk

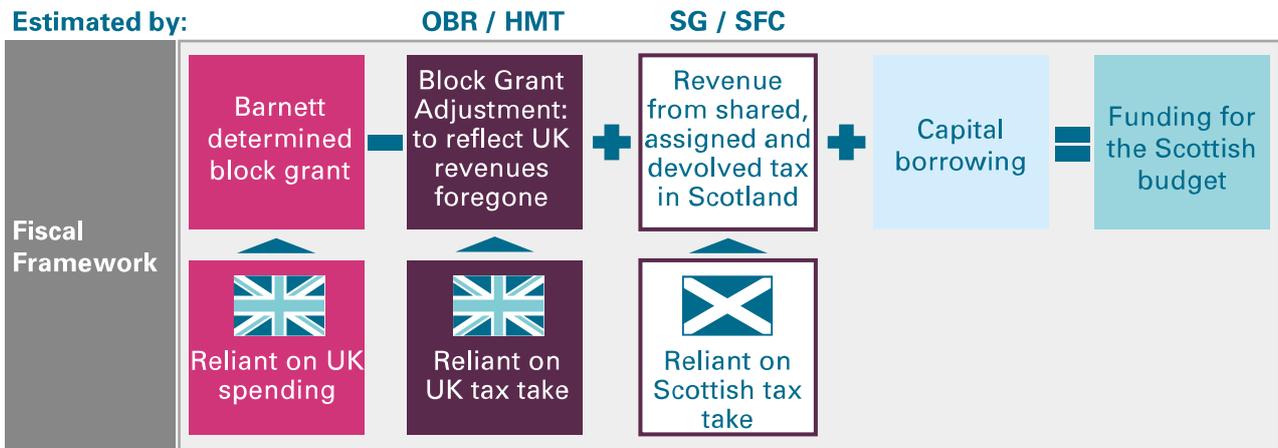
70. The Fiscal Framework is intended to incentivise the Scottish Government to increase economic growth. Where the Scottish economy is performing relatively well, tax revenues will be higher and pressures on spending will ease. Where it performs relatively less well the effect will be to squeeze the budget, reducing available funding and increasing spending demands. Because economic growth is affected by a complex range of factors, many of which are not directly related to government policies, the closer link between economic activity and public finances will mean greater year-to-year changes in available budgets are likely.
71. Economic performance risk is the extent to which Scotland's economic growth will affect the budget available to the Scottish Government to pursue its policy objectives. The extent of this risk will grow as further components of the Fiscal Framework come on stream, particularly the future £5.9 billion VAT assignment and around £3.6 billion of social security spending by 2020/21.
72. Economic performance also affects the demands placed on public sector spending programmes. The devolution of social security powers will increase this effect. Where the economy is doing less well, it is likely that these spending pressures will be higher, even where the policy response remains unchanged. The overall effect is that the Scottish budget is now more closely linked to Scotland's economic performance relative to the rest of the UK.

The relative taxpayer bases in Scotland and the rest of the UK

73. Economic growth affects income tax revenues in both Scotland and the rest of the UK. The net impact on the Scottish budget is driven by the relative per capita growth in the tax base between Scotland and the rest of the UK ([Exhibit 14](#)).

Exhibit 14

The relationship between Scottish and rest of the UK performance on the budget



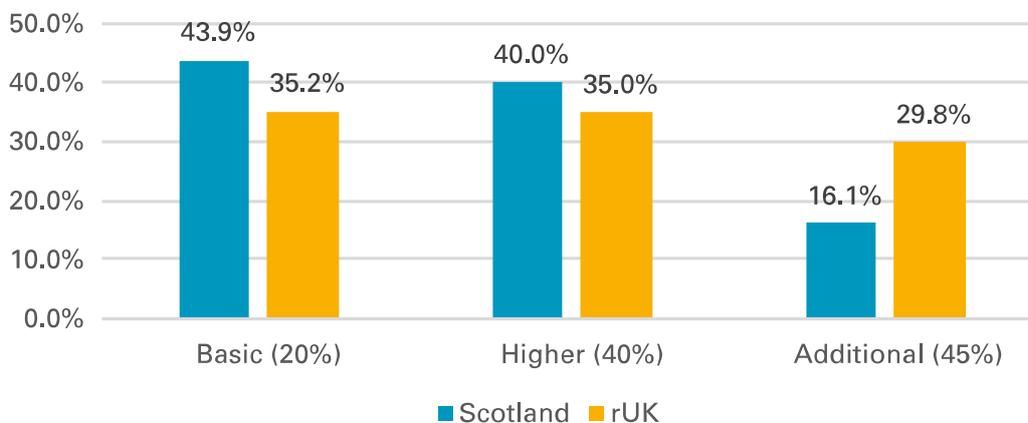
Source: Audit Scotland

74. The make-up of the Scottish taxpayer base relative to the rest of the UK is a significant driver of how this operates in practice. Scottish income tax outturn statistics for 2017/18 (Exhibit 15) show that as a proportion of its income tax receipts:
- the Scottish Government has a higher proportion of its receipts from basic and higher rate tax payers
 - the UK government has a higher proportion of its receipts from additional rate taxpayers.

Exhibit 15

The shape of the taxpayer base relative to the shape of the rest of the UK taxpayer base

The proportion of overall income tax contributed by basic and higher rate taxpayers in Scotland is higher than in the rest of the UK



Source: Scottish income tax outturn figures, HMRC July 2019

75. As well as generating different proportions of tax receipts, the underlying number of taxpayers by band in Scotland and rest of the UK is also different. Most notably, additional rate taxpayers in the rest of the UK account for 1.1 per cent of taxpayers (308,000 taxpayers) compared to 0.5 per cent (13,800 taxpayers) in Scotland.
76. If growth in the economy leads to tax receipts more heavily linked to the incomes of people in a particular tax band, this would affect Scottish and rest of the UK tax receipts differently. For example:
- If growth in the UK as a whole is linked to increases in tax from additional rate taxpayers, the rest of the UK may benefit disproportionately compared to Scotland. Greater relative UK tax growth would increase the BGA more than the corresponding increase in Scottish tax receipts, and reduce the Scottish budget
 - If growth is linked to increases in taxes from basic rate taxpayers, Scottish tax receipts could increase faster than the corresponding BGA, increasing the Scottish budget.

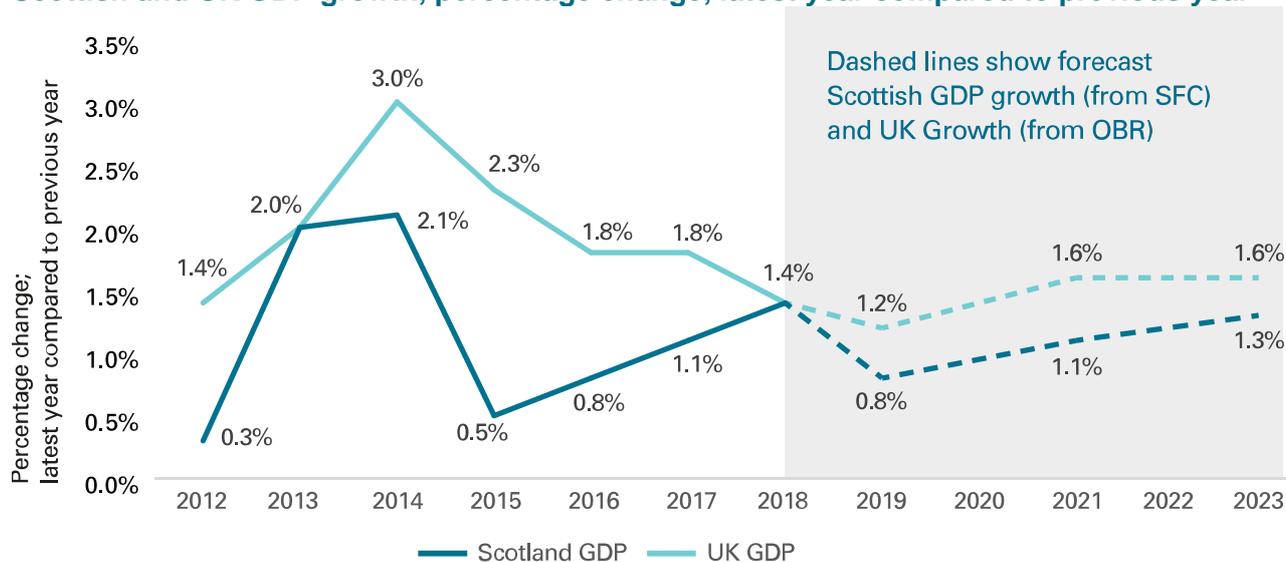
Structural and cyclical differences

77. Changes during an economic cycle can produce budget volatility between years. The economic cycles of the Scottish economy and the economic cycles for the rest of UK may be different. There may also be structural differences between the Scottish economy and the rest of the UK economy. Where differences in growth rates between Scotland and rest of the UK continue in the same direction over an extended period, the cumulative impact on future Scottish budgets will be increasingly significant. The effects of differential tax growth may become more significant once other taxes are devolved and, notably, once VAT is assigned.
78. Understanding and monitoring trends in the Scottish and UK economies is important when considering the potential impact on Scottish revenues and demand-led spending. As well as historic growth data, SFC and OBR forecast analysis provides a helpful insight into the underlying factors affecting the relative economies.
79. Scottish relative performance has improved since 2016, moving towards a convergence in 2018. This reflects a strengthening Scottish growth and weakening UK GDP growth. Based on the most recent forecasts by the SFC and OBR,¹³ Scottish GDP growth will reach 1.3 per cent in 2024, while UK GDP is forecast to increase from 1.2 per cent to 1.6 per cent over the same period ([Exhibit 16](#)).

¹³ *Scotland's Economic and Fiscal Forecasts* (Table 6), Scottish Fiscal Commission, May 2019; and *OBR Economic and Fiscal Outlook* (Table 1.1), March 2019.

Exhibit 16

Scottish and UK GDP growth, percentage change, latest year compared to previous year



Source: Scottish Government, *Quarterly National Accounts Scotland August 2019*; *Scotland's Economic and Fiscal Forecasts, May 2019*; OBR *Economic and Fiscal Outlook, March 2019*

80. UK GDP is due to grow more quickly than Scottish GDP, but it is not clear to what extent this will flow through to net tax revenues. Under the Fiscal Framework, the *per capita* economic and tax receipts growth ultimately affects Scottish budgets, as the relative population is included as part of the BGA calculation. The Fraser of Allander Institute notes that a significant proportion of Scotland's long-term growth gap compared to the rest of the UK can be explained by population growth.¹⁴
81. While the BGA calculation accounts for population change, this is based on overall population figures, not the income tax paying population (the size of the taxpayer base). It also does not account for the distribution of tax bands in this working population. Managing economic risk will therefore involve understanding the relationship between changes in the economy over time and the makeup and size of the taxpayer population, which drives tax receipts.

Relative responses to economic uncertainty

82. Economic uncertainty will apply to both the Scottish and rest of the UK economies. This includes external economic events such as EU Withdrawal or changes in the global economy. The relative extent to which they are affected, and how well they each respond will impact future budgets. If the Scottish economy responds more quickly to economic events, and Scottish tax receipts grow or recover faster than UK tax growth, the Scottish budget will benefit. Should the UK economy and tax receipts grow or recover more quickly, the opposite will be the case.
83. While the Scottish and UK economies are broadly similar, there are some structural differences. Changes that disproportionately affect one sector of the economy could affect

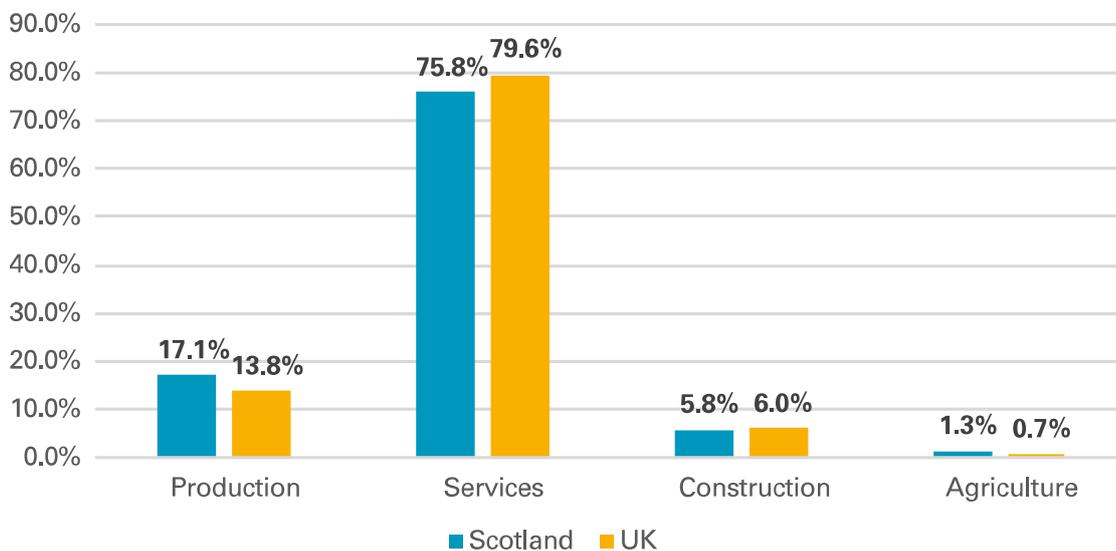
¹⁴ *Economic Commentary*, Fraser of Allander Institute, June 2019.

Scottish and rest of the UK growth differently. For example, the UK economy is slightly more reliant on the services sector, and the Scottish economy on the production sector (which includes manufacturing, electricity and gas supply and food and drink) (Exhibit 17). If the production sector grows at both a Scottish and UK level, this could benefit Scotland more as it is a larger proportion of the overall economy. The opposite could apply if future growth comes predominantly from the services sector.

Exhibit 17

Structure of the Scottish and UK economies by main industry sector

The industry structure of the Scottish and UK economies is broadly similar with the production sector making up a slightly greater proportion of the Scottish economy and the service sector a slightly smaller proportion



Source: Quarterly National Accounts Scotland August 2019

84. A significant source of current economic uncertainty is the potential impact of EU withdrawal. The Fraser of Allander Institute identified six broad channels through which EU withdrawal could have an impact on the Scottish economy:¹⁵
- Exports
 - Supply chains, including imports
 - International investment
 - The labour market (including EU workers and students)
 - The policy and regulatory environment
 - Short-term uncertainty.
85. The Scottish economy may be different to the rest of the UK in other ways, such as proportion of SMEs or sole traders in the relative economies. The Scottish Government will need to understand the nature of these differences and how this affects tax receipts and economic

¹⁵ *Brexit and the sectors of the Scottish economy - Update*, Fraser of Allander Institute, April 2019.

growth respectively. This will help the Scottish Government to monitor how its economic plan is influencing the tax base as well as planning for future economic uncertainty.

- 86. While these factors will affect both Scotland and the rest of the UK, the relative impact may vary depending on underlying differences in the two economies. Part of budget management will be to consider how these factors will impact the Scottish economy relative to the UK as events unfold.

Policy risk

- 87. The way that block grant adjustments for both taxes and social security operate means that different tax and spending policy choices in Scotland compared to the rest of the UK directly affect the Scottish budget. Clearly, if the Scottish Government changes its own policies to raise more or less taxes, or to spend more or less on social security, the budget is affected. But UK policy changes in relation to non-savings non-dividend (NSND) income tax, devolved taxes and social security spending also have a direct effect on the Scottish budget. Where policy choices are more volatile and uncertain, this will make the Scottish Government’s management of the budget much more challenging.
- 88. For example, all else being equal, if the UK Government decided to raise UK tax rates in a devolved area, such as by changing the basic rate of income tax, and the Scottish Government retained its existing rates, the overall Scottish budget would be less as a result. Maintaining the status quo between Scotland and the rest of the UK through the Fiscal Framework now means matching UK Government tax and social security policy. Policy divergence occur where either the UK Government or the Scottish Government choose a different tax policy.
- 89. Where tax or social security policy diverges, these differences are integrated into forecasts and reflected in the Scottish budget. The Scottish Fiscal Commission calculates these “policy costings” in its Economic and Fiscal Forecasts. [Exhibit 18](#) sets out two examples of the forecast effect of recent income tax policy changes.

Exhibit 18
Examples of the impact of tax policy divergence between the UK and Scottish governments



Source: Audit Scotland

90. The additional revenue shown is for the initial budget year. The additional revenue arising from differences between Scottish and UK tax policies will also increase future years' budgets, up until any future point at which the tax policies are aligned. The Scottish Government must manage the implications for its budget of any relevant UK policy changes alongside its own policy decisions. Greater uncertainty about future UK Government policy in devolved areas potentially increases policy risk for the Scottish budget.

Policy interactions

91. UK Government spending decisions, which affect the block grant, will change the Scottish budget differently dependent on whether or not they are funded through devolved taxes. Where UK Government spending decisions are funded by increasing a tax devolved to Scotland, the Scottish Government must decide whether to match the tax increase to prevent the Barnett consequential being offset by a higher BGA.
92. Where UK spending increases are funded through "fiscal headroom" (which is effectively additional UK government borrowing) these spending decisions will result in additional Barnett consequential only, directly increasing the Scottish budget. This is expected to be the case for the increased spending announced by the UK Government in September 2019.
93. Decisions taken by the UK Government about the mix of tax and spending measures between reserved and devolved areas may also have a disproportionate effect on the Scottish budget. For example, a shift in tax raising between personal and corporate taxes that is budget neutral at a UK level would affect the Scottish budget. This is because the BGA associated with income tax would be affected, but there would be no change to the block grant itself as UK spending would be unaffected.
94. The OBR has stated that "corporation tax from small companies is expected to grow strongly over the forecast period. This reflects the rising trend in incorporations, although the reform to off-payroll working in the private sector is expected to temper this rise."¹⁶ The Scottish Fiscal Commission, using modelling outputs from HMRC, estimated that tax motivated incorporations will reduce its income tax forecast by £93 million in 2018/19 rising to £555 million by 2024/25.¹⁷ Because corporation tax is not devolved, this may have a more direct impact on Scottish tax receipts, as lower personal taxes will not be offset by increased taxes in other areas in the same way they are at a UK government level. Because no breakdown of this at a UK level is currently available, it is unclear what the overall impact of increasing levels of incorporations will be on the Scottish budget.
95. Scottish taxpayers can be affected by the way in which Scottish and UK policies interact. In 2019/20, the Scottish Government kept the higher rate threshold at £43,430 while the UK government increased this to £50,000. As National Insurance is not devolved, the reduced rate of 2 per cent only applies from the UK threshold of £50,000. This means that Scottish taxpayers pay a total of 53 per cent in income tax and National Insurance (41 per cent plus

¹⁶ *Economic and Fiscal Outlook*, Office for Budget Responsibility, October 2018.

¹⁷ *Scotland's Economic and Fiscal Forecasts*, Scottish Fiscal Commission, May 2019.

standard rate of 12 per cent NI) between these two thresholds. Comparably, a UK taxpayer pays 32 per cent (20 per cent income tax and 12 per cent NI).

96. While this does not affect the Scottish budget directly, any further tax policy divergence relating to the higher threshold could make this issue more pronounced. Currently, the Scottish Fiscal Commission forecasts that the overall effect of policy divergence on tax behaviour (such as increasing pension contributions, leaving Scotland or not moving to Scotland from elsewhere in the UK) is relatively small. The policy risk is that greater divergence by either Scottish or UK governments could increase tax-motivated behaviour change.

Social security baselines

97. Block grant additions for social security benefits are based on the UK benefits policy at the point the baseline is established. The UK Government is currently undertaking a multi-year benefit reform programme. If the UK Government changes spending on benefits that are devolved, the Scottish Government would need to consider the impact on its budget of diverging from this policy. The extent to which UK Government future reforms affect block grant additions baselines at the point social security entitlements are devolved is unclear. This makes budget planning more difficult.
98. The relative take-up rate of social security benefits in Scotland matters; if there is more take-up of demand-led devolved benefits in Scotland compared to the rest of the UK, a change in the UK policy could disproportionately affect the Scottish budget. For example, if the Scottish Government matched a UK policy increase, and demand for benefits was higher in Scotland, the additional cost would be greater than the increased block grant addition. If the UK policy was to reduce benefits payments, and the Scottish Government matches this policy, the Scottish budget could benefit.
99. The Scottish Government introduced a Carer's Allowance Supplement, paid alongside the UK-wide Carer's Allowance. The Social Security (Scotland) Act 2018, states that Carer's Allowance Supplement is equal to the difference between Jobseekers Allowance indexed annually for inflation and Carer's Allowance. The supplement is funded by the Scottish budget solely; there is no block grant addition for this. There are two separate policy risks arising from this:
- The UK Government changes the Jobseekers allowance rate - for example, a significant increase in JSA would increase the Carer's Allowance Supplement required to be funded from the Scottish Budget
 - The UK Government changes the Carer's Allowance rate - for example, a UK Government increase in the Carer's Allowance would reduce the expected supplement required to meet the JSA rate.
100. As a consequence, policy risk for social security can be affected by both direct changes in the relative UK policy, but also any other UK-level policies which the Scottish Government links its devolved benefits to in future.

Budget management risk

- 101.** As described above, a lot of moving parts now affect the Scottish budget. Each carries a degree of risk and uncertain financial impact. Because the budget process is more complex, and subject to greater uncertainty and volatility, the Scottish Government has to manage its financial position closely. This will include planning for the changes that will affect the budget across current and future years and responding to unexpected events.
- 102.** The extent of the budget management challenge in any one year depends on the interaction of all the factors affecting the Scottish budget. Where various risks crystallise in a way that the effects offset one another, the overall impact may be limited. If the effects are predominantly in one direction, the aggregate effects may be significant and more difficult to manage.

Planning and monitoring

- 103.** The Scottish Government is developing its financial management arrangements in response to the fundamental changes to the Scottish public finances. The more effective that its decision making, planning and monitoring arrangements are, the more able it will be to manage the risks to the Scottish budget. We have previously highlighted this requires a strategic, longer-term approach. Good in-year monitoring and decision making is also becoming increasingly important.
- 104.** The Scottish Parliament also requires good-quality information to enable effective scrutiny of the Scottish Government's budget. 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.
- 105.** We report regularly on the Scottish Government's progress in developing its financial management and reporting through our audits. In September 2019 the Auditor General reported on the Scottish Government's second medium-term financial strategy, Scotland's Fiscal Outlook, which was published in May 2019. She highlighted that:
- the 2019 strategy now includes principles and policies on reserves and borrowing powers. This is a positive step and will help to improve the transparency of decision-making on the capital programme such as the level, type and timing of borrowing, and will support a more transparent approach in managing the Scotland Reserve.
 - the strategy does not reflect some basic components of a medium-term financial plan, with no detail provided about how the Scottish Government plans to address the possible £1 billion reduction in budgets as a result of income tax reconciliations if these were to materialise. There is also little evidence to demonstrate that the strategy is a key component of the government's financial decision-making. Overall, the 2019 strategy represents a missed opportunity and a step backwards for the Scottish Government's

financial reporting. The absence of high-level financial plans, priorities and scenarios will make the Parliament's scrutiny of the forthcoming 2020/21 budget more difficult.¹⁸

Controlling spending

106. The Scottish Government has required to manage a balanced budget since the inception of the Scottish Parliament. It has been important to control overall expenditure effectively against overall spending limits throughout this period. The Auditor General reported that the Scottish Government's budget management during 2018/19 was effective in managing total spending.¹⁹
107. As the Scottish budget becomes increasingly uncertain and volatile, it will become more challenging to match spending to the available funding in any one year. A key aspect of the Scottish Government's ability to do this will be the nature of its spending programmes and how easily it is able to control these sufficiently in the short term. This may mean accelerating some programmes if more funding is available than expected or restricting spending on some programmes if funding is tighter than anticipated.
108. This will need to be done in a way that minimises the disruption to individual public bodies and services, ensures value for money is maintained and avoids unintended consequences. The greater the unplanned variation in budgets that needs to be accommodated, the more difficult it will be to achieve this.
109. Much of the public spending incorporated in the Scottish budget is for areas such as staff costs that are very difficult to change quickly. Increasingly the Scottish Government will need to understand where it is most able to quickly alter spending, and understand what options are available to it in responding to budget fluctuations. It will also need to be increasingly clear in the design and planning of its spending programmes how it expects to accommodate year-to-year volatility by flexing its spending. Public bodies are also likely to need to budget more flexibly as a result.
110. The extent of flexibility within budgets is constrained by the extent of long-term financial commitments created as a result of the previous decisions and activities of the Scottish Parliament and Government. For example, borrowing must be repaid as agreed, contractual commitments must be met and liabilities that may arise from legal claims in relation to past actions need to be covered. The Government will also wish to ensure that it can deliver on its political commitments and priorities.
111. A more complete understanding of how much money has been committed across all devolved public services to long-term investment is important when taking decisions about future tax and spending. The Scottish Government has committed to producing a consolidated account to cover the whole public sector in Scotland, including total assets, investments and liabilities such as local government borrowing and public-sector pension liabilities. This is important for

¹⁸ *The 2018/19 audit of the Scottish Government Consolidated Accounts*, Auditor General for Scotland, September 2019

¹⁹ *Ibid.*

decision making over the longer term as it will provide important information about the impact of past decisions across the Scottish public sector on future budgets, the scale of liabilities, and potential risks to financial sustainability. The Auditor General recently reported that the Scottish Government needs to quicken the pace of its development of this account and should aim to finalise it for audit by the end of the 2019/20 financial year.²⁰

Using the flexibilities in the Fiscal Framework

112. The flexibilities in the Fiscal framework, including resource borrowing facilities and use of the Scotland Reserve, are designed to help the Scottish Government to manage its budget position effectively. How well these powers enable the Scottish Government to respond to budget pressures depends on how such pressures develop. The Scotland Reserve and resource borrowing powers are predominantly designed to manage year-on-year fluctuations. They do not insulate the Scottish budget from structural effects over a number of years.
113. As VAT assignment and further devolved social security benefits are introduced, and as income tax outturns play through, the risks for budget management increase. Until now the Scottish Government has been able to use the Scotland Reserve to manage the volatility between years. The first significant challenge to this approach comes with the 2017/18 outturn data requiring a reconciliation of £204 million to the 2020/21 budget. Over time the potential extent of budget volatility is likely to grow, and the Scottish Government will need to manage this using the tools available to it (Exhibit 19).

Exhibit 19

Financial management of budget volatility

Use of Scotland Reserve	Max resource drawdown: £250 million Scottish Government approach: use the Scotland Reserve as far as possible to smooth resource funding over time, including in relation to potential reconciliations for income tax.
Resource borrowing	Max borrowing for forecast error: £300 million Scottish Government approach: make repayment terms as short as possible, to minimise servicing costs, subject to smooth resource spending over time.
Budget management – flexing spending	No Scottish Government approach set out.

Source: *Scotland's Fiscal Outlook*, Scottish Government; Audit Scotland

Using the Scotland Reserve to manage budget risk

114. We have previously highlighted the importance of the Scottish Government having a clear policy for how it will operate its reserve. In its May 2019 *Scotland's Fiscal Outlook*, the

²⁰ *The 2018/19 audit of the Scottish Government Consolidated Accounts*, Auditor General for Scotland, September 2019

Scottish Government set out how it will aim to use the Scotland Reserve in the future, balancing the principles of flexibility, stability and value for money. Its approach includes:

- building up the balance in the Scotland Reserve over time, while leaving capacity within the Reserve to be able to manage any underspends across years
- using the Scotland Reserve to smooth resource funding over time and achieve a stable spending trajectory. This includes in relation to reconciliations for Scottish income tax.
- using the Scotland Reserve to minimise the use of more expensive revenue-funded investment and resource borrowing.

115. In both the Scottish budgets for 2017/18 and 2018/19, the Scottish Government was using the Scotland Reserve to support expenditure in the following year. As a consequence, only £16 million of the remaining reserves balance is currently uncommitted (Exhibit 20). If the Scottish Government chooses to use the Scotland Reserve for the £204 million reconciliation required for the 2020/21 budget, no more than £46 million could be used to carry forward spending from 2019/20. This is because the Fiscal Framework limits the amount of resource spending that can be taken from the Scotland Reserve in any one year to £250 million.

Exhibit 20

Breakdown of reserves between revenue and capital

There are limits on the use of the Scotland Reserve by Resource and Capital

	Resource	Capital	FT	Total
Use of reserves in 2018/19				
Scotland Reserve at 31/3/18	440.1	86.5	11.4	538.0
Use of reserves in 2018/19	-250.0	-22.0		-272.0
Additions to reserve during 2018/19 (Exhibit 3)	179.3	0.8	121.4	301.5
Closing balance at 31/3/19	369.4	65.3	132.8	567.5
Planned use of reserves in 2019/20				
Planned use of the Scotland Reserve	-234.0	-65.3	-34.7	-334.0
Uncommitted balance on reserve	135.4	0	98.1	233.5
Remaining headroom for deployment in 2019/20				
Annual limit on reserve use as per Fiscal Framework	250	100*		350
Planned use of the Scotland Reserve	234	100		334
Headroom for deployment in 2019/20	16	0		16

Note: the annual limit for capital applies to both capital reserves and financial transactions capital reserves

Source: Audit Scotland

116. The Scotland Reserve may not always be sufficient alone to manage reconciliations. As set out in the forecasting risk section of this paper, there are indicative downward reconciliations forecast for both 2021/22 and 2022/23 budgets for Scottish income tax outturns. The current forecast reconciliation potentially affecting 2021/22 is £608 million. This could not be managed solely through the Scotland Reserve, and other tools, as set out in [Exhibit 19](#) would need to be used.
117. The Scottish Government will also need to manage risks around the relative levels of capital and resource funds in the Scotland Reserve. The Fiscal Framework does not specify the relative levels of capital and resource that can make up the reserve. However, the Fiscal Framework gives a lower capital limit of £100 million for how much can be released from the Scotland Reserve each year. This includes funding for financial transactions, such as loans made by Scottish Government.
118. Currently almost all the capital funding carried in the Scotland Reserve is financial transactions. This changed significantly during 2018/19. At the start of the year, Financial Transactions funding made up only two per cent of the Reserve balance. By the end of March, it accounted for nearly a quarter, with £121 million added to the Reserve through the year.
119. If the level of capital in the Scotland Reserve increases substantially over time, this may restrict the room left in the reserve for resource funds. As only £100 million of capital can be released each year, this also risks restricting the rate at which the Scottish Government can change the size and capital / resource balance of the reserve to manage future budgets.
120. The Scotland Reserve is likely to face further pressures on its use. As arrangements currently stand, it will also be used to manage transactions for the planned Scottish National Investment Bank. The Scottish Government has requested a derogation from the Fiscal Framework that would allow the bank to manage, retain and carry-forward cash balances over financial year-ends. But this has not yet been agreed. Without this, transactions related to the bank at year end would need to be managed through the Scotland Reserve, which could affect the reserve's ability to manage budget volatility between years. This will become a greater risk once the capitalisation of the bank increases, and once larger, perhaps unexpected transactions around year-end become more likely.

Managing resource borrowing powers

121. The Scottish Government's Scottish Fiscal Outlook sets out its policy on how it will use resource borrowing. It states that it will:
- as a general rule consider the scope for reductions in spending and / or use of the Scotland Reserve first
 - any resource borrowing undertaken will be repaid over a term as short as possible to minimise servicing costs, subject to the need to smooth resource spending over time.²¹

²¹ *Scotland's Fiscal Outlook*, Scottish Government

122. The Scottish Government can use available borrowing powers to help manage budget volatility between years within the limits set out in the Fiscal Framework. The overall annual limit for resource borrowing is £600 million up to a total balance of £1,750 million. Budget management risk will include balancing the relative levels of different types of borrowing required, or not, each year. For example, using borrowing for in-year cash management reduces the amount of borrowing available within the limit for forecast error. Given the expansion of social security benefits to come, in-year cash management of demand-led spending may become more complex. Managing and monitoring the interplay of borrowing purposes therefore becomes increasingly important.

Capital borrowing

123. The Scottish Government can choose to fund part of its overall capital programme from capital borrowing. The Scottish Government set out the key elements of its policies for using capital borrowing in the May 2019 Scotland's Fiscal Outlook. The main policies are:

- The duration of the borrowing will aim to strike a balance between flexibility, value for money, stability, and matching the length of the loan to the life of the asset. Decisions will be made annually, based on current interest rates and the likely impact of borrowing repayments on the resource budget.
- £300 million of the capital borrowing limit will be left unused, to provide flexibility.²²

124. Over the period of the National Infrastructure Mission, the Scottish Government plans to borrow between £250–£450 million annually. The Scottish Government has stated that it aims for infrastructure spending to be £1.56 billion higher in 2025/26 than in 2019/20.²³ The capital budget and capital borrowing alone is unlikely to be sufficient to meet this commitment, and the Scottish Government has recognised that other sources of funding will be required.

125. The Scottish Government borrowed £250 million for capital purposes in 2018/19 against a budget of £450 million. The 2019/20 budget sets out the Government's intention to borrow £450 million. Any underutilisation of borrowing cannot be rolled forward to a future year; the £450 million limit on capital borrowing will apply to each year. If capital borrowing is not used as budgeted, for example, because of slippage in capital spending, budget management will need to consider the impact of this on the overall capital spending programme.

²² *Scotland's Fiscal Outlook*, Scottish Government, May 2019

²³ *Scotland's Fiscal Outlook*, Scottish Government, July 2019

Conclusion

126. In this briefing we have set out how the changes flowing from the 2012 and 2016 Scotland Acts mean greater uncertainty, complexity and volatility for the Scottish budget. With a more direct link between the relative performance of the Scottish economy and the public finances, there are new opportunities and risks for the budget process. And the scope for significant budget adjustments is growing as outturn data for Scottish income tax becomes known and as further social security powers and the assignment of VAT begin to operate.
127. Understanding these budget risks and responding effectively is critical to ensuring the affordability of spending decisions and the longer-term sustainability of Scotland's finances. The way in which these risks crystallise directly affects the level of resources available to enable policy choices about tax and spending. Unexpected changes in available resources could also restrict value for money or lead to unintended consequences for public services.
128. This means effective budget management and scrutiny has never been more important. The Scottish Parliament's new budget process aims to support a strategic approach to considering the effectiveness of taxation and public spending. Transparency about the overall public finances is critical to enable the Parliament and the wider public to see and understand the basis on which decisions are made.
129. The operation of the fiscal framework must be considered alongside the risks that arise from the Scottish Government's wider approach to budget management and spending choices. For example, where the Government plans to use the Scotland Reserve to carry forward significant amounts of budget and spending power from one financial year to the next, this will limit the extent to which the reserve is able to operate as a buffer against unplanned budget pressures. Similarly, the Government may be more reliant on the reserve and borrowing provisions within the fiscal framework to manage volatility where its spending plans and programmes are inflexible.
130. The Scottish Government has published principles and policies on reserves and borrowing powers. This is a positive step and will help to improve the transparency of decision-making on the capital programme such as the level, type and timing of borrowing, and will support a more transparent approach in managing the Scotland Reserve. But it has not yet provided any detail about how it plans to address the possible £1 billion reduction in budgets as a result of income tax reconciliations if these were to materialise. The absence of high-level financial plans, priorities and scenarios will make the Parliament's scrutiny of the forthcoming 2020/21 budget more difficult.
131. We are committed to supporting the Parliament in developing world-class arrangements for holding government to account and improving the use of public money. If you would like more information about Audit Scotland's work on the new financial powers, please contact Mark Taylor, audit director at mtaylor@audit-scotland.gov.uk. All our work in this area is available from our [Financial Devolution e-hub](#).

Scotland's new financial powers

Operation of the Fiscal Framework 2018/19

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

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