

Scottish Parliament Finance and Constitution Committee

Written submission by the Auditor General for Scotland on Scotland's Fiscal Framework

Introduction

1. The Scotland Act 2016 means a substantial increase in the financial powers of the Scottish Parliament. It enables new choices over tax and spending. It also means increased volatility and uncertainty for the Scottish public finances, with a direct link to the relative performance of the Scottish economy. The new powers are coming into force at a time of continuing pressures on public finances, and continuing uncertainty about the implications of the vote to leave the European Union.
2. The accompanying Fiscal Framework is critical to how the new powers in the Act will work. It provides agreed rules for a number of elements of the system, including the block grant adjustment mechanism, borrowing and the new Scotland Reserve. It is underpinned by the wider system for Scottish public finances, including budget processes and financial reporting. It is essential that this system is further developed to reflect increasing fiscal responsibility and increasing financial risk. Work on this is progressing, but there is much to do as new powers are introduced and the Fiscal Framework is fully implemented.
3. I and my colleagues in Audit Scotland are keen to support the Committee's work to monitor the implementation and operation of the framework, and the Parliament's interest in this critical area more generally. We do this by contributing our views on the arrangements as they are developed and through our audit work. This includes the following recent material:
 - In March 2016, I [wrote](#) to the Finance and Devolution (Further Powers) Committees for session 4 setting out some views and observations on the Fiscal Framework in advance of final approval of the Scotland Bill.
 - In September 2016, Audit Scotland published *Scotland's New Financial Powers: Key issues for the Scottish Public Finances*, a [short paper](#) summarising key aspects of the new financial powers and Fiscal Framework, and outlining high level issues for the Scottish public finances that flow from them.
 - In September 2016, I published my [report](#) on the Scottish Government's consolidated accounts for 2015/16. This sets out how the Government's accounts relate to the Scottish Budget as a whole and the new financial powers being introduced, discussing implications for financial management and reporting.
 - I have published two reports on developing financial reporting (in [July 2013](#) and [March 2015](#)). These highlighted that transparent financial reporting of the public finances is an essential component of an updated fiscal framework for Scotland.
4. This paper draws on our work to highlight some of the key considerations for public financial management in Scotland that arise from the new powers and the Fiscal Framework.

Strategic financial management

5. The new powers in the Scotland Acts 2012 and 2016 and the accompanying Fiscal Framework have significant implications for Scotland's public finances and how they are managed and reported. The performance of the Scottish economy relative to the rest of the UK will have a direct impact on Scotland's public finances and the Scottish budget. One of the key challenges will be managing greater volatility of revenues from taxation and demand-led spending, to ensure the public finances remain in good health. The Scottish budget will continue to be tied to UK fiscal policy and UK budget decisions overall.
6. The Fiscal Framework includes a number of provisions aimed at enabling the Scottish Government to manage its finances in this context, including new reserve and borrowing powers. These flexibilities include limits, but choices will need to be made on how they are used and on tax and spending policies more generally. In the event of a Scotland-specific economic shock there is scope to agree a temporary increase in resource borrowing limits. Decisions will need to be made in all these areas based on a good understanding of the consequences for future years and how these sit alongside existing commitments, ensuring the financial sustainability of Scotland's public finances over time.
7. In my view this means that a more strategic approach to public financial management will be needed. This will require a good understanding of the economic and fiscal context in both Scotland and the UK as a whole. It also means joined up thinking across different components - revenues, spending, borrowing and reserves - understanding the manner in which they interact with each other and with economic performance. Finally there will be a need for longer-term thinking and planning, and the development of clear financial strategies and principles for decision making. A critical aspect of this will be balancing the need for short-term flexibility with longer-term direction, clarity and resilience.
8. Key issues are likely to include:
 - the need for an overarching medium-term financial strategy setting out expectations and broad financial plans for a number of years ahead, making the link to anticipated economic performance and the consequences for the block grant, devolved and assigned revenue and spending.
 - the development of clear policies and principles for using, managing and controlling the available financial powers within the context of this overall financial strategy. As a minimum, these are likely to be needed for devolved taxation, capital and resource borrowing and the Scotland Reserve. These could set out high-level targets or limits for key measures in addition to those prescribed in the Fiscal Framework. This is an approach similar to the 5% limit on the resource consequences of capital investment that is currently operated by the Scottish Government. This would provide greater clarity over the Scottish Government's fiscal policy.
 - further developing scenario planning, building on existing work by the Scottish Government for the draft budget 2017/18. This will be increasingly important in assessing the range of potential impacts on the Scottish budget. For example, variations in devolved

tax receipts / block grant adjustments, the impact of UK spending decisions and possible changes to funding flows following the EU referendum.

- improving information and understanding over time about the link between economic performance and the different components of the public finances. This will improve forecasting and financial planning, and help better inform policy choices.
- assessing and keeping under review the long-term sustainability of the public finances, considering the long-term implications of policy decisions, the extent of financial commitments and anticipated changes in the economy, revenues and spending.

Managing financial risk

9. There will be greater complexity, uncertainty and volatility affecting Scottish public finances, as a result of the financial powers being devolved. This comes at a time of high geo-political uncertainty, including the potential impact of the UK decision to leave the EU and the recent US election results. This in-turn raises the level of economic and fiscal uncertainty for the UK and Scottish Governments. Some additional clarity may be provided by the UK Government's autumn statement. But however events proceed, the Scottish Government will need to manage greater uncertainty and financial risk than ever before.
10. Under current arrangements the Scottish Government requires to manage aggregate spending within firm limits. There is a facility to carry forward limited amounts under the budget exchange mechanism. Block grant funding for any one year has been largely predictable and much of the Government's spending has been controllable in the short term. This has meant a focus on controlling aggregate expenditure within annual limits, and ensuring that no potential funding is lost. The Government's budget management has been effective in managing aggregate spending. Existing borrowing facilities for in-year cash management have not been used.
11. Devolution of more tax and social security powers means that both funding and spending is inherently more volatile and less predictable. The Fiscal Framework also makes specific changes to the way in which the overall Scottish public finances need to be managed. The Scotland Reserve will provide a facility to smooth spending, manage tax volatility and determine the timing of expenditure between financial years. New revenue borrowing powers will also be available for in-year cash management or to meet shortfalls against forecasts of devolved or assigned taxes.
12. The Scottish Government will still have to balance the budget annually - drawing on reserves and capital borrowing facilities within the limits set, as it considers appropriate - at the budget setting stage in most circumstances. It can then use the available flexibilities to manage actual spending in-year, including the use of resource borrowing. Only in the case of a Scotland-specific shock will it be able to budget to borrow for resource purposes - essentially running a deficit within the limits of the Fiscal Framework.
13. This significantly broadens the nature of the Government's financial management. It also means much less certainty about budgeting. There will be a greater reliance on forecasts, particularly of tax, block grant adjustments and demand-led expenditure. There will also be a

greater need to track and manage actual revenues and spending, with a greater potential to adjust spending plans either in-year or in future years as forecasts are reconciled to outturn. Finally there will be more choices to be made about how to manage each year's budget position.

14. Key issues are likely to include:

- the increased importance of robust forecasting, both in order to set budgets and to understand the factors affecting the public finances through the year. Tax revenues are inherently unpredictable, and actual receipts are likely to differ from those initially forecast each year. This requires a different approach to budgeting. There is a need to understand the sensitivities of tax and spending forecasts in relation to the budget and block grant adjustments, and how these interact with each other.
- trade-offs between borrowing, reserves and controlling spending in responding to actual demand-led spending and revenues. For example if tax revenues are less than forecast the Government may be able to manage this by using reserves, borrowing, curtailing spending or a combination of these. The ability to do this will depend on the limits set out in the Fiscal Framework and on previous borrowing and reserve decisions.
- clarity about the implications of budget management decisions on future years. For example decisions to borrow will introduce a commitment to repayments and interest in future years that will need to be accommodated until debts are repaid. Alternatively, where the Scotland Reserve is at or close to the £700 million limit in the Fiscal Framework, any further unspent resources could not be paid into it.

Transparency and accountability

15. It will be critical for the Scottish Government to report clearly and objectively on how all parts of the Fiscal Framework operate in practice, and on the overall picture. This is needed to enable the Parliament and the wider public to see and understand the basis on which decisions are made. Comprehensive, transparent, reliable and timely reporting of Scotland's public finances is needed to support Parliamentary scrutiny.

16. This includes reporting clearly on:

- movements in the Scottish block grant arising from the application of the Barnett formula, baseline adjustments and indexation for each element of the block grant, and any policy spillover effects as set out in the Fiscal Framework
- revenue and spending forecasts, and the reconciliation of these to actual amounts once they are known
- the impact of any capital and resource borrowing, and movements and balances in the Scotland Reserve.

17. It will also be important for the Scottish Government to demonstrate that anticipated expenditure can be funded from anticipated revenues - with clarity about the main budget aggregates and how they relate to one another. People should also be able to understand the assumptions underlying changes in revenues and spending from one year to another.

18. The Scottish Government has commenced a programme of work to review and broaden its financial reporting in the context of the new financial powers. There will be much still to do as further powers are introduced and to respond to the Parliament's needs.
19. Key issues for the Scottish Government to consider include:
 - the draft budget and materials to support in-year budget revisions, so that these show how the key components of the budget have been established and how planned expenditure is expected to be funded overall
 - continued development of the suite of annual accounts that contain detailed outturn information on the different components of the budget, so that the information provided is set in the context of the budget as a whole, and the overall position is clear
 - accompanying performance reporting, so that it is clearer what spending is aiming to achieve and how this contributes to the Government's overall purpose and specific outputs and outcomes
 - consolidated accounts for the whole of the Scottish public sector. These would help provide the Scottish Parliament, taxpayers and others with a fuller picture and understanding about public spending and the longer-term implications for public finances. Areas for further consideration include information about the total levels of pension liabilities and borrowing across the Scottish public sector.
20. The Scottish Government has committed to reporting on key fiscal issues in the draft budget publication for 2017/18, commenting on outturn in the most recent past year and also on the forecast position for the year ahead. The Scottish Government has indicated that this would cover tax receipt forecasting and outturn, block grant adjustments, and other relevant information. This is consistent with more general commitments by the Scottish Government to enhance financial transparency. The Permanent Secretary recently [wrote](#) to the Public Audit and Post-legislative Scrutiny Committee to outline the Government's further plans and progress in this area, including a commitment to introduce consolidated public accounts.
21. The Convener announced in June 2016 that Parliament would lead a tri-partite review of the budget process. This is an important review at a critical time, and I am pleased to be a member of the review group, along with Parliamentary and Government officials and other external experts. Findings are anticipated prior to summer recess 2017 for consideration by ministers and the Parliament.

Role of audit

22. Public audit provides independent assurance that public money is spent properly and is providing value for money. This helps create a strong and effective system of accountability and transparency which supports the best use of public money in the public interest. Taken together with effective public and parliamentary scrutiny, this contributes to strong and transparent oversight of public funds.
23. As Auditor General, I am committed to supporting the Parliament in developing world-class arrangements for holding government to account and improving the use of public money. I

work closely with the Accounts Commission (which audits local government) and Audit Scotland. The joint paper [Public audit in Scotland](#) sets out the shape, principles and themes of public audit. It reflects the changing context for our work, including the new financial powers coming to Scotland.

24. We work together to play a full part in the successful implementation of the new powers. This includes monitoring progress and reporting publicly as the Scottish Government develops its plans for the new financial powers and as the powers are introduced. We are currently examining how well the Scottish Government and others are implementing or preparing to introduce the new financial powers in the 2012 and 2016 Scotland Acts, and expect to report on this in spring 2017. More information on the [scope](#) of this audit is on our website.
25. Our work provides assurance on the reliability of government accounts, and that the public finances have operated within relevant rules. It also considers whether those organisations spending and raising public money provide value for money. We report publicly on this, enabling the Parliament and others to scrutinise the public finances, hold public bodies to account and inform decision making. We also work with the National Audit Office in areas where UK agencies will play a significant role in devolved matters, such as income tax and social security, to support accountability and provide assurance.

Conclusion

26. The Smith Commission agreed that the Scottish Parliament should seek to expand and strengthen the independent scrutiny of Scotland's public finances in recognition of the additional variability and uncertainty that further tax and spending devolution will introduce into the budget process. I look forward to continuing to work with the Committees of the Parliament to strengthen the oversight of Government in line with this recommendation and to support scrutiny of the implementation of the new financial powers and Scotland's Fiscal Framework.
27. I look forward to exploring these issues in more detail with the Finance and Constitution Committee.

Caroline Gardner
Auditor General for Scotland
November 2016