Scotland's new financial powers

Operation of the Fiscal Framework

AUDITOR GENERAL

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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. Many of the components of the Fiscal Framework are now operating, including tax raising, borrowing and reserve powers. Others, including further devolution of social security and VAT assignment, are coming into force over the next three years (Exhibit 1, page 5).

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.

3. The Scottish Parliament's revised budget process responds to these new fiscal challenges and is being introduced for the 2019/20 budget. 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. It reflects on experience during 2017/18, the first full year of operation of income tax, borrowing and reserve powers, and describes the range of risks that are now affecting the Scottish budget.

5. The briefing is in three parts:

   - **Part 1** is an overview of how the Scottish budget operated during 2017/18. We describe the main elements of the budget, including the funding that was available during the year and how it was spent.
   - **Part 2** summarises how each of the main components of the Fiscal Framework is now operating, and how each is affecting the Scottish budget. We also set out the components that are yet to be brought into effect and what we know about the impact that they will have.
   - **Part 3** provides an overview of the main risks that are now affecting the Scottish budget, 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. This includes draft budget documentation, audited accounts, the newly introduced Fiscal Framework Outturn Report, the Scottish Government's medium term financial strategy and the Cabinet Secretary for Finance's provisional outturn statement. We have drawn from this published information and audit reports throughout this briefing.

Exhibit 1
Timeline for new financial powers

	Timings	New power	£ m
Scotland Act 2012	2015	Land & Buildings Transaction Tax	557 (17/18 outturn)
		Scottish Landfill Tax	148 (17/18 outturn)
		Borrowing & reserve powers (extended by 2016 Act)	2,200 (capital borrowing limit)
	2016	Scottish Rate of Income Tax	4,350 (16/17 outturn)
Scotland Act 2016	2017	NSND Income Tax	11,857 (17/18 forecast)
		Revenue borrowing	1,750 (total limit. Annual limit = £600m)
		Capital borrowing	3,000 (total limit. Annual limit = £450m)
		Scotland Reserve	700 (total limit)
	2019	Value Added Tax First 10p of standard, and 2.5p of reduced, rate raised in Scotland assigned to Scottish budget	5,073 (estimate)
	By 2021	Social Security Responsible for 11 benefits and power to top-up/ create new benefits	Spending of 2,916 (estimate)
	TBC	Air Passenger Duty	275 (estimate)
		Aggregates Levy	57 (estimate)

Source: Audit Scotland

Part 1: Overview of the Scottish budget in 2017/18

7. The 2017/18 financial year was the first full year of operation of the devolved income tax, borrowing and reserve powers contained in the 2016 Scotland Act. This introduced new components to the Scottish budget, alongside powers previously devolved by the 2012 Act including Land and Buildings Transaction Tax and Scottish Landfill Tax. As a result, in 2017/18 many of the provisions in the Fiscal Framework agreed between the Scottish and UK Government began to operate for the first time.

The make-up of the Scottish budget

8. 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 Parliament, responding to changes in the funding available and spending pressures.

9. The Scottish Government's financial decisions affect both the total HM Treasury budget for the year (known as Total Managed Expenditure, or TME) and Scottish budget limits. Up until the 2017/18 budget, TME was categorised as either Annually Managed Expenditure (AME) or Departmental Expenditure Limit (DEL).

10. AME includes demand-led spending in areas such as NHS and Teachers' pensions; it is ring-fenced funding from the UK Government which is managed by the Scottish Government. As such, it does not affect the Scottish Government's spending power and is not covered by the Fiscal Framework. The Fiscal Framework relates to all other spending, referred to in the 2017/18 budget as DEL, making up nearly 80 per cent of the Scottish budget (£31,992 million).

11. The elements of the Scottish budget governed by the Fiscal Framework are set out in Exhibit 2 (page 7). These were classified as DEL in 2017/18. The Scottish Government has agreed with HM Treasury that it will replace the AME and DEL distinction from 2018/19.[1] This is not expected to affect the underlying approach described below.

[1] Office of Budget Responsibility, Economic and Fiscal Outlook Report, March 2018

Exhibit 2
How fiscal budget headings relate to the Fiscal Framework in 2017/18

Type of DEL	How is it used	Funded through the Fiscal Framework			
		Block Grant	Devolved Taxes	Capital Borrowing	Final budget (£m)
Cash Resource DEL (Cash RDEL)	Spending on the operating costs for public services.	✓	✓		27,028
Non-cash Resource DEL (Non-cash RDEL)	Can only be used to meet capital charges that reflect the consumption of physical assets and other technical accounting non-cash items. It cannot be carried forward to future years.	✓			907
Capital DEL (CDEL)	Investing in capital projects, such as new hospitals or schools.	✓		✓	3,639
Financial Transactions	Making loans to, or investments in, companies or individuals.	✓			445

Source: Audit Scotland. Note: CDEL include capital borrowing

12. The Scottish Government's management of the budget focused on "Fiscal DEL" as a measure of real spending power. This included cash RDEL, CDEL and Financial Transactions budgets but excluded Non-cash RDEL.

13. The fiscal framework states that the Barnett formula will continue to be used to calculate the overall block grant. As each of the new financial powers is implemented a further adjustment is made to the block grant, known as a block grant adjustment (BGA) (Exhibit 3).

Exhibit 3
How the funding for the Scottish Budget is determined
The block grant is now adjusted to reflect powers devolved to Scotland

Source: Audit Scotland

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

15. The 2017/18 budget included BGAs for Scottish Tax revenues including Scottish Income Tax, Land and Buildings Transaction Tax (LBTT), Scottish Landfill Tax (SLfT). BGAs were also made for other sources of income now devolved including fines, forfeitures and fixed penalties imposed by courts and tribunals in Scotland, as well as sums recovered under Proceeds of Crime.

Performance against budget in 2017/18

16. The Scottish Government managed overall spending within budget in 2017/18 and within the limits set out in the Fiscal Framework. A summary of the final HM Treasury budget for the year and the actual amount of public spending is set out in Exhibit 4. Total Fiscal DEL expenditure, prior to block grant adjustments was £30.3 billion, which was £403 million less than the available budget of £30.7 billion. The outturn for devolved taxes was £50 million greater than budget. The surplus of £453 million was carried forward for use in future financial years within the Scottish Reserve.

Exhibit 4
Provisional HM Treasury budget performance, 2017/18
£453 million was added to the Scotland Reserve in 2017/18

	Final budget	Actual / provisional outturn	Variance	Can this be added to the Reserve?	Type added to Reserve		
					Resource	Capital	Financial Transactions
Block Grant RDEL	27,028	26,720	308	✓	308		
Block Grant CDEL	3,189	3,105	84	✓		84	
Financial Transactions	445	434	11	✓			11
Non-cash DEL	907	784	123	✗			
Barnett determined block grant	31,568	31,043	526				
Block Grant Adjustment	-12,540	-12,540	0				
Devolved Taxes	12,514	12,564	50	✓	50		
Borrowing - Scotland Act 2012	450	450	0				
Total DEL	**31,992**	**31,516**	**576**				
			Added to Reserve		**358**	**84**	**11**
			TOTAL ADDED TO RESERVE				**453**
			Opening Balance of Reserve				74
			Closing Balance				527

Note: RDEL variance includes £100 million that was received in 2017/18 from HM Treasury Social Security set up costs, to be spent in 2018/19.
Source: Audit Scotland, based on Scotland Office and Office of Advocate General Annual Report and Accounts 2017/18 and provisional outturn statement by Cabinet Secretary for Finance and the Constitution

17. Amendments can be made to the Scottish 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.

18. Details of the amendments made as a result of the autumn and spring budget revisions are set out in the Scottish Government's supporting documents. The budget figures shown in Exhibit 4 incorporate revisions that occurred in year.

Part 2: The main components of the Fiscal Framework

19. Many of the provisions of the Fiscal Framework operated during 2017/18, directly affecting the resources available to the Scottish Budget. Some important components, including the full range of income tax powers and the introduction of the Scotland Reserve, came into effect for the first time. Other components, such as LBTT and SLfT, continued from previous years and enhanced capital and resource borrowing powers were introduced. Further provisions will come into effect over the next three financial years.

20. In this part of the briefing we summarise how each of the main components of the fiscal framework are now operating, and how each is affecting the Scottish Budget. We also set out the components that are yet to be brought into effect and what we know about the effect that they will have.

The block grant

21. Much of the Scottish Budget continues to be funded by grants from the UK Government. In 2017/18 the block grant made up around 59 per cent of the total Scottish DEL budget. This is expected to fall to less than half of the Scottish Budget once the full range of the powers in the 2016 Act are devolved. Since the late 1970s the Barnett formula has determined annual changes in the block grant.

22. When a change is made to a UK Government department’s expenditure budget the Scottish budget is adjusted using the formula. This generally occurs at a UK fiscal event such as the UK budget or spring statement. For each UK budget change, a related change is made to the Scottish budget, based on how comparable the services provided by the UK department are to those devolved to the Scottish Parliament, applying a population proportion as shown below.

Change to the UK Government department’s budget	x Comparability percentage	x Appropriate population proportion

23. This calculation is carried out for all UK departments and the results are applied to the block grant. It is not necessarily the case each change results in an increase; this depends on UK spending decisions, which may lead to reductions in UK departmental and Scottish budgets. The changes made to the Scottish budget are known as Barnett consequentials, determining the block grant for the fiscal resource budget, the capital budget and Financial Transactions. There are restrictions on moving amounts between these different headings, but the amounts involved are not ring-fenced to a particular spending programme. This means they can be

applied to any devolved activities, for example applying all or part of an Education consequential to Justice.

24. Comparability percentages are determined by HM Treasury at each UK spending review, following consultation with the Scottish Government. These capture the extent to which services provided by a UK Government department have been devolved. The population proportions used in the Barnett formula reflect the annual mid-year estimates published by the Office for National Statistics each summer. The current population proportion for Scotland is 9.8 per cent, meaning that Barnett consequentials in areas with a 100 per cent comparability percentage, such as health, are equivalent to 9.8 per cent of changes in English spending.

25. HM Treasury published a Block Grant Transparency report for the first time in December 2017, setting out details of all changes to the block grant since the 2015 UK Spending Review. It is expected that this will be updated annually following each year's UK budget. It contains around 170 separate adjustments that have been made to the Scottish budget following the 2015 Spending Review, until the 2017 autumn budget (for 2018/19 financial year). The majority of these are Barnett consequentials, but changes are also made for:

- specific UK Government funding initiatives outwith the Barnett formula, such as individual City Deals
- transfers of responsibilities and associated funding between UK departments and the Scottish Government, generally known as machinery of government transfers
- block grant adjustments based on the provisions of the Fiscal Framework. The major adjustments made to date are set out below.

Block grant adjustments and taxes

26. To reflect Scottish taxes, adjustments are made to reduce the block grant by the amount of the equivalent taxes that would have otherwise been collected by the UK Government. This adjustment is based on the UK tax collected in the year prior to devolution, known as the baseline year. It is then indexed to reflect changes in the total amount of equivalent UK tax collected each year. The net effect on the Scottish budget is determined by both the tax revenues and the associated block grant adjustment.

27. The amount of tax that will be ultimately collected in both Scotland and the rest of the UK is unknown when the Scottish budget is determined. This means that the amounts initially included in the budget are based on forecasts.

- The Scottish Fiscal Commission (SFC) forecasts devolved tax revenues
- The Office for Budget Responsibility (OBR) forecasts the block grant adjustment.

28. Each of these organisations is independent, helping to ensure that the forecasts they prepare are objective and unbiased. When outturn information is available, the following year's budget is adjusted through a process of reconciliation. The risks and opportunities arising from forecasts and outturns are discussed further in Part 3 of the report, but in general terms:

- If more tax is collected than was forecast, this amount is available to spend in the future year's budget
- If less tax is collected than was forecast the available future year's budget will be reduced.

29. Fully devolved taxes and Scottish income tax both affect the block grant adjustments, but they differ in terms of both the size of the revenues, and the timeliness of the outturn information. (Exhibit 5).

Exhibit 5
Key points in how block grant adjustments are applied to taxes operating in 2017/18

	Fully devolved taxes (Scottish Landfill Tax and Land and Buildings Transaction Tax)	Scottish Income Tax
Collected by	Revenue Scotland	HMRC
Baseline year (year prior to devolution of the tax)	2014/15	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 of population 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 the UK outturn tax position is known	Year after year of collection	15 months after year end
When the Scottish outturn tax position is known	Year of collection	15 months after year end
Approximate proportion of DEL budget	2.0%	37%
Year of adjustment to the budget	Reconciled and adjusted largely **in the budget year itself, and again in the following year** after UK outturn position is known (See Exhibit 6 for details)	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**. For example, the 2017/18 reconciliation will be adjusted through the 2020/21 budget

Source: Audit Scotland

Fully devolved taxes

30. 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, either in year or shortly after year end. This means that budget adjustments can be managed in part during the budget year itself, with a small adjustment required to the following year's budget. The risks to the Scottish Budget from fully devolved taxes are therefore relatively small and can be managed over a short horizon.

31. The overall effect that fully devolved taxes for 2017/18 will have on the Scottish budget is now known (Exhibit 6). The net adjustment to the budget for 2017/18 is £16 million, of which £18 million was adjusted for in the 2017/18 budget year. The in-year adjustment impacting the 2017/18 budget of £49 million is reflected in the contribution to reserves shown in Exhibit 4. The block grant adjustment of £31 million was absorbed through the budget in 2017/18.

Exhibit 6
Provisional adjustments required to budgets for fully devolved taxes for 2017/18

Adjustment	BGA	Scotland	Net effect
Original budget figures	£664m	£656m	-£8m net effect on budget
In-year adjustment impacting the 2017/18 budget	BGA increases by £31m	Scottish devolved taxes adjustment increases by £49m	Scottish budget increases by £18m
Future adjustment impacting the 2019/20 budget	BGA increases by £2m	No change	Scottish budget decreases by £2m
Net effect of 2017/18 outturns on budgets	BGA increases by £33m	Scottish devolved taxes adjustment increases by £49m	Scottish budget increases by £16m
Provisional outturn figures	£697m	£705m	+£8m net effect on budget

Source: Fiscal Framework Outturn Report

Scottish Income Tax

32. Scottish Income Tax powers contained in the 2016 Scotland Act came into effect in 2017/18, replacing the Scottish Rate of Income Tax (SRIT). The Scottish Parliament set non-savings non-dividend income tax rates and bands for Scottish taxpayers for the first time. HMRC

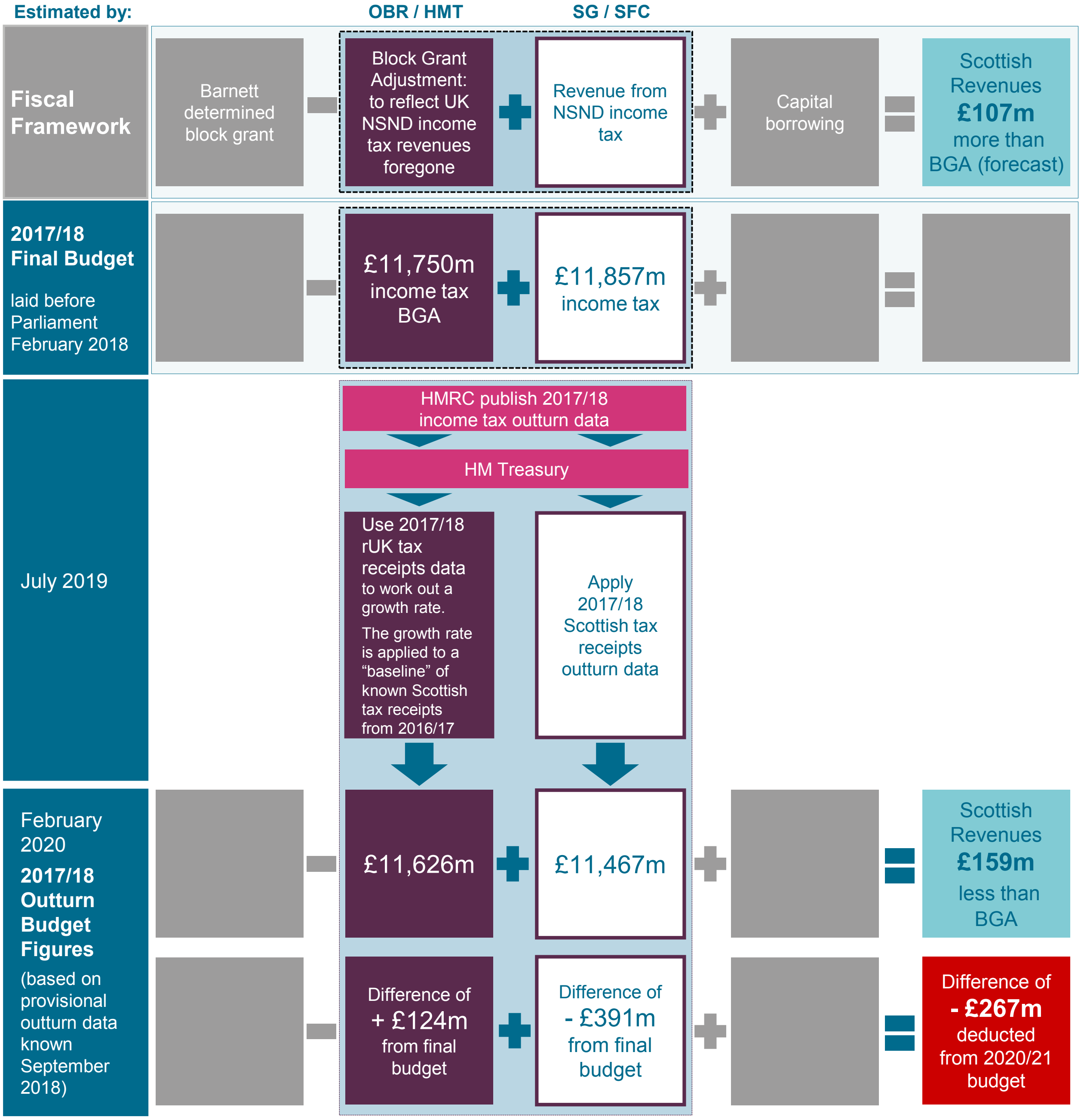
continues to collect income tax across the UK and is responsible for separately identifying the amounts that relate to Scottish taxpayers.

33. Scottish Income Tax makes up a considerable proportion of the Scottish Budget. Unlike fully devolved taxes, there is a 15-month delay in receiving outturn figures and then a further delay until any adjustments are applied to subsequent budgets. As it is a larger tax, small percentage differences in outturn figures to forecasts can make a large difference to budgets, so the risks to the Scottish Budget are greater and must be managed over a longer horizon.

34. Updated forecasts of Scottish Income Tax revenues and the associated BGA were prepared in May 2018, and further updates are expected when the 2019/20 budget is published and in May 2019. Each of these will give an indication of the potential size of the reconciliation required in the 2020/21 budget. No changes will be made to budgets before that point, and the final amount of the reconciliation will remain uncertain until then.

35. The effect on the 2017/18 budget and the potential effect on the 2020/21 budget is shown in Exhibit 7 (page 15). This shows that based on the original forecasts for Scottish income tax and the associated BGA, the Scottish budget for 2017/18 was £107 million more because of the devolved tax. If the most recent forecasts are an accurate assessment of final outturns, the Scottish budget will ultimately be £159 million lower due to the devolution. The 2020/21 budget would be reduced by £267 million to correct for this. Further updated forecasts will be published in December 2018.

Exhibit 7
How the Fiscal Framework Outturn Report potential NSND income tax budget adjustment was calculated
Current forecasts suggest that £267 million will be deducted from the 2020/21 budget



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

36. HMRC's 2017/18 annual accounts included a provisional estimate of £11.9 billion for Scottish Income Tax revenues for 2017/18. This is broadly in line with the forecast included in the 2017/18 budget, but because of the way this is constructed, it has little benefit in assessing the likely outturn. In their report on their 2016/17 audit of SRIT the National Audit Office noted that HMRC had not used Scottish taxpayer data in preparing the provisional estimate included in their 2016/17 accounts. The HMRC has reported that its provisional estimate of Scottish income tax revenues for 2017/18 was on a similar basis to its 2016/17 SRIT estimate.

Capital borrowing

37. Capital borrowing powers have been available since 2015/16, with an annual limit of £330 million and an overall limit of £2.2 billion. Capital borrowing limits rose in 2017/18; annual borrowing is now limited to £450 million and total borrowing stock (the aggregate amount of borrowing across years, less repayments made) of £3 billion.

38. In 2015/16 and 2016/17 the Scottish Government used its capital borrowing limit to accommodate the impact of decisions by the Office for National Statistics (ONS) to reclassify some major Non-Profit Distributing (NPD) investment projects as public-sector projects. The Government agreed with HM Treasury that these amounts would be recorded against its capital borrowing limit.

39. This notional borrowing was £283 million in 2015/16 and £333 million in 2016/17. This notional borrowing will be treated as if it is being repaid over 30 years for the purposes of the overall limit. As no actual borrowing occurred, no repayments need to be accommodated in future year's budgets.

40. The 2017/18 Scottish budget approved by Parliament included the full £450 million available, and the Scottish Government borrowed this amount during the year. By the end of 2017/18, the Scottish Government had utilised £1.036 billion of its £3 billion capital borrowing limit (35 per cent). The 2018/19 budget included provision for borrowing of £450 million and the Government has set out plans to borrow a further £450 million in 2019/20. If it does so, and repayments continue to be made over 25 years, borrowing stock at the end of 2019/20 will be £1.867 billion (57 per cent of the limit).

41. The Scottish Government has yet to decide on its future capital borrowing plans. If it continues to borrow the maximum amount available each year, the total limit will be reached during 2023/24. We have previously recommended the Scottish Government urgently needs to finalise the longer-term policies and principles within which it will manage its borrowing powers.

42. The Fiscal Framework states that borrowing would usually be paid back over ten years, but that this can change depending on the life of the assets that the borrowing funds. Borrowing in 2017/18 was undertaken over 25 years, with approval from HM Treasury. More detail on this is included in the Auditor General's report on the 2017/18 audit of the Scottish Government's Consolidated Accounts. If the Scottish Government wishes to borrow over more than ten years in the future, this will also have to be approved by HM Treasury.

43. Once borrowing is undertaken the Scottish Government is committed to making repayments and interest from future budgets. The Scottish Government has a longstanding policy to help ensure the affordability and sustainability of all its revenue funded investment, by restricting the future revenue costs of investment decisions to no more than five per cent of its total

annual budget. This measure includes the resource budget consequences of borrowing and other revenue funding models, currently including PFI, NPD and Network Rail RAB Borrowing.

44. Under current plans, the Scottish Government has assessed that committed projects are estimated to peak in 2019/20 at 3.88 per cent against its five per cent limit. When planned projects, which are not yet contractually committed, and planned borrowing in 2018/19 and 2019/20 are included, this increases to 4.23 per cent in 2020/21.

Resource borrowing

45. The Scottish Government can choose to borrow to bridge short-term gaps in its resource budget in defined circumstances (Exhibit 8). 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.

Exhibit 8
Resource borrowing limits in the Fiscal Framework
Resource borrowing is limited by statute and is available for certain purposes only

Resource borrowing power	Purpose	Annual limit
In-year cash management	For example, if cash is needed because of timing differences between devolved revenues and spending commitments	£500 million
Forecast error	To account for errors in forecasts of devolved taxes or welfare spending, and errors in the forecasting of the block grant adjustment	£300 million
Economic shock	Access to the borrowing is triggered when onshore Scottish GDP is below one per cent in absolute terms on a rolling four-quarter basis, and one percentage point below UK GDP growth over the same period. The shock may be triggered from outturn data or forecasts.	£600 million
Overall annual limit on resource borrowing		£600 million
Overall statutory limit on resource borrowing		£1,750 million

Source: Audit Scotland, based on the Fiscal Framework

46. The Scottish Government has not yet undertaken any resource borrowing and the 2018/19 budget contains no plans to do so. Because the net outturn position is better than the net forecast position for both LBTT and SLfT, the resource borrowing powers for forecasting errors are not required, nor available for use. The criteria for economic shock was not met in 2017/18, again meaning that this resource borrowing was not required, nor available.

The Scotland Reserve

47. The Scotland Reserve was introduced in 2017/18, allowing the Scottish Government to carry forward fiscal resource and capital funding to future years. It can accumulate up to £700 million, with amounts separated between Resource and Capital. A maximum of £250 million of RDEL and £100 million of CDEL can be drawn from the Reserve in any year to be applied as part of the Scottish budget, either to fund future commitments or as a buffer mechanism to manage increased volatility in the Scottish budget between years.

48. We have previously highlighted the importance of the Scottish Government having a clear policy for how it will operate its reserve. The Scottish Government has recently stated that it,

"intends to build up the balance in the Scotland Reserve over time as resources allow, in order to have a financial cushion available while ensuring that there remains sufficient capacity in the Reserve to prudently manage any underspend across financial years."

49. With the scope of budget adjustments increasing in the years ahead, we expect the Scottish Government will need to be clearer in how it will balance the extent to which balances on the reserve are committed to future spending priorities and amounts uncommitted and available to manage volatilities between years.

50. Prior to 2017/18 the Scottish Government could retain any fully devolved tax outturns in a cash reserve. It had accumulated £74 million of revenues by the end of 2016/17, and this was transferred to the Scotland Reserve as an opening balance. The current balance and intended use for the 2018/19 budget is shown in Exhibit 9.

Exhibit 9
Breakdown of reserves between revenue and capital
There are limits on the use of the Scotland Reserve by Resource and Capital

	Resource	Capital	Total
Devolved Taxes Cash Reserve at 31/3/17	74	-	74
Revenue to capital switch	(2)	2	-
Additions to reserve during 2017/18 (Exhibit 4)	358	95	453
Closing balance at 31/3/18	**430**	**97**	**527**
Amounts committed to support 2018/19 budget	(238)	(97)	(335)
Uncommitted balance on reserve	**192**	**-**	**192**
Annual limit on reserve use	250	100	350
Amounts committed to support 2018/19 budget	(238)	(97)	(335)
Headroom for deployment in 2018/19	**12**	**3**	**15**

Source: Audit Scotland

51. £335 million of the £350 million limit on use of reserves has been committed to support spending in the 2018/19 budget. Only £15 million of the remaining reserves balance of £192 million is uncommitted, for example, to cover the net outturn position on fully devolved taxes if this is worse than forecast.

Main components yet to be implemented

52. 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 in the coming years. These include:

- Devolution of social security powers. Further social security powers are being devolved during 2018/19 (carers allowance and best start grants), with all powers expected to be devolved by the start of 2020/21. The block grant adjustment, forecast and reconciliation mechanisms will be broadly similar to those operating for the fully devolved taxes – with the BGA leading to an addition to the block grant, based on a population share of social security spending in England and Wales. Reconciliations will be performed largely in-year alongside a final year-end reconciliation.
- VAT assignment. This will be introduced from 2019/20. The block grant adjustment, forecast and reconciliation mechanisms will be broadly similar to those operating for Scottish income tax. The reconciliation to outturns for 2019/20 will not impact the Scottish budget. VAT will be assigned based on a methodology that will estimate expenditure in Scotland on goods and services that are liable for VAT. This is being developed and agreed by the Scottish and UK Governments.
- Other fully devolved taxes. Both Air Passenger Duty and Aggregates Levy remain to be devolved, but there is currently no firm timetable for the devolution of either tax. Once devolved, the block grant adjustment, forecast and reconciliation mechanisms will be the same as other fully devolved taxes.

Part 3: Managing the risks now affecting the Scottish budget

Understanding and managing budget risk

53. The Scottish budget now faces a widening range of risks, with a growing proportion of public spending directly funded from taxes raised in Scotland. Understanding these risks and responding effectively is critical to ensuring the affordability of spending decisions and the longer-term sustainability of Scotland's finances.

54. Budget risk 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 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.

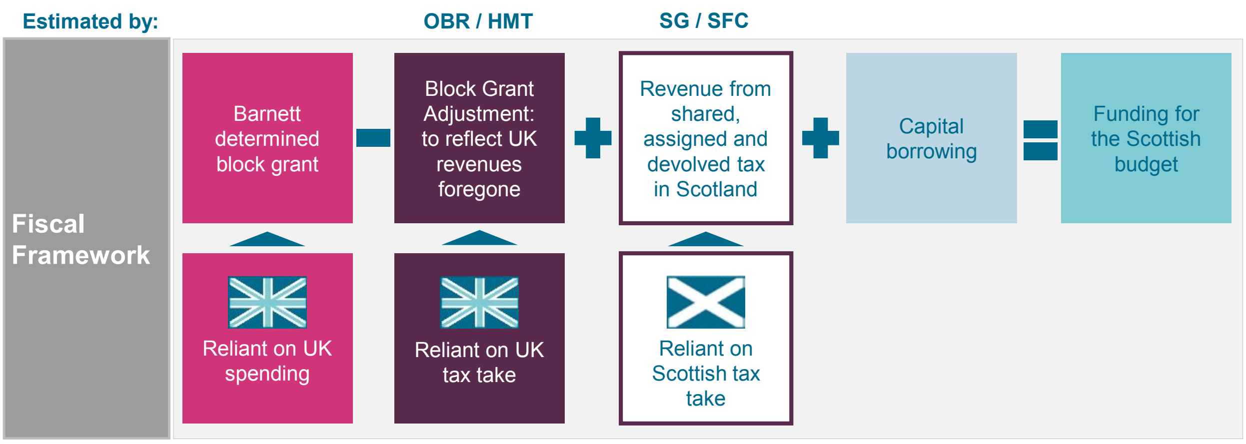
55. A lot of moving parts now affect the Scottish budget. Each carries a degree of risk and uncertain financial impact. Where the effects offset one another, the overall impact may be limited. If the effects are predominantly in one direction, the aggregate effects may be significant and difficult to manage.

Economic performance risk

56. 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. The extent of this risk will grow as further components of the Fiscal Framework come on stream, particularly £5.6 billion VAT assignment from 2019/20 and around £3.3 billion of social security spending by 2020/21. 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.

57. Economic performance also affects the demands placed on public sector spending programmes. The devolution of social security powers will increase this effect – with demand for individual benefits linked to economic and demographic factors. Where the economy is doing less well, it is likely that social security spending 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 (Exhibit 10, page 21).

Exhibit 10
The relationship between Scottish and rest of the UK performance on the budget



Source: Audit Scotland

Structural and cyclical differences

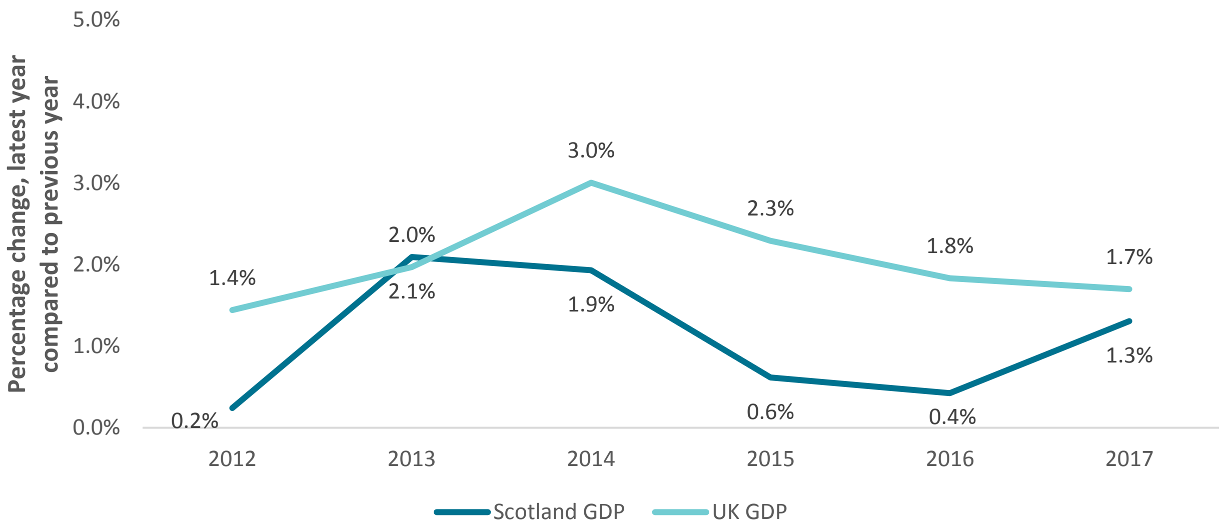
58. Changes during an economic cycle can produce budget volatility between years. The economic cycles of the Scottish economy and the economic cycles for the rest of UK may be different. Budget management will involve smoothing out the consequences of this. Indeed, the purpose of fiscal tools, such as resource borrowing and reserve powers, in the Fiscal Framework is to help the Scottish Government to manage this volatility.

59. 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 Fraser of Allander Institute has estimated that a 0.2 per cent differential in growth rates would change budget revenues in the first year by £25 million, rising to around £130 million by the fourth year if this differential continued. The effects of differential tax growth may become more significant once other taxes are devolved and, most notably once VAT is assigned.[2]

60. Understanding and monitoring trends in the Scottish and UK economies is important when considering the potential impact on Scottish revenues and demand-led spending. While Scottish relative performance has improved since 2016, this is in part due to weakening UK GDP growth (Exhibit 11, page 22).

[2] Fraser of Allander Institute, *Scotland's Budget: 2016*

Exhibit 11
Scottish and UK GDP growth, percentage change, latest year compared to previous year



Source: Scottish Government

61. Based on Scottish Government GDP data, Scotland's economy performed better than rest of the UK's economy in the first two quarters of 2018.[3] The Scottish Fiscal Commission estimates that as far ahead as 2022/23, Scottish GDP growth will be subdued and below one per cent, while UK GDP is forecast to be between one and 1.5 per cent over the same period.[4] Enhanced short-term resource borrowing powers are available in the case of defined economic triggers (‘a Scotland specific shock’). But these are not designed to insulate the Scottish budget from any structural differences in economic performance that continue over a number of years.

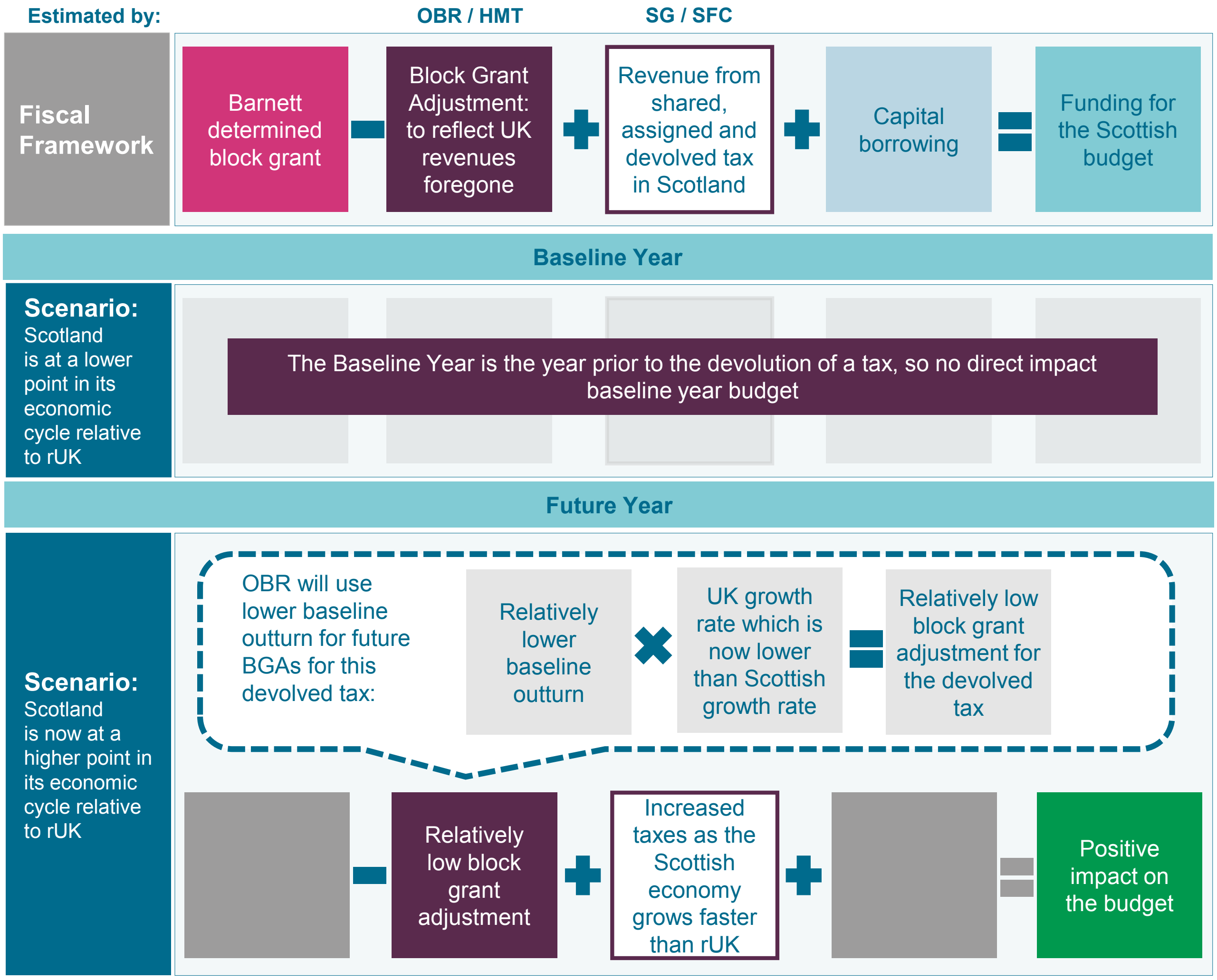
Timing of baseline years in economic cycles

62. There may be some years where the Scottish economy performs better than the rest of the UK and others where it performs less well. As well as the effect on revenues from taxes already devolved, the baseline years for newly devolved taxes will also be affected. While the 2016/17 outturn for Scottish Income tax is now known, the outturns for 2017/18 will not be known until June 2019. Baseline year tax take is indexed for future years' growth each year for block grant adjustments. If the baseline year was a relatively weak year for the economy, the baseline amount to be indexed will be lower. In effect, this means that a baseline set in a weaker year for the economy could result in a lower block grant adjustment than would have otherwise been the case, which has a positive impact on the budget. The opposite would also be the case in a stronger year for the economy (Exhibit 12, page 23).

[3] Scotland's Gross Domestic Product (first estimate), Quarter 2 2018, A National Statistics Publication for Scotland, published September 2018.
https://www.gov.scot/Topics/Statistics/Browse/Economy/PubGDP/GDP2018Q2

[4] Scotland's Economic and Fiscal Forecasts, May 2018, Scottish Fiscal Commission, and Economic and Fiscal Outlook, March 2018, Office of Budget Responsibility

Exhibit 12
Scotland's position in the economic cycle when the baseline is set will have implications for future budgets



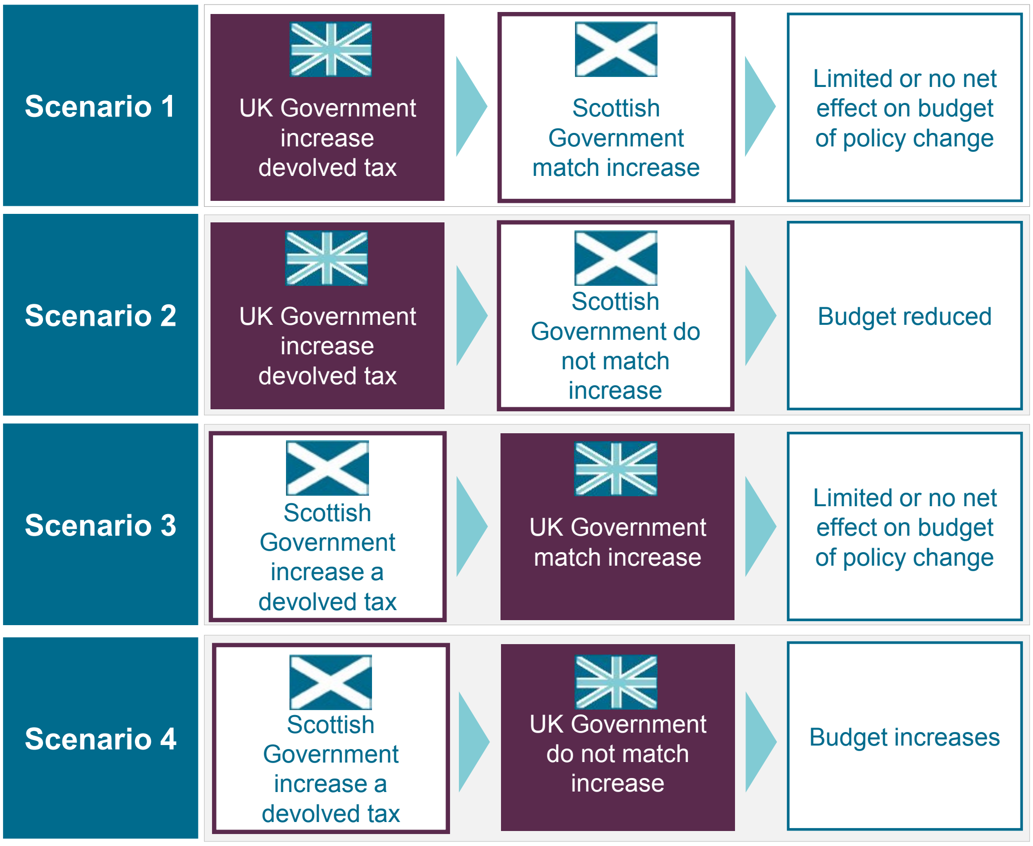
Source: Audit Scotland

Policy risk

63. The way that block grant adjustments for both taxes and social security operate also 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. For example, if the UK Government decided to raise UK tax rates in a devolved area, such as by changing the base rate of income tax, and the Scottish Government retained its existing rates, the overall Scottish budget would be less as a result.

64. Maintaining the status quo between Scotland and the rest of the UK through the Fiscal Framework now means matching UK tax and social security policy. Policy divergence will occur where either the UK Government or the Scottish Government choose a different tax policy. Exhibit 13 shows example scenarios of how this could affect the Scottish budget, depending whether the policy change is matched. The scenarios show the effects of increasing a devolved tax, but the logic also applies to policy decisions to decrease tax.

Exhibit 13
Scenarios of possible changes to the Scottish Budget from tax policy



Source: Audit Scotland

65. 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.

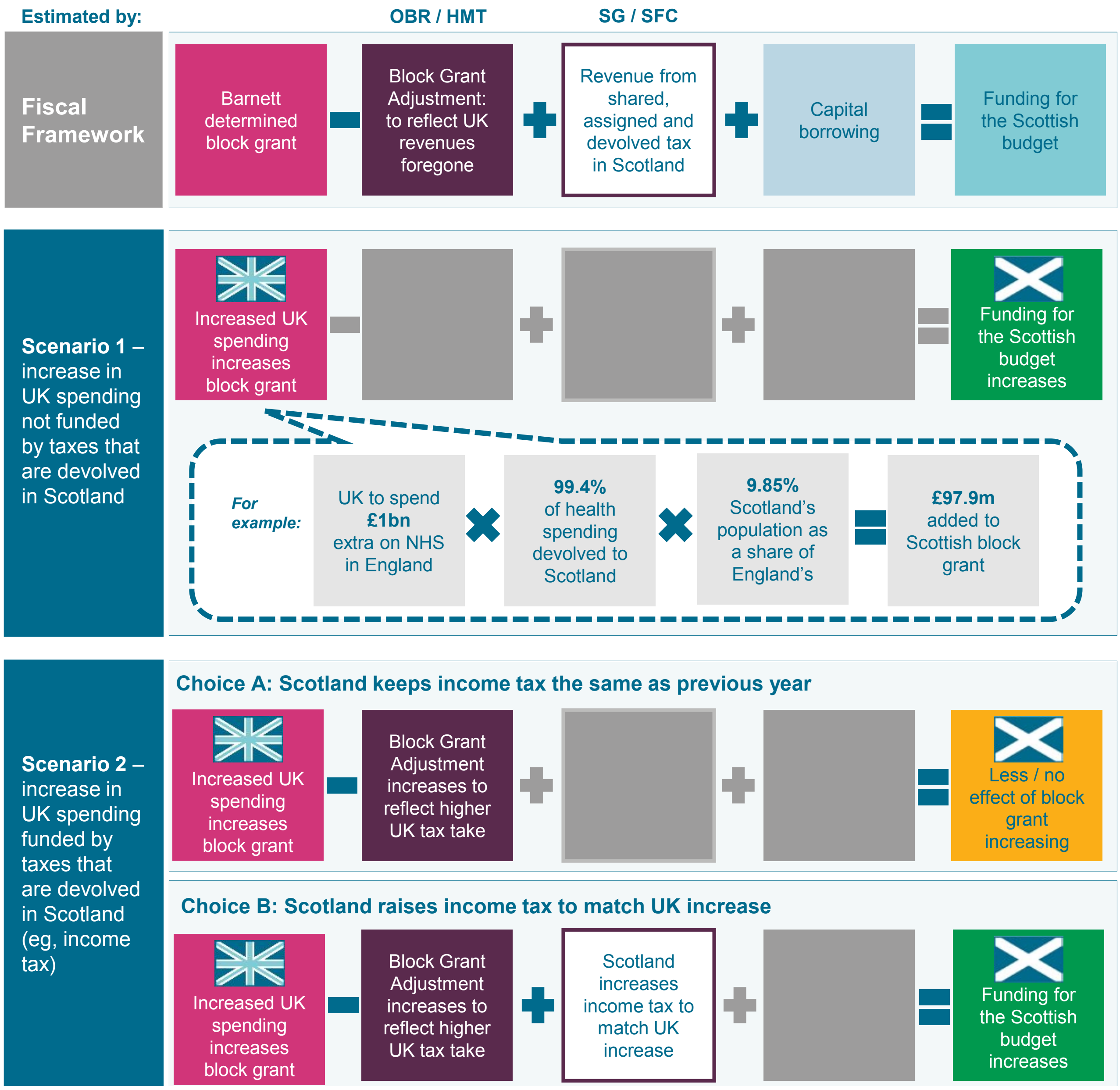
Policy interactions

66. The overall impact on the Scottish budget will depend on the extent of policy divergence over time between the Scottish and UK Governments in devolved areas. The greater the difference in policy and the longer that it is in place, the more significant the impact on the budget will be.

67. Where tax and spending policies are stable and consistent, and any changes are known about well in advance, uncertainty is reduced, and budget implications can be better planned for. But where policy choices are more volatile and uncertain, this will make the Scottish Government's management of the budget much more challenging.

68. UK decisions on tax and spending are also interrelated, within the UK Government's overall fiscal policy. The following exhibit shows how 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 (Exhibit 14).

Exhibit 14
UK spending and tax policy effects on the Scottish budget



Source: Audit Scotland

69. 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.

Social security baselines

70. The way BGAs are calculated means that the UK policies being pursued at the point the baseline is established will underpin future BGAs. The UK Government's is currently undertaking a multi-year benefit reform programme. The extent to which this will affect individual BGA baselines at the point individual social security entitlements are devolved is unclear, making budget planning more difficult and potentially increasing the financial impact of any subsequent Scottish policy change. A similar risk applies in relation to the taxes that have yet to be devolved.

Policy spillover

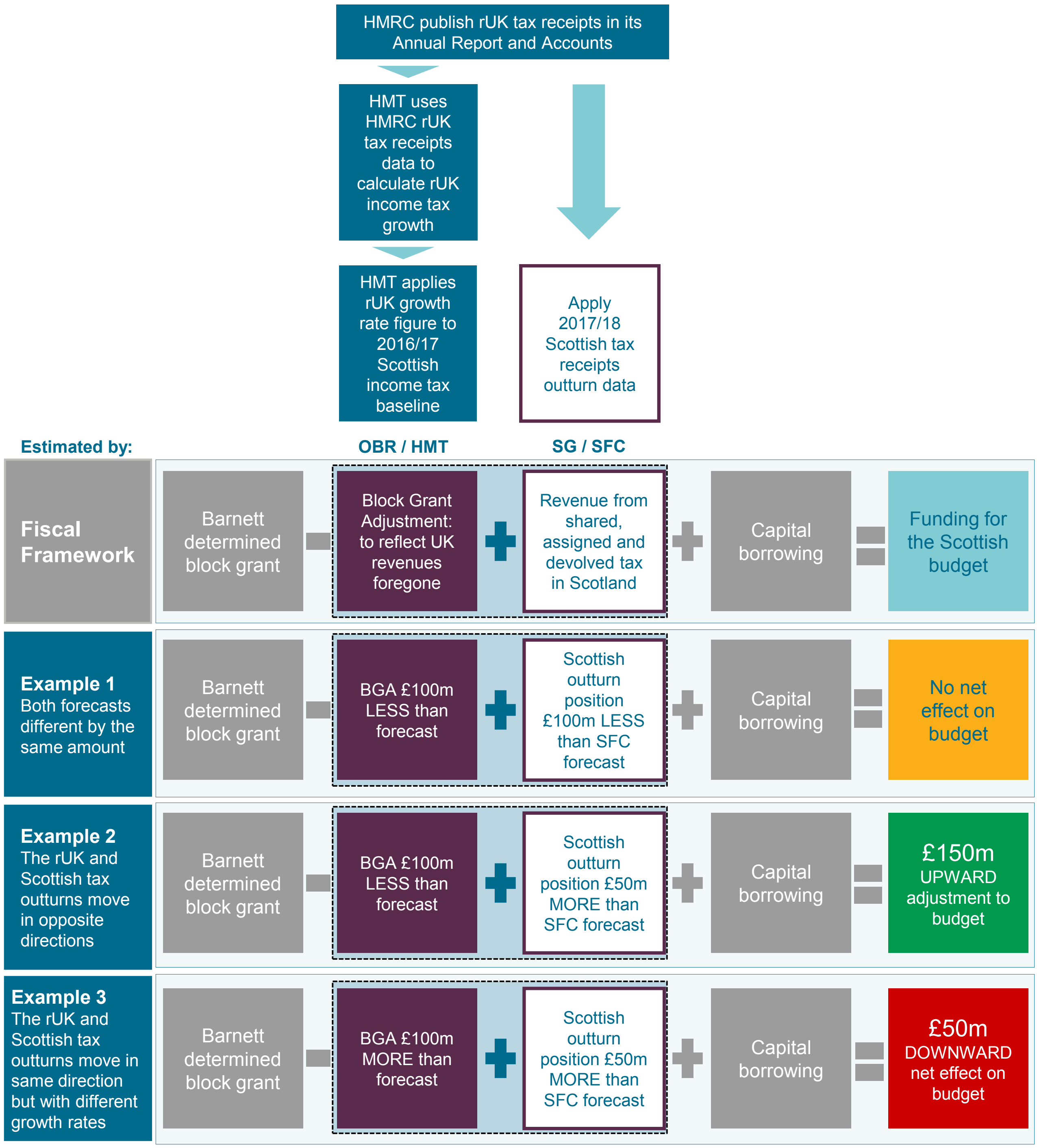
71. Changing policies in either Scotland or at a UK level may produce a fiscal impact within the other jurisdiction. For example, increasing tax in Scotland may lead to more universal credit payments being required to Scottish people from the UK Government. The Fiscal Framework includes provisions to adjust for such effects where a 'policy spillover' effect is demonstrated to the satisfaction of both parties. These have not been used to date, and the extent to which adjustments may be made to future budgets and when they may occur is uncertain. Any adjustment would need to be accommodated as part of the Scottish Government's overall management of the budget.

Forecasting risk

72. 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 corresponding block grant adjustments (BGAs) built into the annual budget. Alongside the block grant, these forecasts provide the basis for the Scottish Government's spending plans.

73. Forecast error is the difference between what was forecast and what happens. The likely size of forecasting errors is affected by the extent of underlying uncertainty about the economy and other areas subject to forecasts. The uncertainties inherent in the forecasting process mean that the actual amounts ('final outturns') will 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. 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 (Exhibit 15, page 27).

Exhibit 15
Illustrative scenarios of forecast error effects on the Budget
SFC and OBR forecast errors can have different effects on the Scottish budget depending on their relative error



Source: Audit Scotland

74. The Scottish Government has to manage the effect of having more or less resources than was anticipated in original forecasts, as these adjustments (‘reconciliations’) are made. The greater the range of possible outcomes, the greater the forecasting risk.

Timing and complexity

75. The point at which budgets are adjusted for known outturns differs between the components of the fiscal framework

- reconciliations for fully devolved taxes and social security spending are made largely in-year and need to be accommodated within the Scottish Government's management of the budget during the relevant financial year. For example, Social Security spending outturns for 2018/19 will largely be managed as part of the 2018/19 budget.
- final outturns for Scottish Income Tax for any financial year will not be known until around 15 months after the end of the relevant financial year, and reconciliation will affect the subsequent year's budget. For example, 2017/18 income tax outturns will need to be managed when the 2020/21 budget is set. The timings of final outturns for VAT assignment are yet to be confirmed.

76. The interaction between forecasts and outturns will become increasingly complex as the remaining components of the Fiscal Framework are introduced and the reconciliation processes play through. If VAT reconciliation follows a similar timetable to Scottish income tax, then the first reconciliation for VAT assignment will be made in 2023/24. In managing the 2023/24 budget the Scottish Government will therefore need to take account of budget impact of:

- revenue and BGA outturn reconciliations for Scottish income tax for 2020/21
- tax revenue and BGA outturn reconciliations for VAT assignment for 2020/21
- final adjustments to BGA reconciliations for fully devolved taxes and social security relating to UK Government outturns for 2021/22
- in-year adjustments to BGA and expenditure for social security outturns for 2023/24.

Data availability

77. Relevant and robust data about the UK and Scottish economies, tax and social security spending is critical to good forecasting. Data can come from a number of sources, including accounting systems (which record individual transactions as they occur), official statistics and other surveys and estimates. Some data sets, such as economic statistics, are subject to revision as further information is gathered.

78. Forecasters have a broad range of statistical and data needs, as their economic and fiscal forecasts use various types of information in the underlying models and have different data requirements. In its recent Statement of Data Needs, the SFC highlighted that "further work to expand or improve the current data provision would be very valuable for [its] forecasts". It highlighted priority areas of interest for statistical developments, and its reliance on other UK and Scottish public bodies to produce the data require.

79. The SFC has highlighted that establishing an agreed Memorandum of Understand (MoU) with DWP is a priority for Commission. This will be critical to the quality of future social security expenditure forecasts. In this and other areas, data availability also depends on how underlying information systems are constructed. It may be difficult or costly to capture and extract information that is relevant to the operation of the Fiscal Framework. In particular, UK Government departments such as HMRC and DWP have not previously needed to identify Scottish taxpayers or people entitled to social security payments separately. In 2017 the NAO highlighted the continuing challenge in maintaining and updating records of addresses in order to identify Scottish taxpayers.

80. The Scottish Government has also previously paid to increase the number of Scottish participants in large UK surveys such as the Living Cost and Food Survey (jointly funded by the UK Government). This helps improve the quality of the conclusions and evaluations that are undertaken as part of such surveys, with a view to improving the accuracy of forecasts that use such sources.

81. While agreements with public bodies to develop their information systems and investment in new data sets and surveys help to improve the availability of current data, there are limited opportunities to improve historical information. Information going back many years is available in some areas, such as estimates of Scottish economic growth and population, but such data has not previously been collected it will take some time before meaningful trend information emerges in other areas that are now relevant to the Scottish budget.

82. Developments in outturn data can also have a significant impact on forecasters' understanding of the economy and taxes, including revisions to historic data. For example, full administrative data on the number of taxpayers became available for the first-time following publication of HMRC's most recent annual accounts. The SFC has highlighted that this will cause a significant revision to the baseline level of receipts used in future Scottish income tax forecasts.

Approach to forecasting

83. The robustness of the methodologies used by the SFC and OBR is also critical to the extent of forecasting risk. Both organisations operate independently from government, which helps ensure that their judgements are objective and unbiased. 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 crises.

84. The SFC's most recent forecast evaluation report appraised its previous forecasts and considered ways of improving them in the future. This included commentary on its methodologies alongside some data issues. Overall it concluded that the scale of forecast error in its forecasts was reasonable compared to other forecasters.

85. The SFC and OBR operate independently from one another and apply their own methodologies and judgements to their respective responsibilities. This means that Scottish tax and social security forecasts and forecasts used in block grant adjustments are prepared in different ways. Where forecasters reach significantly different conclusions this will have a

direct impact on both the initial Scottish budget, and subsequent reconciliations. For example, they may take different perspectives on issues such as the likely impact of EU withdrawal, underlying economic capacity, the prospects for productivity growth and the behavioural responses of taxpayers or those entitled to social security payments. The less their forecasts and subsequent reconciliations are correlated, the greater the potential volatility will be for the Scottish budget.

Budget Management Risk

86. The risks arising from the operation of the Fiscal Framework need to be managed by the Scottish Government as part of its overall management of the Scottish budget position. Effective budget management is required to ensure the sustainability of the Scottish public finances over the long term, enable the Scottish Government to deliver its policies and minimise disruption to public services. It also needs to ensure that public spending programmes provide value for money, while remaining within authorised budgets and the limits in the Fiscal Framework.

87. 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. The extent of the budget management challenge in any one year will depend 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 might be significant and more difficult to manage effectively.

Planning and monitoring

88. The Scottish Government is developing its internal 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. The Scottish Government has published its medium-term financial strategy, Scotland Fiscal Outlook, to inform this approach. Good in-year monitoring and decision making is also becoming increasingly important. We report regularly on the Scottish Government’s progress in developing its financial management and reporting through our audits.

89. 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. A new budget process is being introduced from 2019/20 with a greater emphasis on the longer -term effectiveness of spending programmes and improved public reporting. Parliamentary committees have a key role in scrutinising the overall affordability and sustainability of the Scottish budget, the effectiveness of the Scottish Government's arrangements, and the value for money being achieved from public spending.

Using the flexibilities in the Fiscal Framework

90. The flexibilities in the Fiscal framework, including resource borrowing facilities and use of the Scotland Reserve, are designed to enable the Scottish Government to manage its budget position effectively. The extent to which it will be able to do this will depend on:

- the extent of volatility experienced compared to the limits over the size and use of the relevant facilities. As set out in Part 2 the volatility experienced to date has been able to be accommodated within the Scotland Reserve as part of the Scottish Government's overall management of the budget position. As further components of the Fiscal Framework come into play, including social security and reconciliations for Scottish income tax and assigned VAT the potential scale of volatility increases substantially
- the effect of previous decisions on use of the borrowing and Scotland Reserve. For example, if significant amounts are being carried in the Scotland Reserve this will provide a bigger buffer against budget pressures, but provide less flexibility to accommodate underspends or additional revenues
- whether the specific triggers for resource borrowing powers occur. The Scottish Government only has an option to use these powers if the relevant conditions are met, including the reconciliation process resulting in a budget reduction or when a Scottish-specific economic shock is forecast or has occurred. In all cases the Scottish Government will be able to decide whether to undertake resource borrowing.

91. How well these powers enable the Scottish Government to respond to budget pressures depends on how long such pressures continue. The Scottish Reserve and resource borrowing powers are predominantly designed to help manage year-on-year fluctuations. They do not insulate the Scottish budget from structural effects that continue over a number of years.

Controlling spending

92. 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 2017/18 was effective in managing total spending.

93. 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.

94. This will need to be done in a way that minimises the disruption to individual public bodies and services and ensures value for money is maintained. The greater the variation in budgets that

need to be accommodated, the more difficult it will be to achieve this. Much of the public spending incorporated in the Scottish budget is for areas such as staff costs that are very difficult 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. Public bodies are also likely to require to budget more flexibly as a result.

Existing financial commitments

95. A range of long-term financial commitments are 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.

96. The Scottish Government's first five-year financial plan, Scotland's Fiscal Outlook, sets out a range of policy priorities and the potential financial consequences of these. Taken together, the greater the range of existing commitments that require to be funded from future Scottish budgets the more challenging it is likely to be to respond effectively to other significant budget risks (Exhibit 16).

Exhibit 16
Impact on the 2018/19 resource budget (central scenario) of a 2 per cent drop in spending

£ billion	Current values	If Total Budget fell by 2 %...	
		Values	Percentage change
Total Budget	27.9	27.3	-2.0%
Priority expenditure	15.6	15.6	0.0%
Other expenditure	12.3	11.7	-4.5%

Source: Scottish Government. Note: these figures exclude capital spending and AME. We have presented these figures for the central scenario. Under the upper scenario, the impact would be approximately the same, and under the lower scenario, the impact of a 2 per cent drop in total budget would be slightly more, 4.6 per cent.

97. Spending on priority areas will increase to 63 per cent in 2022/23 in cash terms, from £15.6 billion to £20.8 billion. Were the Scottish budget to face significant pressure as a result of the range of risks it is now exposed to, and the Scottish Government protected spending programmes its priority areas, the spending programmes in other areas would be disproportionately affected (Exhibit 17).

Exhibit 17
Outlook for the resource budget over the period covered in the *Scotland's Fiscal Outlook*

Area	2018/19 £ billion	2022/23 £ billion	Change in spend over period	
			Cash terms	Real terms
Priority expenditure - all scenarios	**15.6**	**20.8**	33%	25%
Other expenditure - upper scenario	12.6	13.4	6%	-1%
Other expenditure - central scenario	12.3	12.0	-2%	-9%
Other expenditure - lower scenario	11.9	10.6	-10%	-16%

Note: these figures exclude capital spending and AME
Source: Scottish Government

Overall public finances

98. 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 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 and should aim to publish the account, using 2017/18 financial information, before the end of 2018.

Conclusion

99. In this paper we have set out how changes the 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 will grow as outturn data for Scottish Income Tax becomes known and as further Social Security powers and the assignment of VAT begin to operate. The impact on available resources will affect the policy choices available to the Scottish Government and its ability to deliver on its priorities in a sustainable manner.

100. This means effective budget management and scrutiny has never been more important. The Scottish Parliament's new budget process is being introduced from this year and aims to support a strategic approach to considering the effectiveness of taxation and public spending.

101. 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. The publication of the Scottish Government’s first medium-term financial strategy and Fiscal Framework Outturn Report are significant developments in the Scottish Government's annual financial reporting and key components of the new budget process. These are expected to develop further over time. Reporting by the SFC and OBR on their forecasts, and the work of respected commentators such as the Fraser of Allander Institute, also helps understanding of budget issues.

102. This paper puts into context the importance of recent Audit Scotland recommendations, including those made within the Scottish Government Consolidated Accounts audits. The Scottish Government has not yet published a consolidated account covering the whole public sector in Scotland. This is an important commitment that will improve strategic public financial management, support Parliamentary scrutiny and enable better decision making. The Scottish Government also needs to finalise the policies and principles within which it will manage its borrowing powers. This will help to improve decision making about the level, type and timing of borrowing. Similarly, we have previously highlighted the importance of the Scottish Government having a clear policy for how it will operate its reserve.

103. 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.

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

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

106. We do this by contributing our views on the arrangements as they are further developed and through our audit work. To date, we have published a number of reports and provided submissions to the Scottish Parliament's committees on the new financial powers and related topics. Our forward work programme includes planned reports on social security implementation and others on important economic drivers including higher education, skills and investment, digital and city deals. All of these will provide insight into how well the Scottish Government is pursuing its aim of a globally competitive, entrepreneurial, inclusive and sustainable economy. We will also continue to report on the overall management of the Scottish budget.

107. 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

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