The Committee will meet at 10.00 am in the David Livingstone Room (CR6).

1. **Decision on taking business in private**: The Committee will decide whether to take item 3 in private.

2. **Fiscal Framework**: The Committee will take evidence from—
   
   Caroline Gardner, Auditor General for Scotland, and Mark Taylor, Assistant Director, Audit Scotland.

3. **Land and Buildings Transactions Tax**: The Committee will consider a draft report on the Land and Buildings Transactions Tax.

Jim Johnston  
Clerk to the Finance and Constitution Committee  
Room T3.60  
The Scottish Parliament  
Edinburgh  
Tel: 0131 348 5215  
Email: James.Johnston@parliament.scot
The papers for this meeting are as follows—

**Agenda item 2**

Written Submission and Audit Scotland Report  
FCC/S5/16/13/1

**Agenda item 3**

PRIVATE PAPER  
FCC/S5/16/13/2
Introduction

The evidence session with Audit Scotland will involve taking evidence from Audit Scotland on their report ‘Scotland’s new financial powers’ which considers how Scotland’s public finances are changing as a consequence of the Scotland Act 2016 and the implementation of the fiscal framework. Audit Scotland have provided a written submission which is provided at Annex A of this paper. A copy of the Audit Scotland report, ‘Scotland’s new financial powers’, is provided at Annex B.

The witnesses from Audit Scotland are:

- Caroline Gardner, Auditor General for Scotland; and
- Mark Taylor, Assistant Director, Audit Scotland.
Audit Scotland: Written Submission

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.

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

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.

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.

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.

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

Auditor General for Scotland

The Auditor General’s role is to:
- appoint auditors to Scotland’s central government and NHS bodies
- examine how public bodies spend public money
- help them to manage their finances to the highest standards
- check whether they achieve value for money.

The Auditor General is independent and reports to the Scottish Parliament on the performance of:
- directorates of the Scottish Government
- government agencies, eg the Scottish Prison Service, Historic Environment Scotland
- NHS bodies
- further education colleges
- Scottish Water
- NDPBs and others, eg Scottish Police Authority, Scottish Fire and Rescue Service.

You can find out more about the work of the Auditor General on our website: [www.audit-scotland.gov.uk/about/ags](http://www.audit-scotland.gov.uk/about/ags)
**Introduction**

1. The Scottish Parliament’s financial powers are changing substantially, with new responsibilities for taxes, social security and borrowing (Exhibit 1, page 4). Over the next five years, spending is set to rise from about £38 billion to over £40 billion and the amount of money raised in Scotland will go up by about £17 billion to £22 billion. This means that the amount of devolved spending in Scotland met by money raised directly will increase from around ten per cent prior to the Scotland Act 2012, to over 50 per cent once the Scotland Act 2016 powers are implemented (Exhibit 2, page 5).

2. The new powers give more control over public finances and bring new opportunities and challenges. The Scottish Government will have more choice over tax and spending, and more decisions to make about how and when to use its new borrowing and reserve powers. The relative strength of the Scottish economy will have a greater influence on public finances than ever before. The budget process will become increasingly complex, and subject to greater uncertainty and volatility than when the block grant from the UK Government was relatively fixed. As a result, forecasting will become more important.

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

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

**Managing the new financial powers**

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

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

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

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

<table>
<thead>
<tr>
<th>From</th>
<th>Land and Buildings Transactions Tax</th>
<th>Estimate</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>£416 million</td>
<td></td>
<td>Actual 2015/16: £425 million</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>From</th>
<th>Scottish Landfill Tax</th>
<th>Estimate</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>£147 million</td>
<td></td>
<td>Actual 2015/16: £147 million Total LBTT + SLfT = £572 million</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>From</th>
<th>Borrowing and cash reserve powers (up to 10% of capital budget each year):</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>• Revenue borrowing</td>
<td>Overall limit – £500 million</td>
</tr>
<tr>
<td></td>
<td>• Capital borrowing</td>
<td>Overall limit – £2.2 billion</td>
</tr>
<tr>
<td></td>
<td>• Cash reserve</td>
<td>Overall limit – £125 million</td>
</tr>
<tr>
<td></td>
<td>Borrowing can be from:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- the National Loans Fund</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Commercial banks</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Issuing of bonds</td>
<td></td>
</tr>
<tr>
<td></td>
<td>£74m added to reserve from 2015/16 receipts</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>From</th>
<th>Scottish Rate of Income Tax (SRIT)</th>
<th>Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>£4.3 billion</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>From</th>
<th>Control over income tax rates and bands</th>
<th>Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>£11.2 billion</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>From</th>
<th>Increased borrowing and reserve powers over:</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>• Revenue borrowing</td>
<td>Overall limit – £1.75 billion</td>
</tr>
<tr>
<td></td>
<td>• Capital borrowing</td>
<td>Overall limit – £3 billion</td>
</tr>
<tr>
<td></td>
<td>• Scotland Reserve</td>
<td>Overall limit – £700 million</td>
</tr>
<tr>
<td></td>
<td>Extends 2012 Act powers</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Annual limit £600 million</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Annual limit 15% of overall limit</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Annual limit £350 million</td>
<td></td>
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<table>
<thead>
<tr>
<th>From</th>
<th>Air Passenger Duty</th>
<th>Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>£275 million</td>
<td></td>
</tr>
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<table>
<thead>
<tr>
<th>From</th>
<th>VAT: the first 10p of standard rate of VAT (and 2.5p of reduced rate) raised in Scotland will be assigned to Scottish budget</th>
<th>Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019</td>
<td>£5.6 billion</td>
<td></td>
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<table>
<thead>
<tr>
<th>From</th>
<th>Aggregates Levy</th>
<th>Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>£53 million</td>
<td></td>
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</tbody>
</table>

Social security

<table>
<thead>
<tr>
<th>From</th>
<th>Responsibility for 11 social security powers ranging from Disability Living Allowance to winter fuel payments</th>
<th>Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019</td>
<td>£2.7 billion</td>
<td></td>
</tr>
</tbody>
</table>

Note: 1. Estimates for taxes are taken from *Government Expenditure & Revenue Scotland 2015-16*, Scottish Government, August 2016, Source: Audit Scotland
We have produced a Supplement alongside this paper to provide a high-level view of the new landscape showing how funds flow through the system and which organisations are involved.

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

Exhibit 2
Taxation as a share of spending

Note: Figures are rounded to nearest £10 million.
Source: Scottish Parliament Information Centre Financial Scrutiny Unit, August 2016
Key issues

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

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

Budget process and scrutiny

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

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

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

Key questions

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

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

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

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

Key questions

• How will policy decisions affect the Scottish economy and financial sustainability in the short, medium and long term?

• How will all the elements and sensitivities of tax and spending forecasts be clearly and comprehensively explained and reported?

• How will variability in revenue from tax and demand-led spending be managed?

• What information will be available on borrowing and the impact of borrowing on future budgets?

Financial management

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

18. The financial powers include new options for the Scottish Government to help it manage public finances. Existing borrowing limits to bridge any unplanned gap between budgeted and actual tax revenues have been increased (Exhibit 1, page 4), with new powers to manage a Scotland specific economic shock. The Scottish Government can use reserves to smooth the impact of any variability in tax revenues. Borrowing and use of the cash reserve will have to be managed within the limits and other rules set out in the fiscal framework.
19. Clear strategies, for example setting out how and when borrowing will be used, will be important for managing and controlling the new powers. Robust financial management processes will be important to deal with the potential volatility of revenues and demand-led spending.

Key questions

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

Transparent financial reporting

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

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

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

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

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

Implementation of the new financial powers

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

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

Key questions

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

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

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

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

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

30. If you would like more information about Audit Scotland’s work on the new financial powers, please contact Mark Taylor, assistant director at mtaylor@audit-scotland.gov.uk.
Appendix 1

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

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

- *Preparations for the implementation of the Scotland Act 2012*\(^1\), December 2014

The AGS will publish a report on *Managing new financial powers*\(^3\) in spring 2017.

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

- *Developing financial reporting in Scotland*\(^4\), July 2013
- *Update on developing financial reporting*\(^5\), March 2015.

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

- In April 2015, Audit Scotland submitted a response\(^6\) to the Finance Committee’s call for evidence on Scotland’s fiscal framework.
- In June 2015, Audit Scotland submitted a response\(^6\) to the Public Audit Committee’s call for evidence on audit, accountability and the further devolution of powers.
- On 21 August 2015, the AGS wrote\(^7\) to the Public Audit Committee in response to the Committee’s issues paper on audit, accountability and the further devolution of powers.
- In October 2015, Audit Scotland submitted a response\(^8\) to the Finance Committee’s call for evidence on the Scottish Fiscal Commission Bill.
- On 4 March 2016, the AGS wrote\(^9\) to the conveners of the Devolution and Finance Committees (copied to the Public Audit Committee) offering observations on the fiscal framework and highlighting the important role of public audit in the implementation of new financial powers.
Scotland’s new financial powers

Key issues for the Scottish public finances

This report is available in PDF and RTF formats, along with a podcast summary at: www.audit-scotland.gov.uk

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