Public Audit Committee

29th Meeting, 2022 (Session 6), Thursday, 1 December 2022

Scotland's public finances: challenges and risks

Introduction

1. At its meeting today, the Committee will take evidence from the Auditor General for Scotland (AGS) on his briefing, Scotland's public finances: challenges and risks, which was published on 17 November 2022.

2. The AGS has prepared a note on the key messages from the briefing which, along with a copy of the briefing, can be found in the **Annexe**.

Clerks to the Committee
28 November 2022

Annexe

BRIEFING PAPER BY THE AUDITOR GENERAL FOR SCOTLAND

1. The Auditor General's briefing paper on Scotland's public finances: Challenges and risks was published on 17 November 2022. Key messages from the briefing are:

   - **Rising costs and increasing demands mean that the Scottish Government has to closely and carefully manage its position, to avoid the real risk that it will overspend on the 2022/23 budget.**

   - The pressures placed on Scottish public finances have been significant and varied for several years. They pre-date the current cost of living crisis and the Covid-19 pandemic, and have worsened because of them.

   - The Emergency Budget Review process identified savings of nearly £1.2 billion in response to pressures on the budget. However, the fiscal environment continues to be uncertain. If the Scottish Government were to overspend against its budget, this money could be clawed back from the following year's budget. This would be the first such occasion since the creation of the Scottish Parliament.

- The current high level of inflation means that the Scottish Government faces higher public-sector pay and other costs, at the same time as it faces increasing demand for support from people impacted by the cost crisis. The budget was set when inflation was lower, and the Scottish Government is unlikely to receive additional funding to address this issue in the near future.

- The Scottish Government must manage the increased costs of running the public sector on an ongoing basis. Although inflation is not forecast to stay high over the long term, the like-for-like increased costs are locked in for future budgets, and will not fall back to their previous levels. As a result, the Scottish Government must manage these higher unit costs permanently, or change the way it operates.

- **The Scottish Government has limited room for manoeuvre to make changes to balance the 2022/23 budget, and will face difficult choices setting the 2023/24 budget.**

- Much of the Scottish budget is committed, which means that there is limited flexibility in the short term. Setting the 2023/24 budget will be challenging, and the UK Government's spending and tax decisions will impact on this. A balance must be struck between short-term necessities and longer-term priorities, and the Scottish Government will need to revisit its priorities if the economic and fiscal conditions worsen.

- The financial pressures faced may have implications for the scale, range and types of public services that can be provided. The Scottish Government may be in the difficult position of deciding what spending programmes and areas of government it will deliver differently, deliver less of, and which programmes it may need to stop delivering completely.

- The Scottish Government needs to understand how its decisions will affect different groups. To minimise the negative impacts from the any future changes to public spending on people's outcomes, the near-term pressures on the budget must be managed while maintaining a focus on long-term priorities.

- **The pace and scale of reform required across the public sector needs to increase.**

- While the Scottish Government must continue to react to immediate events and financial pressures, this must not distract from the immediate need for broader reform. The Scottish Government's Resource Spending Review sets out its planned reforms and next steps. In the past, the Auditor General has highlighted an implementation gap between the Scottish Government's ambitions for reform and delivery on the ground. The changes required to public services are significant, will be long standing, and will impact on people's lives. As such, it is important that citizens and communities are fully involved in the key decisions about how public services will need to change.

- It is important that it is clear how spending is affecting the outcomes the Scottish Government wants to achieve. The current lack of good milestones for National Outcomes will make monitoring how changes to budgets impact on people and longer-term goals much more difficult. Many of the indicators reflect data from the pre-pandemic period, or have no data available at all. A lack of good quality and up-to-date data limits public bodies' ability to target spending to where it is needed, as it is harder to understand and predict where demand will come from. Collecting this data will require both time and money, but will be an important step towards mapping spending to the aspirations of the Scottish Government.

- Reform is most successful when it is planned and targeted –in contrast with flat budget reductions across the board which reduce spending across the public sector, without considering the impact on wider ambitions. If this does not happen, it will become increasingly difficult for the Scottish Government to manage the pressures on the budget, meaning that the cuts to spending necessary to balance the budget will become larger, and the quality of public services delivered will worsen.

Annexe

Briefing

Scotland's public finances

Challenges and risks

AUDITOR GENERAL

Prepared by Audit Scotland
November 2022

Contents

Introduction

1. The pressures placed on Scottish public finances have been significant and varied for several years. The level of funding available to the Scottish Government has fluctuated, falling in real terms between 2010/11 and 2017/18 but steadily increasing since.[1] The response to the Covid-19 pandemic saw further, significant increases to the Scottish budget but this funding was temporary and has now come to an end.

2. The Scottish public sector has had to adapt to these changes in funding levels alongside managing increasing demand for services and external events such as the Covid-19 and cost of living crises. These challenges continue to grow, with real-life implications for people in Scotland.

3. The re-opening of economies following Covid-19 led to inflation across the world because of growing demand, labour shortages and increased transport costs. The war in Ukraine has increased energy prices.[2] Inflation is outstripping any increases that people are seeing to wages or benefits, and real earnings fell at the fastest rate since records began between April and June.[3]

The rising cost of living is described as a ‘cost of living crisis’

4. According to the Office for National Statistics, 87 per cent of adults in the UK reported an increase in their cost of living in August-September 2022.[4] Businesses, the third sector and the public sector also face higher operating costs, including higher labour costs as wages rise in response to inflation. In this paper, when we talk about the cost of living crisis, or the cost crisis, we mean all these pressures across the economy that are caused by rising prices.

5. The Scottish Government has said that it faces ‘significant financial challenges’ because of the cost crisis,[5] as it supports individuals and businesses affected by rising prices, at the same time as inflation means its funding buys less than was expected when the budget was set in December.

6. This paper focuses on the pressures facing the Scottish budget this financial year and in the medium term, and the implications this has for public services. It intends to inform and support scrutiny of proposed spending and tax plans in the current context, and emphasise the need for reform to public services.

[1] Institute for Fiscal Studies, How and why has the Scottish Government’s funding changed in recent years?, March 2021
[2] Institute for Fiscal Studies, The Cost of Living Crisis, accessed August 2022
[3] BBC, Inflation drives fastest fall in real pay on record, August 2022
[4] ONS, Public opinions and social trends, Great Britain, 30 September 2022
[5] Deputy First Minister, Letter to the Finance and Public Administration Committee, September 2022

Key messages

Scotland’s public finances: challenges and risks

- **Rising costs and increasing demands mean that the Scottish Government has to closely and carefully manage its position, to avoid the real risk that it will overspend on the 2022/23 budget.** There have been significant financial pressures on public services for some time before the cost of living crisis. The current high level of inflation means that the Scottish Government faces higher public-sector pay and other costs, at the same time as it faces increasing demand for support from people impacted by the crisis. The budget was set when inflation was lower, and the Scottish Government is unlikely to receive additional funding to address this issue in the near future.

  If the Scottish Government were to overspend against its budget, this money could be clawed back from the following year’s budget. This would be the first such occasion since the creation of the Scottish Parliament.

- **The Scottish Government has limited room for manoeuvre to make changes to balance the 2022/23 budget, and will face difficult choices setting the 2023/24 budget.** Within the year, much of the Scottish budget is committed, which means that there is limited flexibility available to the Scottish Government in the short term. Setting the 2023/24 budget will be challenging, and the UK Government’s spending and tax decisions will impact on this. A balance must be struck between short-term necessities and longer-term priorities, and the Scottish Government will need to revisit its priorities if the economic and fiscal conditions worsen.

- **The pace and scale of reform required across the public sector needs to increase.** While the Scottish Government must continue to react to immediate events and financial pressures, this must not distract from the immediate need for broader reform. The Scottish Government’s Resource Spending Review sets out its planned reforms and next steps. In the past, the Auditor General has highlighted an implementation gap between the Scottish Government’s ambitions for reform and delivery on the ground. It is vital that these reforms are delivered effectively, and with public engagement, to deliver sustainable services that improve people’s outcomes.

The cost of living crisis adds to the pressures on the Scottish budget

Sustainability pressures on Scotland's public finances pre-date the current cost crisis and the Covid-19 pandemic, and have worsened because of them

7. Significant risks to the financial sustainability of public services in Scotland are not new:

- In 2018, the Auditor General first stated that the NHS was not in a financially sustainable position.[6] NHS boards were increasingly reliant on additional financial support from the Scottish Government or non-recurring savings to break even.
- The Accounts Commission has also highlighted for some years that councils in Scotland are also facing financial sustainability pressures. In the Local Government Overview published in June 2020, the Accounts Commission highlighted that councils making continued use of reserves to manage the funding gap was unsustainable.[7]

8. The long-term financial and operational effects of Covid-19 are still being felt. The pandemic has had a range of indirect and direct health and societal impacts, such as backlogs in NHS treatments and court cases.

9. No additional separate funding was provided by the UK Government for Covid-19 in 2022/23, although the overall Scottish budget has grown in comparison to pre-pandemic levels. The extra pressures caused by the pandemic are being funded through the core Scottish budget, placing more pressure on Scottish public finances.

The Scottish Government must meet any additional spending above UK measures from its existing budget

10. The current high levels of inflation bring further uncertainty and volatility to UK and Scottish government budgets. During the Covid-19 pandemic, the UK Government response included both direct support for individuals and businesses (for example, the furlough scheme) and also increased departmental spending, which led to increased funding for the Scottish

[6] Audit Scotland, NHS in Scotland 2018, October 2018
[7] Accounts Commission, Local government in Scotland: Overview 2020, June 2020

Government. As set out in Scotland's financial response to Covid-19, the UK Government provided the majority of funding for the Scottish Government's £15.5 billion spending response to the pandemic in 2020/21 and 2021/22.

11. To date, the main financial responses to the cost crisis have been in reserved rather than devolved areas, which do not directly impact the Scottish budget. To help manage energy costs, the UK Government has announced the Energy Price Guarantee (for households) and the Energy Bill Relief Scheme (for non-domestic customers). Both these schemes were expected to cost £60 billion in 2022/23 across the UK when they were announced.[8]

12. Funding from the UK Government provided through the block grant is the main source of funding for the Scottish budget. This gives Scotland a proportion of the amount that the UK Government allocates to its departments for spending on devolved issues (such as health and education). The block grant only changes in response to UK Government decisions, and is not automatically uprated for inflation.

13. The UK Government has not changed its departmental spending this year to account for the higher costs facing the public sector, meaning that if the Scottish Government wishes to spend more money to support individuals and business through the cost of living crisis, this must be funded from the existing Scottish budget, rather than through additional Barnett consequentials.

14. Increased inflation means the public pound buys less than was expected when the budget was set. As part of the Programme for Government, the First Minister highlighted that because of inflation, the Scottish 2022/23 budget is worth £1.7 billion less than it was when it was set in December.[9]

15. The Comprehensive Spending Review (CSR) sets out the UK Government's intended spending over the medium term and was announced when forecasts for inflation were much lower. The CSR projected 3.3 per cent real-terms growth in its departmental resource budgets between 2021/22 and 2024/25. In August 2022, the Institute for Fiscal Studies estimated that the real terms growth in spending over that period has now dropped to 1.9 per cent.[10] Any increased costs must be met through the original spending envelope given to UK Government departments – and consequently, that given to the Scottish Government.

16. The UK Government has announced that it will deliver an Autumn Statement on 17 November. This will contain important information for the Scottish Government to consider as it sets its 2023/24 budget.

[8] UK Government, The Growth Plan, September 2022

[9] Scottish Government, Programme for Government 2022-2023: First Minister's speech, 6 September 2022

[10] Institute for Fiscal Studies, The inflation squeeze on public services, 10 August 2022. This is based on levels of inflation for the GDP deflator as opposed to the Consumer Price Index. Please see the article for more information.

The Scottish Government must manage the increased costs of running the public sector on an ongoing basis

17. Although inflation is not forecast to stay high over the long term,[11] the like-for-like increased costs are locked in for future budgets, and will not fall back to their previous levels. As a result, the Scottish Government must manage these higher unit costs permanently, or change the way it operates. Examples of the rising costs the Scottish Government faces are set out in Exhibit 1.

Exhibit 1
Examples of cost pressures on the public sector

The enhanced pay offers that have been made to date total over £700 million.[12] Agreement has yet to be reached with unions in some key areas of the public sector.

Electricity costs through the National Framework Agreement have increased by 27.5 per cent over the last year.

Gas prices through the National Framework Agreement have increased by 197 per cent over the last year.[13]

Food costs are estimated to increase by five per cent over the next year. Councils currently spend around £86 million on food each year.[14]

The costs of capital projects are also increasing, with councils reporting increases of around 30 per cent on anticipated costs.[15] This is likely to be reflected more widely across the public sector.

Source: Audit Scotland

18. Wages are the most significant of these costs, accounting for over £22 billion across the devolved public sector (including local government).[16] The Scottish Government pay policy set in December 2021 reflected inflation of 3.1 per cent,[17] but by the time of the next Medium-term Financial Strategy in May, this had increased to nine per cent.[18]

[11] Bank of England, Monetary Policy Report, August 2022
[12] Deputy First Minister, Letter to the Finance and Public Administration Committee, September 2022
[13] Scottish Parliament Written Answer, S6W-07596, March 2022
[14] COSLA/SOLACE/CIPFA Directors of Finance Section, Finance and Public Administration Committee consultation response, August 2022
[15] COSLA/SOLACE/CIPFA Directors of Finance Section, Finance and Public Administration Committee consultation response, August 2022
[16] Scottish Government, Scotland's Fiscal Outlook, May 2022
[17] Scottish Government, Scotland's Fiscal Outlook, December 2021. This is CPI inflation.
[18] Scottish Government, Scotland's Fiscal Outlook, May 2022

19. Public-sector trade unions have called for pay rises that match inflation.[19] The Scottish Government, local government, and trade unions agreed a deal over the summer. Funding for any future pay deals will need to be found from the 2022/23 budget.

The costs of supporting people through the crisis have increased

20. Social security spending is a key channel through which the Scottish Government provides support to individuals, and in 2022/23 accounts for approximately ten per cent of the Scottish Government budget.[20] The Scottish Fiscal Commission (SFC) forecast that higher inflation will increase social security spending by £156 million in 2023/24 and by £213 million in 2026/27, compared to their forecast in December 2021.[21] Social security spending is forecast to rise from £5,072 million in 2023/24 to £6,490 million in 2026/27.

21. The Scottish Child Payment (SCP) will also be increased from £20 per week to £25 when it is rolled out to households with children aged 6–15 in November 2022. From 2024/25 onwards the benefit is forecast to cost around £25 million more than forecast in May 2022, because of higher inflation.[22]

22. It is not clear if the current environment will lead to more people being eligible and applying for benefits. In their latest SCP costing from September, the SFC has not changed its assumption of the number of families receiving qualifying benefits or the underlying forecasts of unemployment. These will be updated in the SFC's next forecasts which will be published to accompany the Scottish Government's 2023/24 budget announcement. This could mean further cost pressures if the economic position were to worsen as social security spending is demand-led and needs-based.

23. The Scottish Government has also announced other new support in response to the cost of living crisis, including an extra £21.75 million to provide free school meals to eligible children over the school holidays[23] and the expansion of home energy schemes, including £161 million for the Warmer Homes Scotland scheme, Area Based schemes, and Home Energy Scotland.[24] The Scottish Government has also committed to doubling the quarterly bridging that will be paid in December to children and young people in receipt of free school meals.[25]

[19] STUC, Scotland Demands a Pay Rise, 2022
[20] The Scottish Fiscal Commission, Scotland's Economic and Fiscal Forecasts, May 2022
[21] The Scottish Fiscal Commission, Scotland's Economic and Fiscal Forecasts, Figure 5.11, May 2022
[22] The Scottish Fiscal Commission, Supplementary Costing – Scottish Child Payment, September 2022
[23] Scottish Government, Summer support for children, July 2022
[24] Scottish Government, Cost of living support, July 2022
[25] Scottish Government, Extra winter cash for children and young people in receipt of free school meals, October 2022

The Scottish Government faces tough choices for the 2022/23 and 2023/24 budgets

Without very close management of the budget, there is a real risk the Scottish Government overspends against its 2022/23 budget

24. The Scottish Government has reported balanced budgets since devolution was introduced in 1999. Early in 2022/23, the Scottish Government was forecasting a significant budget gap for the financial year, which was larger than could be managed through its usual budget processes. The Scottish Government identified the need for more substantial changes to spending, which were announced through the Emergency Budget Review process. The fiscal environment continues to be uncertain, and the Scottish Government must closely manage its budget for the rest of the financial year.

25. The Scottish Government has recognised that the financial situation it faces is by far the most challenging since devolution. An overspend on the budget would be a new development for Scottish public finances. The potential consequences and how this would take shape are unclear at this stage. Our understanding is that HM Treasury rules mean that any overspend against the 2022/23 budget would be deducted from the following year's block grant.[26] This would mean that there is less funding available for spending on next year's budget, exacerbating existing pressures on future public spending.

26. As set out in the fiscal framework, the Scottish Government can borrow to cover a temporary cash shortfall in year. Borrowing powers available to the Scottish Government are limited, and those available for resource borrowing must be paid back over three to five years. Ultimately, the Scottish Government's finances will not be sustainable if its spending commitments cannot be met by its funding and its tax raising powers.

[26] HM Treasury, Statement of Funding Policy, October 2021

Savings have already been found from the 2022/23 budget

27. In September, the Scottish Government has announced £560 million of additional income and savings to the 2022/23 budget to fund the increased cost of public sector pay deals.[27] In November, a further £615 million of savings were identified through the Emergency Budget Review process, the majority (£400 million) of which were changes within the health portfolio to support the proposed pay offer.[28]

28. At just under £1.2 billion, these changes include nearly £200 million of income and funding not expected at the time the budget was set and of the remainder, £300 million relates to capital changes, and £700 million relates to day to day spending.

29. The details of these changes are set out below, and in Exhibit 2 (page 11):

- **Changes to capital:** This includes deferral and reprofiling of capital spending, as well as some changes as result of reduced demand. An example includes £120 million of capital reprioritisation identified from multiple portfolios and transferred to local government to increase their overall resources available to support the local government pay offer.

- **Deferral of funding:** spending can be delayed into future years' budgets. For example, ring-fenced UK funding has been deferred for the Rural Affairs and Islands portfolios, and £70 million of Social Care and National Care Service (NCS) spending has been re-profiled.

- **Increased income and additional consequential funding:** additional funding has been applied to cover increased costs. For example, in September the Scottish Government applied £56 million of funding generated by the ScotWind clearance process to the 2022/23 budget, and has received an additional £82 million in Barnett consequentials.

- **Demand changes:** Where demand is less than expected, underspends are redeployed. Examples include a cut of £37 million in funding for concessionary fares, a £20 million reduction in further education student support, based on a forecast reduction in demand, and a reduction in justice spending based on a lower than anticipated requirement for services within the justice system as it recovers from backlogs. The Scottish Government notes that this does not impact on service delivery.

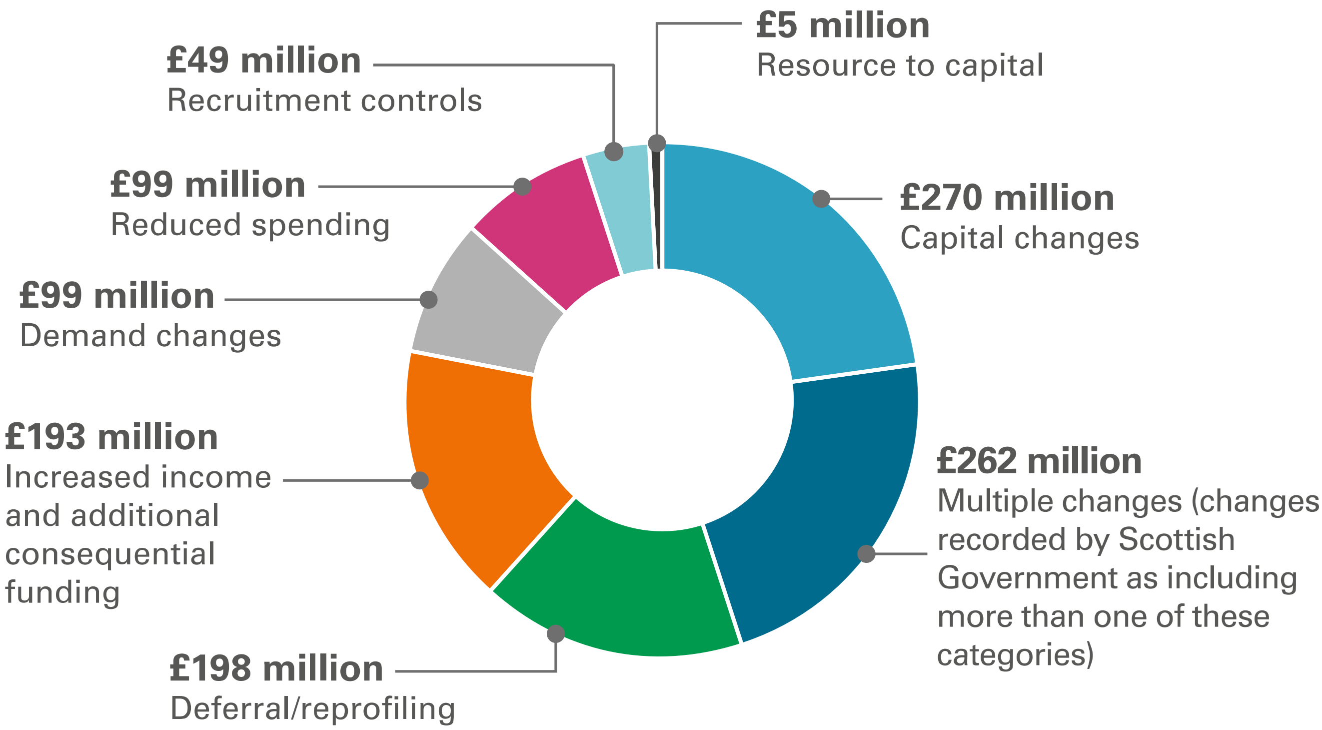
- **Reduced spending:** this includes a reduction of £53 million in funding for employability schemes, and £38 million of mental health spending that has been reprioritised to support the NHS pay offer.

[27] Deputy First Minister, Letter to the Finance and Public Administration Committee, 7 September 2022
[28] Scottish Government, Emergency Budget Review 2022/23, 2 November 2022

- **Recruitment controls:** restrictions in hiring across a range of public bodies.
- **Resource to capital switches:** resource spending is being replaced by capital spending, for example, within the Education and Skills portfolio for Gaelic support.

30. The EBR notes that as a result of the ongoing uncertainty, there remains a risk to balancing the 2022/23 budget.[29]

Exhibit 2
Breakdown of types of savings and reductions included in 2022/23 savings announced to date



Source: Scottish Government, Audit Scotland analysis. September changes come from the Deputy First Minister's letter to the Finance and Public Administration Committee, dated 7 September, and the November changes come from the Emergency Budget Review.

The Scottish Government has tools available to manage its budget, but its options are limited

31. The Scottish Government's options – its ability to flex its budget in response to events – comes from multiple sources, as set out in the following paragraphs.

[29] Scottish Government, Emergency Budget Review 2022/23, 2 November 2022

Fiscal framework tools and powers

32. The Fiscal Framework agreed between the Scottish and UK governments in 2015 includes levers that the Scottish Government can use to manage volatility in its budget. However, these were largely designed to address volatility that arises from forecasting error and were not designed to help balance the budget.

33. The Scotland Reserve is used to manage spending across years. In his letter to the Finance and Public Administration Committee, the Deputy First Minister confirmed that all the available funds from the reserve have been allocated to support spending in the 2022/23 budget.[30] As highlighted in Scotland's new financial powers: Operation of the Fiscal Framework 2018/19, when the Government plans to use the Scotland Reserve to carry forward significant amounts of budget and spending power from one financial year to the next, this will limit the extent to which the reserve is able to operate as a buffer against budget pressures, and this money can only be spent once.

34. The fiscal framework also included borrowing powers. As set out in paragraph 25, the in-year cash management borrowing powers can only be used to fund a temporary shortfall in cash flow or working capital, and do not enable the Scottish Government to spend beyond the funding as set in the budget.[31]

35. The Scottish Government also has capital borrowing powers. While capital borrowing cannot be used to support revenue spending, in the wider public sector (for example, local government) certain types of capital spending could be moved to resource spending. For example, during the Covid-19 pandemic, the Scottish Government identified a package of financial flexibilities for councils, including permitting the use of capital receipts received to fund day-to-day costs.[32] In such a scenario, the Scottish Government could use its capital borrowing powers to offset this, and to restore capital funding available. This would need to be done in line with HM Treasury's Consolidated Budgeting Guidance.

36. Taxes are another source of funding for the Scottish Government budget, and higher inflation can lead to higher tax takes as prices or wages grow faster than tax thresholds. However, Scotland's tax revenues will not change significantly for the rest of 2022/23, because the contribution that Scottish Income Tax, (which accounts for 94 per cent of Scotland's tax revenues)[33] makes to the 2022/23 budget was fixed in cash terms when the budget was agreed. The income tax policy for 2023/24 will be announced alongside the budget in December.

[30] Deputy First Minister, Letter to the Finance and Public Administration Committee, 7 September 2022

[31] For more information, see Audit Scotland, Operation of the Fiscal Framework, October 2018

[32] Scottish Government, Local Government Finance Circular No 2/2021, February 2021

[33] This is the share of Scottish Income Tax, Land and Building Transaction Tax and Scottish Landfill Tax. It does not include Non-domestic Rates revenues.

Controllable and non-controllable costs

37. Reducing budgets in an unmanaged way can have significant impacts on the quality of services provided, how accessible services are, and on people's long-term outcomes. The Scottish Government and other public bodies will need to understand well in advance what constraints there are to their flexibilities to cut spending. Examples include statutory services and duties that must be provided by law (for example, statutory targets for net zero commitments), the Scottish Government's human rights duties, and commitments such as no compulsory redundancies.

38. In addition, in the short term, much of the budget is fixed and committed, and there are limits to what can be changed without significant disruption. Much of the public spending incorporated in the Scottish budget is for areas such as staff costs that are difficult to change quickly.

39. 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 be required to budget more flexibly as a result. For example, to fund the local government pay deal agreed in August, the Scottish Government allowed councils to take some funding that had previously been ringfenced for another use and use this to cover the cost of the pay agreement.

40. In the medium to long term, fewer costs are fixed and more can be changed. This means there is more opportunity for reforming public services, as discussed in more detail in section 3.

Wider public sector flexibilities

41. Some public bodies, such as councils and integration health and social care authorities, also have reserves that can be used to carry funding over from one financial year to the next. However, funding held in reserves can only be spent once and cannot be reliably used to cover recurring costs. As highlighted in Scotland's financial response to Covid-19, some of the money held in council and integration authority reserves has been earmarked for specific purposes, such as the ongoing response to Covid-19. The Scottish Government has requested that some funding which is currently allocated for Covid-19 in integration authority reserves is now used for wider Covid-19 purposes.

42. As the Auditor General has highlighted in previous section 22 reports on the audit of the Scottish Government Consolidated Accounts,[34] there remains a need for a public consolidated account to provide a comprehensive and transparent assessment of the state of Scotland's public finances. This is important for decision-making over the longer term as it will provide information about the impact of past decisions on future budgets, the potential risks to financial sustainability and the scale of assets and liabilities, including those held by publicly owned companies. The report on the 2021/22 audit of the Scottish Government Consolidated Accounts will update on this matter when it is published later in 2022.

[34] Auditor General for Scotland, The 2020/21 audit of the Scottish Government Consolidated Accounts, December 2021

The Scottish Government will have to consider UK Government policies when setting the 2023/24 budget

43. The level of funding that will be available to the 2023/24 Scottish Budget is not yet known. There is ongoing uncertainty around UK Government policy on spending, tax, and social security, with the Chancellor of the Exchequer stating that ‘nothing is off the table’ in terms of changes to tax and cuts to public spending. Changes to UK Government spending in devolved areas impacts the size of the Scottish budget, and reductions to the budgets of public services such as the NHS in England will reduce the funding available to the Scottish Government. The Scottish Government will need to manage this uncertainty when setting the 2023/24 Scottish Budget.

44. While most of the changes to UK tax policy announced in the September mini-budget have been reversed, the changes that had been announced to Stamp Duty have been retained and will impact on the Scottish budget. While the Scottish Government is responsible for setting its own equivalent to Stamp Duty in the form of the Land and Buildings Transaction Tax (LBTT), changes to UK Government tax policy impact the net benefit to the Scottish budget as a result of this devolved tax. If the Scottish Government chooses to retain the existing rates and thresholds for LBTT, then UK Government changes to Stamp Duty would result in additional funding of approximately £65 million for the Scottish Budget in 2023/24.[35]

45. In March 2022, the UK Government announced that working age benefits would rise in line with inflation for 2023/24. It is unclear if this is still the UK Government’s intention.[36] If the UK Government chooses not to increase benefits to fully cover inflation this has implications for Scottish social security spending.

46. If the UK Government decides to uprate the reserved benefits by less than inflation in April 2023, the devolved Scottish benefits that are administered by the Department for Work and Pensions (DWP) may need to be updated by the same rate. This is because of an agreement between the Scottish Government and DWP to ensure payments are consistent while clients are transferred to Scotland.[37]

47. In addition, this means that there would be less funding available for the benefits that are now administered by Social Security Scotland (such as Adult Disability Payment and Child Disability Payment) because the Block Grant Adjustment that the Scottish Government receives from the UK Government would increase at the lower rate. There is a statutory requirement in the Social Security Scotland Act (2018) to consider the effect of inflation and respond if

[35] Deputy First Minister, Letter to the Convener of the Finance and Public Administration Committee, 3 October 2022

[36] House of Commons Work and Pensions Committee, Letter to Chancellor of the Exchequer, October 2022

[37] For example, please see: the Secretary of State for Work and Pensions and the Scottish Ministers, Agency Agreement in respect of Personal Independence Payment for people resident in Scotland, 2020

that effect is, in the opinion of the Scottish Government, material. The Scottish Government has not yet published its report on the effect of inflation on benefits for 2023/24 so it is not clear what rates it will apply in 2023/24.

The Scottish Government has been developing its approach to managing financial sustainability risk

48. The Scottish Government recognises the issues and risks relating to the sustainability of the public finances over the medium term, and is changing how it manages its financial sustainability risks.

49. The Director-General Scottish Exchequer is responsible for managing the financial sustainability risks to the Scottish Government, and the core purpose of the Scottish Exchequer Directorate is 'a fiscally sustainable Scotland'. The directorate is developing its strategy for fiscal sustainability, with the goal of balancing the 2023/24 Budget. The Scottish Government has informed us that the work being undertaken aims to ensure there is an understanding of fiscal risks across the whole of the Scottish Government, and an early priority of this work is to strengthen the spending data available.

50. In Scotland's financial response to Covid-19, the Auditor General and the Accounts Commission highlighted that when the Scottish Government is understanding spending and performance information across several portfolios, it should consider the lessons learned from Covid-19, when the Scottish Government had difficulties in tracking actual spending because its budget processes were not designed to separate specific spending in areas across portfolios.

51. It will be important that the results of the Scottish Government's fiscal sustainability work are transparently shown to improve scrutiny of the financial position, and to highlight risks early.

The financial pressures faced may have implications for the scale, range and types of public services that can be provided

52. Worsening economic conditions will increase demand for public services. The Scottish Government may be in the difficult position of deciding what spending programmes and areas of government it will deliver differently, deliver less of, and which programmes it may need to stop delivering completely.

53. The Scottish Government set out four priority spending areas in the Resource Spending Review (RSR) published in May:

- tackling child poverty
- addressing the climate crisis
- securing a stronger, fairer, greener economy
- delivering excellent public services.[38]

[38] Scottish Government, Resource Spending Review, May 2022

54. If spending in these areas is protected, then reductions and changes to services will have to be applied to non-priority areas. In the RSR, the Scottish Government planned real-terms decreases in spending to areas such as local government, the police, prisons, justice, universities and rural affairs over the spending review period.

55. The current new financial realities mean that if the economic or fiscal environment continues to worsen, the Scottish Government may need to revisit all current priorities and policy commitments. Even if spending in priority areas is protected, services may be under significant pressure due to higher demands, especially on top of backlogs and challenges caused by Covid-19.

The Scottish Government needs to understand how its decisions will affect different groups

56. Recent research by the Glasgow Centre for Population Health has indicated that there is an increasing body of UK and international evidence attributing falls in life expectancy in the UK between 2011 and 2019 to reductions in UK Government spending, particularly in relation to social security, during that period.[39] To minimise the negative impacts from the any future changes to public spending on people's outcomes, the near-term pressures on the budget must be managed while maintaining a focus on long-term priorities.

57. This will be difficult in the current context, when it may be unavoidable that some of the choices that need to be made will negatively impact on wider work to improving outcomes. The more challenging the financial situation, the larger the impact this is likely to have on people and outcomes.

58. The Scottish Government and public bodies must understand how the decisions they make will impact on different groups in society. In advance of the Emergency Budget Review, several gender equality organisations wrote to the Deputy First Minister to highlight the importance of analysing the impact that the budget will have on women, children, and other marginalised groups.[40] Alongside the Emergency Budget Review, the Scottish Government published a summary of the evidence on equality and fairness of the Emergency Budget Review. This considers the evidence at a high level and focuses on the most substantial changes, but is more limited than a full Equality Impact Assessment.[41]

[39] Walsh D, Wyper GMA, McCartney G, Trends in healthy life expectancy in the age of austerity, Journal of Epidemiology and Community Health 2022
[40] Engender, Gender Budget Analysis in Budgetary Reviews, letter to DFM, October 2022
[41] Scottish Government, Emergency Budget Review: equality and fairness – evidence summary, November 2022

Reforms to public services are now required

Failure to make the necessary changes to how public services are delivered will likely mean further budget pressures in the future

59. In the long term, the economic and fiscal outlook means that continuing to make small-scale budget cuts is unfeasible. The Auditor General and the Accounts Commission have continued to underline the importance of reforming public services to manage the sustainability of public finances.

60. Reforming public services means changing how services are delivered to people in a way that more effectively meets both their needs and the Government's policy aspirations. Reform is most successful when it is planned and targeted – in contrast with flat budget reductions across the board which reduce spending across the public sector, without considering the impact on wider ambitions.

61. The significant pressures which require immediate reform are even greater than when medium-term plans were last set out by the Scottish Government. The Medium-term Financial Strategy (MTFS) published in December 2021, projected that by 2026/27 there would be a £3.5 billion gap between its central funding and spending scenarios.[42] The MTFS was then updated in May 2022 and published alongside the RSR.[43] This reflected a balanced medium-term position, where the central funding scenario and central spending scenario align, closing the previously identified funding gap. A key part of how the Scottish Government planned to close the funding gap was by making necessary budgetary savings through public service reform.

62. The RSR includes reference to four main types of reform, summarised in Exhibit 3 (page 18).

[42] Scottish Government, Medium Term Financial Strategy, December 2021
[43] Scottish Government, Medium Term Financial Strategy, May 2022

Exhibit 3
Public service reforms included in the RSR

Type of reform	Summary from RSR
New approaches to public services	Key reforms over the course of this Parliament include: • the establishment of the National Care Service • keeping the Promise (as set out following the Care Review), including by investing £500 million in preventative spend through the Whole Family Wellbeing Funding • the Vision for Justice in Scotland – the future justice system • Education Reform – replacing existing education bodies • National Strategy for Economic Transformation.
Public sector capacity and pay	The RSR includes plans to: • from 2023/24, a broad aim to keep the total cost of the overall annual pay bill the same as 2022/23 • a broad aim to return the total size of the devolved public sector workforce to around pre-Covid-19 levels by 2026/27, through effective vacancy and recruitment management • continued development of the use of technology within the public sector to support hybrid and flexible working.
Efficiencies for the public sector	Recurring annual efficiencies of at least three per cent will be required from public bodies. Planned efficiencies include: • further use of shared services • management of the public sector estate (around 30,000 properties) • effective procurement (current levels of procurement spending stood at £13.3 billion in 2020/21, or around a quarter of the Scottish budget) • management of public sector grants.
Reform to public bodies	The RSR notes that there are currently 129 public bodies in Scotland, and notes 'reform is inevitable'.

Source: Audit Scotland, Scottish Government

63. The cost of living crisis, and the pressures on public spending and public services, mean that these reforms are more necessary than they were even when the RSR was announced earlier this year.

In the past, delivery of the reform of public services has not matched the original ambition

64. Both the Auditor General and the Accounts Commission have highlighted previously how difficult it is to reform public services, for example in their papers on health and social care integration, Scotland's colleges, drug and alcohol policy, and police and fire reform.

65. Reflecting on the progress made ten years on since the Christie Commission, the Auditor General commented that, "concerted action has been taken to try and implement progressive policies... But audit work consistently shows a major implementation gap between policy ambitions and delivery on the ground." [44]

66. For example, social care reforms aimed to offer people more choice and control about the services they received. A 2017 progress audit on self-directed support found that, after seven years, there was no evidence that authorities had made a transformation in services.[45]

67. The recent Social care briefing sets out key learning points from past public service reforms, including:

- realistic costs in financial memorandums accompanying parliamentary bills for legislative change
- a comprehensive business case, clearly setting out the purpose and objectives of reform
- evidence to support major changes and being clear about how they will improve outcomes, options, appraisals and economic modelling
- governance, accountability, roles and responsibilities in the new structure.

68. These points will be more important during a period of tight budgets to ensure reform achieves maximum value for money. Investing in good processes and data for reform may be challenging in the current context when money and capacity is restricted, but learning from previous reforms will help ensure reforms deliver the expected outcomes.

69. Audit Scotland has raised concerns about the approach being taken to some of the reforms currently planned. For example, in the recent Social care briefing paper, the Auditor General and the Accounts Commission noted that the proposals were not fully costed and there is much to do to establish the true costs of reform.[46] This briefing paper also noted the importance of strong, stable, and collaborative leadership. In recent years, the Auditor General and

[44] Auditor General for Scotland, Christie's clarion call can't wait another decade, September 2021
[45] Auditor General for Scotland, Christie's clarion call can't wait another decade, September 2021
[46] Auditor General and the Accounts Commission, Social care briefing, January 2022

the Accounts Commission have reported on the leadership capacity across the public sector, emphasising the critical need for effective leadership at a time of increasing pressures and change. Public bodies, including councils, integration authorities and the NHS are experiencing a high turnover in senior staff and are competing not only with each other for the best quality leaders but also with the private and third sectors.

70. In the face of the financial challenges, the pace and scale of reform needs to increase, and this will require a sense of urgency from the Scottish Government, at a time when it is also pressing to resolve short-term issues facing the budget.

71. If this does not happen, it will become increasingly difficult for the Scottish Government to manage the pressures on the budget, meaning that the cuts to spending necessary to balance the budget will become larger, and the quality of public services delivered will worsen.

72. Following the publication of the RSR, the Scottish Government has set up a new Public Spending Portfolio Board, to ensure the delivery of the RSR across directorates, identify links across workstreams, and provide advice across Scottish Government as needed. This aims to link the RSR both to the Emergency Budget Review and to the 2023/24 budget.

73. The board has met three times since June, and is at the early stages of its role of overseeing the implementation of the required reforms, and has focused so far on the workstreams (such as public sector pay and the reform of public bodies) which will feature in the 2023/24 budget. A Public Spending Analytical Unit has also been set up to monitor public spending and support the reform agenda.

74. To be effective, the Scottish Government's new approaches will need to clearly set out what reform intends to deliver, how it intends to track and monitor both savings and other financial impacts and the impacts on outcomes, and how these link across the public sector.

A shift to preventative spend is essential alongside meeting immediate challenges

75. The recent Social care briefing reflected that the Christie Commission stated that one of the major barriers to increasing preventative spending – that is, public spending that aims to prevent negative social outcomes from occurring in the first place – was the extent to which resources are currently tied up in dealing with short-term problems. The report warned that without a shift to preventative action, increasing demand would swamp public services' capacity to achieve outcomes.

76. This still holds true, over a decade later. Although it will be difficult, investing in preventative spending will be necessary to meet some of the Scottish Government's core outcomes. Recently the Auditor General and the Accounts Commission have reported on two areas where preventative spend in priority areas may be under pressure because of the cost of living crisis:

- The Scottish Government had significantly increased in investment in employability support for parents to reduce child poverty. In September 2022, this spending was reduced from £81 million to £29 million as part of the Emergency Budget Review statement.[47]
- The Accounts Commission's recent briefing on Scotland's councils' approach to addressing climate change reported that the cost of living crisis could lead to climate change activity being deprioritised or delayed by councils.[48]

77. In the recent Drug and alcohol services update, we highlighted that public health prevention programmes are cost-effective in drug and alcohol services, but it was not clear what percentage of spending in this area was targeted on early intervention and prevention. The Auditor General noted that over the last ten years since the Christie Commission report the focus has still been on short-term metrics for public services.[49] Preventative spend, like the reform agenda, will stop the problems Scotland is facing now from growing over time.

Covid-19 has shown that public bodies can change how services are provided – and at speed

78. The Covid-19 pandemic and the lockdowns that were implemented to reduce the spread of the virus completely changed what was possible in terms of providing public services, at the same time as individuals and communities needed entirely new forms of support.

79. In our work on public services' response to the pandemic, we have highlighted that public bodies worked well together to deliver new funding and work in different ways. As reported in the Covid-19: Vaccination programme briefing paper, excellent progress was made in rolling out the Covid-19 vaccination programme, and new digital tools were developed at pace to support this. In the Local government in Scotland: Overview 2021, the Accounts Commission noted that councils' working practices changed at a pace and scale 'that would have been considered impossible in the past'.

80. Since the pandemic, the number of challenges has multiplied, and uncertainty can make it harder to focus on the longer term and reform. However, the pandemic response has shown that change can be achieved quickly, and decisions can be taken in different ways with wider public participation (paragraph 85).

[47] Auditor General for Scotland and the Accounts Commission, Tackling child poverty, September 2022
[48] Audit Scotland, Scotland's councils' approach to addressing climate change, September 2022
[49] Auditor General for Scotland, Christie's clarion call can't wait another decade, September 2021

The public should be fully involved in the key decisions about how public services will need to change

81. The changes required to public services are significant, will be long standing, and will impact on people's lives. As such, it is important that citizens and communities are informed about the scale of the challenge and have a say in how services change.

82. The Accounts Commission's community empowerment and Best Value audit work has noted limited progress in citizen participation in budget processes, particularly for marginalised groups, for example in relation to participatory budgeting. The recent Tackling child poverty briefing paper reported that not enough involvement of children and families with lived experience of poverty are hindering the development of sufficiently targeted policies for tackling child poverty.

83. We have however found good examples of public engagement from our work on social security.[50] The programme continues to learn from existing benefit recipients through user experience panels and engagement with targeted client groups to inform its design decisions.

84. Empowering communities to participate in democratic processes can help to reduce disadvantage and inequality and improve outcomes for communities and individuals. There are many benefits of getting community empowerment and public participation right, as set out in our Principles of community empowerment work with scrutiny bodies in 2019. However, good public participation needs a lot of investment and capacity building to include a cross-section of the community, not just the most vocal, articulate, or resourced.

85. The Community empowerment: Covid-19 update found communities played a crucial role in the response to the pandemic. Public bodies can learn from this by encouraging public participation and adopting new ways of working. Issues to consider include:

- designing flexible governance and decision-making processes best suited to the communities they serve
- implementing more local decision-making structures with active local participation
- reducing the digital divide and continue to learn from and improve digital engagement with communities.

[50] Auditor General for Scotland, Social Security: Implementing the devolved powers, May 2019

It must be clear how changes in budgets affect performance if value for money is to be attained

86. It is important that it is clear how spending is affecting the outcomes the Scottish Government wants to achieve. In The 2020/21 audit of the Scottish Government Consolidated Accounts, the Auditor General noted that based on the current information published on Scottish Government spending and outcomes, it is hard to form an overall picture of the performance of the Scottish Government and assess whether the national outcomes are being achieved.

87. In its recent paper on the National Performance Framework (NPF), the Finance and Public Administration Committee (FPAC) set out some recommendations to better link budgets to outcomes. This highlighted the need to consider how money can be allocated (including through procurement and grants) based on the intended impact of the programmes it will fund and how these will contribute to the NPF. It also recommended looking at how funding can be used to incentivise different parts of the public sector to work together.[51]

Linking performance and budgets requires good quality data

88. To understand how to best target support and monitor how reform and change is affecting people, it is essential that public bodies have access to good quality and up-to-date data.

89. A lack of data limits public bodies' ability to target spending to where it is needed, as it is harder to understand and predict where demand for services will come from. For example, in recent outputs both the Auditor General and the Accounts Commission have highlighted some significant gaps in the outcome data available:

- The NHS in Scotland 2021 report (February 2022) highlights a lack of robust data in relation to health inequalities and the need for intersectional equality data. Without this data it will be hard to measure the impact of the cost of living crisis and find appropriate ways to target support.
- The Accounts Commission's Local government in Scotland: Overview 2022 highlights that a lack of up-to-date, publicly available data makes it difficult to assess the extent to which council activities have returned to pre-pandemic levels, the level of demand for services and levels of unmet need.

90. The national indicators that underpin the NPF give a measure of national wellbeing. Ideally, these indicators could be monitored in real time to evaluate the impacts of budget changes and prioritisations on the people of Scotland. However, many of the indicators reflect data from the pre-pandemic period, or have no data available at all.

[51] Finance and Public Administration Committee, Report on the National Performance Framework: Ambitions into Action, October 2022

91. Given that outcomes are long-term in nature, milestones are helpful in judging progress. The current lack of milestones for National Outcomes will make monitoring how changes to budgets impact on people and longer-term goals much more difficult. It also makes it harder for parliament and other bodies to scrutinise the work of public bodies and have assurance that spending is providing maximum value for money.

92. The Planning for outcomes briefing paper published in 2019 noted that for equalities and poverty outcomes, public bodies should consider whether the data they have is sufficient to measure the impact of decisions about services, funding and taxation on different equality groups affected.

93. Collecting this data will require both time and money, but will be an important step towards mapping spending to the aspirations of the Scottish Government. We have recently published a blog on data and the radical action needed in Scotland's public sector.

Conclusion

94. At the time of writing, the picture for the Scottish public spending is still developing. The UK Autumn Statement is expected 17 November, with the Scottish Budget 2023/24 budget to be announced in December. The Spring Budget Revision in the new year will set out the final budget for 2022/23. In March 2023, the Scottish Fiscal Commission will publish its first Fiscal Sustainability Report, which will give a long-term outlook for the Scottish Government's finances.

95. Audit Scotland will continue to monitor how the Scottish Government's financial position develops, through both financial audit work and performance audit work. The Auditor General will shortly publish the 2021/22 audit of the Scottish Government Consolidated Accounts, which will contain key information from the 2021/22 Consolidated Accounts and explain what they show about the Scottish Government's management of its budget.

96. This paper has set out the urgent case for the reform of public services. The Auditor General and the Accounts Commission will return to these issues through the forward work programme in the coming months. Examples of relevant planned work for 2023/24 includes performance audits relating to:

- Early learning and childcare
- Drug and alcohol services
- Social care
- Climate change.

97. For more information on planned outputs, please see our work programme. This is dynamic and regularly updated, meaning that we can respond to changing circumstances as required.

Scotland's public finances

Challenges and risks

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