

Finance and Public Administration Committee

Medium Term Financial Strategy Review

Submission from the Auditor General for Scotland

Introduction

1. I am pleased to provide my views on the Scottish Government's Medium Term Financial Strategy to help inform the Finance and Public Administration Committee's review of the content. My written submission is provided in response to the Committee's request, covering each of the questions it has posed. I would be happy to discuss these views further with the Committee as helpful.

Background

2. The introduction of the Medium Term Financial Strategy (MTFS) has been an important addition to the Scottish Government's financial reporting and a key component of the revised budget process. Audit Scotland first recommended the development of a MTFS in March 2017¹. We highlighted this was a key element of a more strategic, longer-term approach to support financial decision-making and scrutiny. We also described some of the features of a MTFS that we considered important, and how this sat within an overall approach to strategic financial management necessary following the introduction of new tax and social security powers.

3. This work, alongside similar thinking elsewhere including at official level with the Scottish Government and Scottish Parliament, informed the work of the Budget Process Review Group (BPRG). Audit Scotland welcomed the findings and recommendations of the BPRG in this and other areas, recognising the consistency of themes previously reported to Parliament by the former AGS. She served on the BPRG and colleagues in Audit Scotland supported her contribution and the wider work of the group. My comments below reflect this involvement and our wider experience of auditing Scotland's public finances.

4. An important aspect of the BPRG's conclusions was that the content of the MTFS would need to develop and evolve over time, responding to parliamentary and wider public scrutiny. The framing of recommendations reflected this, with the group's report articulating how the MTFS might develop and the elements it could contain. This provided some scope for the Scottish Government to reflect on the availability of information and ensure its approaches are cost effective. The Committee's current review is an important

¹ - <https://www.audit-scotland.gov.uk/report/managing-new-financial-powers-an-update>

contribution to ongoing development. I welcome the Scottish Government's commitment in the most recent iteration of the strategy to work collaboratively with the Committee to identify where further improvements can be made.

5. The introduction and development of the MTFS over its four iterations has helped strengthen the Scottish Government's approach to strategic financial management. Nonetheless in some areas development has not been quick enough. Section 22 reports on the audit of the Scottish Government Consolidated Accounts have highlighted the relatively slow pace of progress. For example, in September 2019 my predecessor reported that the second edition of the MTFS did not reflect all the basic components of a medium-term financial plan². And in December 2020 I reported that there was a need for the strategy to make the links between planned spending options and expected outcomes clearer to aid Parliament's understanding of financial risks and opportunities emerging from the Covid-19 pandemic³.

6. My detailed comments below are based on the fourth edition of the MTFS, except where otherwise stated. They draw on and should be read in conjunction with the findings, conclusions and recommendations made in relevant audit reports.

Objectives for the MTFS

7. The BPRG envisaged that the MTFS' purpose is to provide a means of focusing on the longer-term sustainability of Scotland's public finances. It also enables Parliamentary committees to consider the overall fiscal context and the financial implications of existing government policies over future years.

8. At a high level the BPRG saw this as requiring an objective and accessible assessment of anticipated economic performance and what this means for devolved funding, revenues and public expenditure and investment. This needs to set out clearly the relevant figures and narrative commentary to articulate the issues at stake – in essence the risks and opportunities present. Importantly this should be prepared annually on at least a five year forward rolling basis, enabling a medium-term perspective to be maintained throughout each Parliamentary session.

9. The MTFS largely delivers on the overall approach envisaged. In my view it is important that it is further strengthened in some important respects to make the full contribution anticipated. Critically, there is little information provided on the resource spending implications of existing government policies and commitments in areas other than demand-led social security. While the assessment of the potential gap between the funding and spending levels is an important addition to previous approaches, there is limited articulation of

² - <https://www.audit-scotland.gov.uk/report/the-201819-audit-of-the-scottish-government-consolidated-accounts>

³ - <https://www.audit-scotland.gov.uk/report/the-201920-audit-of-the-scottish-government-consolidated-accounts>

the extent to which existing policy commitments restrict the room for manoeuvre in balancing future budgets.

10. It is also important that the MTFS more clearly reflects and explains how the Scottish Government's key policy goals and ambitions will be resourced and funded during the period of the strategy. Without this it is difficult for Parliament and the public to properly understand the implications of fiscal issues for public services, Government's priorities and expected outcomes.

11. Clearly the upcoming resource spending review will support further decision making on spending priorities. This should enable the multi-year implications of these to be better reflected in future iterations of the MTFS and build on approaches that were adopted in the first edition of the MTFS but since removed. I expand on these issues and other areas where I consider it important to improve the MTFS below.

Elements of the MTFS

12. Most of the elements set out by the BPRG in paragraphs 81 to 86 of its final report are covered to some degree in the MTFS. This includes each of the main areas set out in paragraph 81 incorporating many of the potential areas described in the subsequent paragraphs. Nevertheless, there remain some important gaps and some areas where the content needs further developed to deliver on the approach envisaged.

Forecast economic performance

13. Data and commentary are provided on the economic and fiscal outlook. This includes information about forecast economic performance, including an assessment of the relative prospects for the Scottish and rUK economies and the broad implications of UK fiscal policy – including the known outcomes of the most recent UK spending review. This draws on relevant information from the Scottish Fiscal Commission (SFC) and the Office of Budget Responsibility, with the SFC's own independent reporting providing further assessment.

Broad financial plans

14. There are clear high-level statements about the expected level of funding, revenues and spending in each of the five years of the plan, alongside some historical information. Figures 4 and 6 provide an accessible articulation of the overall 'resource' position. Importantly this includes an assessment of the potential balance between funding and spending – in this case noting the potential for a widening affordability gap that may require to be addressed.

15. There is analysis of the projected levels of revenues and funding, including expected and forecast levels of grant and tax revenues (based on current policies), and the expected impact of Block Grant Adjustments and reconciliations. The annual impact of each of these factors is articulated well on a budget year basis, with a good level of detail on the different components

of tax and social security expenditure in Annex B. One area not sufficiently covered is Non-Domestic Rate income and the anticipated financial impact of existing policies and reliefs.

16. Detailed year-by-year information is provided on the anticipated use of both resource and capital borrowing. While some commentary is provided on the use of the Scotland Reserve, it is not clear how the Scottish Government expects this to affect each year and the potential interplay with resource borrowing. For example, the MTF5 does not estimate the extent to which balances are expected to be carried from one year to another and the movement in the reserve over time. While I recognise the challenges in providing reasonable estimates in this area, the way the anticipated use of reserves affects the annual expenditure profile reported is not sufficiently clear.

17. Some detailed analysis is provided of the outlook for capital spending, alongside some commentary on current forecasts of social security spending and an assessment of future pay costs. Further analysis of spending pressures in some key areas including health, social care, social security, pay and inflation is included in the Resource Spending Review (RSR) Framework. While this clearly provides some important context, this analysis is focussed on external pressures that the Scottish Government will need to respond to, through its RSR and otherwise. At this stage it's not clear how spending plans or the anticipated growth in spending in other areas will evolve based on the Scottish Government's existing plans and policies.

18. Critically, the MTF5 is not clear enough on how the Scottish Government's key policy goals and ambitions will be resourced and funded during the period of the strategy. In setting out spending plans more clearly there is a need to link these to overall aims, including the three core priorities identified by the Scottish Government – child poverty, climate change and a stronger fairer greener economy. This would better help Parliament and the public to properly understand the implications of fiscal issues for public services, the Government's priorities and expected outcomes from public spending.

19. While it may be assumed that the spending analysis set out in the RSR Framework and the MTF5 contributes to the overall assessment of spending, this is not set out. It is not clear enough how these different factors contribute to the overall position or what (if any) other factors or assumptions have been used to construct aggregate figures. Similarly, the way in which figures for tax revenues, block grant and other funding factors aggregate to the overall funding position is not set out. This restricts the ability of Parliamentary committees to scrutinise the overall financial assessments presented.

Clear policies and principles

20. The Scottish Government first outlined the principles and policies that it would apply in making use of its resource and capital borrowing powers and in managing the Scotland Reserve in the second edition of the MTF5 (2019).

This was a positive step, improving transparency on decision making on these aspects of the fiscal framework. This approach has continued and the 2021 MTFS included current approaches, recognising the need for decisions to be taken on an ongoing basis.

21. Previous editions of the MTFS have described the Scottish Government's approach to limiting the committed annual cost of revenue-funded investment (including capital borrowing and NPD/PFI commitments) to 5% of its resource budget excluding social security. Information on monitoring compliance with this self-imposed affordability limit was also previously included in the budget document. No information is provided on whether this affordability limit continues to be applied or the extent to which existing commitments and plans are expected to affect annual costs using this metric. Table 4 provides a broad assessment of the potential use of revenue financed investment other than borrowing, but there is no information on the mix of approaches anticipated (including the use of the Mutual Investment Model) or the consequences of this for future resource budgets.

22. The Scottish Budget document provides details of current and proposed tax and social security policies, and the SFC's reports set out the policy expectations (including any changes) factored into its forecasts. These are carried into the MTFS in turn, although the document itself does not set these out. Social security expenditure is being factored into forecasts as executive competence transfers as recommended by the BPRG. While I recognise that policies in these areas are generally well understood, providing a definitive single statement of relevant tax and spending policies factored into the MTFS would further improve transparency. This could either be in the MTFS or elsewhere with a link in the MTFS.

23. The Scottish Government has recently published its first Framework for Tax at the end of 2021. In my view application of this framework will help increase transparency over the tax policy making process and provide a more coherent approach to tax policy making and implementation.

24. As noted elsewhere in this submission there is no articulation of spending priorities or future spending trends for different areas of the Scottish budget (other than Social Security or capital). This was a key component of the MTFS envisaged by the BPRG.

Scenario planning

25. The MTFS sets out three high-level scenarios for funding and spending – downside, central and upside. The Scottish Government states that it considers the central scenario to be the most likely. Other scenarios are illustrative of how actual funding and spending may depart from the central scenario over the period of the MTFS. This approach is helpful in describing high-level expectations, some of the main factors that will affect the fiscal trajectory and how these may translate into funding and spending totals.

26. A key aspect of the approach is that it enables an assessment of the potential gap between funding and spending at the central scenario and both extremes across the MTFS period. This illustrates the underlying pressures on fiscal sustainability that the Scottish budget will likely be exposed to, providing an important focus for the RSR – with the Scottish Government highlighting the importance of identifying efficiencies, reviewing long-standing decision and encouraging reform.

27. The MTFS is clear that ‘there is no reason to believe the three optimistic assumptions used to generate the upside funding scenario will necessarily occur together’. And as noted above the central scenario is considered most likely. Beyond that there is limited assessment of the likelihood of different scenarios or the confidence levels that actual experience will be within the envelope set out.

28. In exploring scenarios and in analysing the underlying factors affecting the Scottish Government, the MTFS gives a good articulation of the funding and fiscal risks that the Scottish budget is exposed to. This is important to understanding some of the key components affecting fiscal sustainability. The MTFS itself does not currently provide the Scottish Government’s overall assessment of fiscal sustainability. The Committee has recently welcomed the SFC’s plans for the introduction of a fiscal sustainability report for Scotland from 2023. In my view this would be a valuable addition to the information available to support Parliamentary scrutiny.

29. Tables 8 and 9 summarise the short, medium and long-term risks to fiscal sustainability, drawing from narrative earlier in the report to identify what the Scottish Government considers are the main risks faced. This provides helpful clarity over this assessment. The second column proports to set out the mitigation for these risks. Much of the content is further articulation of the nature of the risks faced and the Scottish Government’s articulation of the limitations on its ability to respond. Here, and elsewhere in the document, there is less detail provided on how the Scottish Government plans to respond to the risks it has identified. The Scottish Government does state in its conclusions that ‘forecasting, controlling and prioritising expenditure is [its] primary lever for managing fiscal risk.

Financial implications of current policy

30. The first edition of the MTFS included a section that outlined the key policy priorities for the Scottish Government at that time (covering health, police, early learning and childcare, attainment, higher education and social security) alongside the implications of these for the resource budget. This approach has not been repeated or updated since (except in relation to social security forecasts prepared by SFC). My predecessor reported that the removal of this information was a step backward⁴.

⁴ - <https://www.audit-scotland.gov.uk/report/the-201819-audit-of-the-scottish-government-consolidated-accounts>

31. The BPRG envisaged the inclusion of such information in the MTFS. Without it, the ability of Parliament and public to scrutinise the medium-term financial implications of policies in these and other areas is limited. In my view, if the MTFS is to support consideration of the longer-term sustainability of Scotland's public finances it is essential that it provides enhanced information on the financial implications of existing government policies on its spending programmes over future years. The Scottish Government has been too slow to properly embed such an approach.

32. The upcoming resource spending review will support further decision making on spending priorities. This should enable the multi-year implications of these to be better reflected in future iterations of the MTFS. It will also be important that the Scottish Government rolls forward its assessment of the ongoing impact of current policy across the full period of future MTFS – beyond the period of the RSR – stating the assumptions it has based this on. This is akin to the approach currently adopted for UK Government funding beyond the term of the current UK SR period.

Supporting committee scrutiny

33. The BPRG envisaged that the Parliamentary finance committee's interest in the MTFS would be focussed on overall sustainability, the main fiscal risks, the efficacy of tax policies and operation of the fiscal framework. The MTFS' current content provides some important information to support the Committee's scrutiny in these areas, particularly when taken alongside other material prepared by the SFC and Scottish Government. Addressing the information gaps identified elsewhere in this written submission would improve the ability of the MTFS to support the Committee's role.

34. The MTFS has been of limited use to subject committees. The BPRG envisaged that their interest would be focussed on the high-level spending information set out in the MTFS, the overall fiscal and policy context and what the wider expectations of economic performance might mean for public services in their area. The absence of specific information about spending priorities or future spending trends for different areas of the Scottish budget (other than Social Security or capital) has meant there has been limited incentive amongst subject committees to consider the initial editions of the document. Including such information would better support subject committee scrutiny.

35. While the MTFS does provide information about overall economic performance, identifying the expected implications for public services would enable further scrutiny at portfolio level by subject committees.

Approaches in cross-cutting areas

36. Coverage of cross-cutting issues such as addressing equalities, tackling climate change and inclusive economic growth in the MTFS is largely limited to a high-level summary of aims and priorities set out in relevant strategy and

policy documents. These include for example reference to the Scottish Government's Covid-19 recovery strategy and the forthcoming 10-Year National Strategy for Economic Transformation. The Scottish Government also notes that it will “ensure [its] spending choices support progress towards meeting ... ambitious child poverty and climate change targets, and secure a stronger, greener, fairer economy”.

37. Limited coverage of the financial implications of current policies on spending plans means that the impact of these policy priorities and associated policies already established on spending and investment levels is not clearly articulated. While there is some information on aspects of these plans in relation to social security capital spending, the link between overall objectives and the figures presented in the MTFS is not sufficiently clear. Clearer information in these areas is needed to support scrutiny of the implications of fiscal matters on cross cutting issues.

Other improvements

38. I highlight in paragraph 19 above that it is not clear enough how different factors build up to the overall funding and spending position reported. Annex B provides detailed figures for some key components, related to the operation of the fiscal framework. Further figures are provided in sections on capital spending and pay, and in the RSR Framework document. But it is not possible to identify how each of these components build up to the overall picture. The impression given is of selective presentation of the underlying analysis, and it is not possible to follow the links between the different aspects covered.

39. Including a more comprehensive set of tables in the annexes (clearly linked to information set out in the text of the document) would significantly improve the MTFS, reinforcing the objective nature of the document. As a minimum it is important that the Scottish Government publishes the figures underpinning the graphs used in the document, for example in relation to figure 6 which sets out the modelled funding and spending scenarios.

40. The ongoing development and evolution of the MTFS, as envisaged by the BPRG, has meant that the content, layout and presentation of the document has changed significantly over time. While this approach can be expected to continue to some extent with further refinement, having key information presented in a consistent format from year to year would make it more straightforward to follow changes over time. This would aid Parliamentary scrutiny, helping build understanding of what the MTFS covers and where to find it – making it easier for different stakeholder groups to access the specific information most relevant to them.

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