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UK COVID-19 INQUIRY

WITNESS STATEMENT OF THE DIRECTOR GENERAL FOR THE SCOTTISH EXCHEQUER

This statement is one of a suite provided for Module 1 of the Covid Inquiry and these should be considered collectively. In relation to the issues raised by the Rule 9 notice dated 4th November 2022 served on the Scottish Government, in connection with Module 1, the Director General for the Scottish Exchequer will say as follows:

Overview of how the Scottish Government is funded

1. The majority of the funding for the Scottish Government is a grant from the UK Government.

2. Scottish Government funding comes from a combination of devolved taxes and revenues, and the Block Grant transferred to the Scottish Government from the UK Government. The fiscal relationship between the Scottish and UK Governments is set out in the *Statement of Funding Policy (2021)* and in the *Fiscal Framework Agreement (2016)* which are provided, [AS/0001-INQ000102912], [AS/0002-INQ000102914].

3. How the Scottish Government is funded has changed significantly over time. This has brought both opportunity and a greater level of fiscal risk.

4. The Scotland Act 1998 legislated for the establishment of the devolved Scottish Parliament with tax varying powers and the Scottish Government, which was set up in 1999. At this point, over 90% of money for the Scottish Government's Budget

came in the form of a block grant calculated through the Barnett formula with the remaining balance from non-domestic rates. The Barnett formula is an administrative mechanism used by HM Treasury to determine annual changes in the block grant allocated to the devolved administrations in Scotland, Wales and Northern Ireland, reflecting changes in spending levels allocated to public services in England, England and Wales or Great Britain, as appropriate. Under the Barnett formula, the Scottish Government's block grant in any given financial year is equal to the block grant baseline plus a population share of changes in UK Government spending on areas that are devolved to the Scottish Parliament. Detail of how the Barnett formula works is set out in the UK Government's *Statement of Funding Policy* [AS/0001-INQ000102912].

5. For many years, prior to the Scotland Act 2012 and the Scotland Act 2016, the Scottish Government's predominant source of funding was from the Block Grant from the UK Government. The growth of the annual Block Grant was (and still is) determined by the operation of the Barnett formula. The Scottish Parliament's main tax powers were then limited to local taxes for local expenditure, in particular non-domestic rates, which are collected by Scottish Local Authorities. The Scottish Government guarantees a level of revenue funding to Scottish Local Authorities through the combined total of Non-Domestic Rates income and a General Revenue Grant.

6. The Scotland Act 2012 and the Scotland Act 2016 devolved a number of significant new fiscal powers, both tax (see Figure 1, on page 5) and spend, to Scotland from the UK Government.

7. Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax (SLfT) were fully devolved from the financial year 2015-16 under the Scotland Act 2012. These replaced the UK taxes for Stamp Duty and Landfill and are administered by Revenue Scotland.

8. The Scottish Rate of Income Tax was devolved under the Scotland Act 2012, with the Scotland Act 2016 extending income tax powers significantly from 2017-18 (known as Scottish Income Tax). Scottish Income Tax is a partially devolved tax. The Scottish Government is able to set the rates and bands for Scottish taxpayers on non-savings and non-dividend income, e.g. earnings from employment, self-employment, pensions or property. The personal allowance, reliefs and the rates

and bands for savings and dividend income all remain reserved to the UK Government. Scottish Income Tax is administered by His Majesty Revenue and Customs.

9. Three Scotland Act 2016 tax revenues are yet to be implemented: assigned VAT, Air Passenger Duty and Aggregates Levy. Meanwhile, these taxes are still subject to UK Government policies and administration. Ministers launched a consultation to inform future Scottish legislation on the Aggregates Levy on 22 September 2022. Only when these further three tax changes are fully implemented will over half the Scottish Government's budget[1] come from taxes raised in Scotland.

10. As part of changes to the devolution to public spending, 11 social security benefits transferred to the Scottish Parliament under the Scotland Act 2016. Since then, the Scottish Government has introduced 13 benefits, seven of which are entirely new forms of financial support available only in Scotland.[2] Any excess social security demand in any one year has to be made by compensating reductions in spend elsewhere in the Scottish Budget.

11. The *2014 Smith Commission* [AS/0003-INQ000102915] recommended that 'the devolution of further fiscal powers with responsibility for taxation and public spending, including elements of the welfare system, should be accompanied by an updated fiscal framework for Scotland, consistent with the overall UK fiscal framework'. An explanation of the Smith Commission is contained within the Director General for Strategy and External Affairs Module 1 statement.

12. In February 2016 the Scottish Government (SG) and UK Government (UKG) reached agreement on a *Fiscal Framework for Scotland*, guided by Smith Commission principles, which set out how the tax powers would impact on overall levels of funding available to the Scottish Budget [AS/0002-INQ000102914].

13. Specifically, it described: i) arrangements for the calculation of Block Grant Adjustments (BGAs) to offset additional revenues that would be raised directly by

[1] DEL – Departmental Expenditure Limit comparison

[2] The 13 benefits are Adult Disability Payment, Scottish Child Payment, Best Start Foods, Best Start Grants (Pregnancy and Baby, Early Learning, and School Age), Carer's Allowance Supplement, Funeral Support Payment, Job Start Payment, Young Carer Grant, Child Winter Heating Assistance, Child Disability Payment, and Winter Heating Payment.

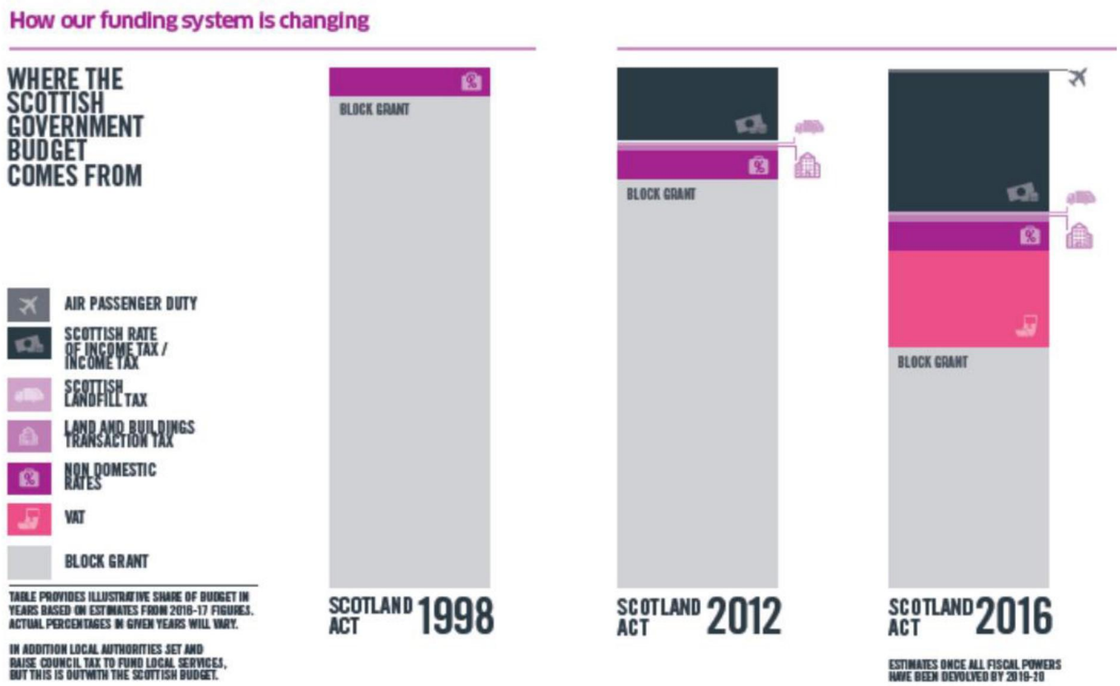
the Scottish Parliament (this is covered in more detail in paragraph 14 below); ii) the forecasting 'landscape' that would support these new arrangements; iii) new budget and financial risk management levers for the Scottish Government (i.e. borrowing and reserve limits); and iv) Governance arrangements between the two governments, including measures for dispute handling.

14. The Framework lays down three main components for calculating the Scottish Government's Budget:
    i. Component One – Barnett-determined Block Grant. Barnett continues to determine the initial size of the Block Grant
    ii. Component Two – Adjustment to the Block Grant. The Block Grant is adjusted to reflect the impact of the transfer of tax and social security powers to the Scottish Budget. These are called BGAs
    iii. Component Three – Devolved Revenues. These are the revenues retained from devolved and assigned tax powers which contribute to Scotland's funding.

15. Overall, the net impact of forecast revenues from individual taxes and Block Grant Adjustments can move the Scottish Government's Budget in a positive or negative direction. If the Scottish Government raises more in devolved taxes than it loses in the corresponding BGA, the net position is positive. If the Scottish Government's Budget is reduced via BGA more than it raises in the corresponding devolved taxes, the net position is negative.

16. In the case of social security benefits, the situation is reversed – if BGA forecasts for these benefits exceed spending forecasts, this results in a positive net position; there is a negative net budget position if spending forecasts exceed the BGA. In cases where spending exceeds the BGA, the gap would need to be funded from the existing Scottish budget envelope.

Figure 1: Sources of funding for Scottish Government budget 1998, 2012 & 2016 Legislation



Source: The Budget Process Review Group – Final Report - March 2017 [AS/0004-INQ000000]

17. Figure 1 above, from the (independent) *Budget Process Review Group* publication in March 2017 [AS/0004-INQ000102916] shows the relative *proportions* of the Funding elements that support public spending in Scotland. The actual *amounts* available for public spending has not been static and have also changed over time.

18. The table shown below at Figure 2 shows the total annual amounts for the period prior to the pandemic. The table needs to be read in conjunction with the explanatory notes because of the nature of the changes over the period.

Figure 2: Funding available to the Scottish Government, split by resource, capital (excluding Financial Transactions) and Annual Managed Expenditure (AME), 2009-10 to 2019-20

All figures in £m, current prices	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Fiscal Resource	25,123	25,624	25,296	25,527	25,631	25,777	25,991	26,088	27,027	27,200	28,770
Capital (excluding FTs)	3,927	3,335	2,804	2,717	2,549	2,820	2,734	2,892	3,189	3,596	4,106
Total Fiscal Budget	**29,050**	**28,959**	**28,100**	**28,245**	**28,180**	**28,596**	**28,725**	**28,980**	**30,215**	**30,795**	**32,876**
AME	5,610	5,432	5,617	5,269	5,657	5,790	6,789	6,549	7,731	7,568	7,898
Total Managed Expenditure	**34,660**	**34,391**	**33,717**	**33,514**	**33,837**	**34,386**	**35,514**	**35,529**	**37,946**	**38,363**	**40,774**

Explanatory notes:

i. It is not possible to provide a wholly comparable dataset since devolution due to for example, changes in devolved responsibility, reprofiling of budgets etc. The following caveats should therefore be noted
ii. For 2009-10, figures are sourced from latest published PESA outturn figures - From 2010-11, HM Treasury budget figures are used
iii. AME figures sourced from annual Budget Bill supporting documents
iv. Rail Services amounting to around £400m were devolved to the Scottish Government in 2006-07
v. A significant build-up of underspend in the prior years to 2006-07 was applied to budgets for 2007-08 to 2010-11 (£350m, £300m, £400m, £174m respectively)
vi. Around £300m of capital budget was reprofiled from 2010-11 to 2008-09 and 2009-10 in order to boost the economy following the recession
vii. Significant increases in AME for NHS and Teachers Pensions due to changes in discount rates in 2006-07 (£641m), 2015-16 (£850m) and 2017-18 (£1.1 billion)
viii. Council Tax Benefit of around £400m was devolved to the Scottish Government in 2013-14, so the budget for 2010-11 to 2012-13 have been adjusted for comparison purposes
ix. Significant consequentials (around £600m) have been added to 2019-20 due to increased funding for Health.

Money allocated by the UK Government in the event of civil emergencies

19. The funding mechanisms set out above continue to apply in the event of civil emergencies. In relation to the Covid-19 pandemic, any additional block grant funding made available by the UK Government to respond to the crisis was allocated to the Scottish Government in accordance with the principles set out in the *Statement of Funding Policy* [AS/0001-INQ000102912] with additional funding being calculated in proportion to allocations to equivalent UK Departments.

20. The sequencing and announcement of UK Government departmental funding decisions dictate the value and the timing of the increases to the Block Grant to the Devolved Administrations. The announcements of funding additions were not always aligned with either the rate and spread of the Covid-19 pandemic across the four nations within the UK or the preferred public health responses across different parts of the UK.

21. The lack of alignment in funding was both in terms of timing and scale. While the overall arrangements remain determined by the Statement of Funding Policy, processes or considerations were developed *during* the course of the Covid-19 pandemic to aid planning and management. For example, following recognition of the need to support planning in Devolved Administrations, HM Treasury guaranteed minimum funding levels at various points during the Covid-19 pandemic prior to determining and declaring the UK departmental funding allocations, but final allocations to the Scottish Government remained calculated by reference to the standard Barnett calculations.

Setting budgets and applying spending controls within the Scottish Government and to other public bodies

22. Every year the Scottish Government sets out a plan of how it plans to spend the money it receives from the UK Government and from taxes raised in Scotland. Setting the Budget is a year-round process that begins in May each year. The normal milestones during the year are set out in Figure 3 below:

Figure 3: Milestones in the Budget year

Event	Date expected
Medium-Term Financial Strategy	May
Fiscal Framework Outturn Report	September
Parliamentary subject committees submit spending proposals	October
The UK Government publishes the UK Budget	November
The Scottish Fiscal Commission publishes Scottish Income Tax Estimates	December
The Budget Bill is introduced, and the draft spending and tax plans published in a supporting document	December

The Budget's tax and spending proposals are scrutinised by Parliament	January
The Budget Bill is debated by Parliament	January (stage 1) and February (stages 2 and 3)
The Budget Bill receives Royal Assent and becomes the Budget Act	April
Autumn Budget revision	September
Spring Budget revision	February

Medium-Term Financial Strategy

23. In May the Medium-Term Financial Strategy is published, which:
    - Sets out the Scottish Government's approach to financial management and fiscal rules by outlining the principles and policies to guide the use of fiscal powers to manage budget volatility;
    - Sets out a range of possible funding scenarios for the Scottish Budget over the next five years; and
    - Details the Scottish Government's key policy priorities and approach to supporting Scotland's economy.

Fiscal Framework Outturn Report

24. In September a Fiscal Framework Outturn Report is published, which covers the following elements of the fiscal framework:
    - Reconciliation process
    - Scotland Reserve
    - Borrowing powers
    - Social security powers.

The Budget Bill

25. Through the Written Agreement with the Finance and Public Administration Committee, Scottish Ministers are expected to present the Scottish Parliament with a draft Scottish Budget which details the spending proposals for the new financial year within three weeks of the publication of the UK Budget. The Budget Bill is introduced to the Scottish Parliament one week later. Once this is considered and

approved by the Scottish Parliament, and obtains Royal Assent, this becomes the Scottish Budget Act for the new financial year. The Scottish Government is required to set its tax policy as part of the annual Scottish Budget process. Various pieces of legislation are required to give the respective tax policies statutory effect – these are voted on separately.

26. The Budget Bill has three stages:
    - Stage 1: Parliamentary Committee scrutiny and a Stage 1 debate in the Parliament to agree on the general principles of the Budget Bill
    - Stage 2: Any changes proposed by Scottish Ministers to the Budget Bill are scrutinised and voted upon by the Finance and Public Administration Committee
    - Stage 3: The Parliament decide on any further changes proposed by Scottish Government Ministers and the Budget Bill is debated and voted on by the Parliament. After the Budget Bill is approved by the Parliament, it is reviewed by Scottish Law Officers and is then sent to the Palace to seek Royal Assent. Once Royal Assent is granted, the new Budget Act comes into force.

27. The Budget Bill is distinct from other bills in that it is likely to be considered within a condensed timeframe and only Scottish Ministers can propose amendments once the Bill has been introduced.

28. The Budget Bill has specific Parliament Standing Orders that it must normally comply with. This includes completing Stage 3 within 70 days of the Bill being introduced. To ensure Royal Assent ahead of the start of the financial year, there is limited opportunity to delay the process.

<u>The Budget Act</u>

29. When the Budget Bill receives Royal Assent it becomes that year's Budget Act. This is a major element of the annual legislative programme and gives the statutory authority to spend money as set out in the Budget.

<u>Scottish Parliament Subject committees</u>

30. From 2018, subject committees have had direct input to the budget process. Six weeks prior to the publication of the draft spending plans, the subject committees set

out their views on the delivery and funding of existing policy priorities, any proposed changes, and how these should be funded. The Scottish Government responds to their suggestions in the Budget Bill supporting document, then debate any proposed amendments in Parliament prior to stage 1.

Scottish income tax

31. The proposed rate of income tax for Scotland must be approved by Parliament separately to the rest of the Budget Bill, prior to stage 3.

Devolved taxes

32. The rates and bands for the Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax are published in the draft Budget Bill supporting document. Any changes to the devolved taxes must be pursued in parallel with the Budget Bill.

Budget revisions

33. The Budget Act is typically amended twice a year (although the regulations allow for a third revision if required) via a Scottish Statutory Instrument to better reflect the spending patterns emerging from the monitoring of budgets.

34. These are known as the Autumn and Spring Budget Revisions and are laid around September and February, after which they are scrutinised by the Scottish Parliament's Finance Committee. However, it is not possible to change the Scottish Rate Resolution (the Scottish rate of income tax) once the year to which it applies has begun.

History of the Scottish Budget

35. Originally, the Scottish Parliament's annual budget setting process started with a consultation period that began with the publication of the draft budget. This method was proposed by the Financial Issues Advisory Group (FIAG), which was established in 1998 by the then Secretary of State for Scotland. Back then, the Scottish Parliament had no powers over taxation other than non-domestic rates, so its budgeting activity focused almost entirely on expenditure.

36. The process has since been revised frequently, as the Parliament has gained experience and new fiscal powers. All changes have been agreed with the Parliament's Finance and Constitution Committee.

Revised budget process

37. The Scotland Act 2012 and the Scotland Act 2016 devolved new fiscal powers to the Scottish Parliament which the budget needed to take into account. In 2017 an independent Budget Process Review Group was established to carry out a fundamental review of the budget process. The *Budget Process Review Group*'s final report [AS/0004-INQ000102916] recommended some structural changes to the Budget process, as well as changing expectations placed on SG, the Parliament and public bodies. The recommendations were agreed in full by the then Finance and Constitution Committee and the Cabinet Secretary for Finance and the Constitution, and formed the basis of the revised written agreement between the Committee and the Scottish Government which was subsequently approved by Parliament in May 2018.

38. The changes to the written agreement have led to a broader budget process, in which subject committees have the flexibility to incorporate budget scrutiny into their work prior to the publication of firm and detailed spending proposals, with an emphasis on developing a deeper understanding of the impact of budgetary decisions over a number of years.

Budgets and funding arrangements in respect of public health and healthcare bodies, other public bodies and regional and local government:

General spending

39. Scottish Ministers develop spending proposals ahead of the new financial year, which are published and presented to the Scottish Parliament with draft legislation (the annual Budget Bill) for scrutiny and approval by the Parliament. The Annual Budget sets out the allocation for each Portfolio and Cabinet secretaries take lead responsibility to apply their Portfolio Budget in the best way to achieve the Government's objectives.

40. The Scottish Parliament considers spend related to a range of different policy areas including schools, hospitals, policing, certain social security benefits, the economy, climate change and the environment. The UK Government is responsible for spending on areas that are reserved, including immigration, certain social security benefits, foreign policy and defence.

41. Planned expenditure is provided for each portfolio across the Scottish Government. These support Scottish Ministers in the delivery of the national outcomes for Scotland as set out in the *National Performance Framework* [AS/0005-INQ000102917].

The Scottish Government Finance and Economy Entities' roles in approving expenditure in respect of the Scottish Government, public health and healthcare bodies, other public bodies and regional and local government.

42. The annual budget process is the main driver for budget allocation decisions, and these budget allocations enable portfolios to shape their spending plans. Spending plans for the financial year are set out in the draft budget, with consideration by Scottish Parliament Committees. Plans are presented in the Budget Bill (see paragraph 25) and receive Royal Assent as a Budget Act. Parliamentary approval for in-year revisions to the plans set out in the Budget Act are developed through the Autumn Budget Revision and Spring Budget Revision.

43. Local Government is allocated a budget at the start of each financial year in line with the annual budget process, with a finance circular collating funding provided and details of any resources that are ring fenced for specific purposes.

44. The delegation of financial and procurement responsibility is outlined in the core Scottish Government Scheme of Delegation. Public bodies also have framework agreements that set out delegations and any areas requiring approvals for them.

45. Within the Scottish Government, delegation for budgets flows from designated accountable officers (Directors General) to Directors, then to Deputy Directors. An overview of delegated authority is provided in the *Scottish Public Finance Manual* (SPFM) [AS/0006-INQ000102918]. The scheme covers internal structures and working relationships, the delegation process, internal controls through the

certificate of assurance process, areas of financial responsibility and delegated authority.

46. Budgets for the areas within the Health and Sport portfolio are managed by the Health Finance Directorate within DG Health and Social Care. The Director of Health Finance oversees financial strategy for the Health and Social care portfolio, financial management of NHS Boards, and related financial performance and financial advice activities. Funding to Local Government and the policies for local taxation in Scotland is managed by a designated team in DG Communities.

47. As part of the process, spend is also controlled through in year management mechanisms. For example, spend control templates were initiated during the response to Covid-19 to help manage the fast pace of spending decisions that were required. These enable review and consideration of spending by professional groups (including finance) and then by Ministers as required, linked to value thresholds. Professional advice and support are also provided on tasks such as pre-expenditure assessments, business cases and wider submissions.

Identification of the entities to which the budget process applies

48. The Scottish Budget covers the bodies within the Scottish Administration (which is the Scottish Government (portfolios, Executive Agencies and Health bodies), the non-ministerial bodies (such as Revenue Scotland) plus the directly-funded bodies (the Scottish Parliamentary Corporate body and Audit Scotland). The bodies covered by the Scottish Budget are set out in the annual draft budget publication, as illustrated for 2021-22 [AS/0007-INQ000102919]. The bodies covered in any budget year may vary according to the legislative framework. The Scottish Government's consolidated accounts reflect the consolidated assets and liabilities and the results of all entities within the Scottish Government consolidation accounting boundary as required by and defined in the Government Financial Reporting Manual (FReM). The annual budget process applies to these bodies.

49. Full details of the Accounting Boundary, including lists of the Executive Agencies are set out in the *Annual Consolidated Accounts Publications*, the 2021 to 2022 report is provided as an example [AS/0008-INQ000102920].

50. The Scottish Government Consolidated Accounts report actual outturn, compared to the budget authorised by the Scottish Parliament. As set out at paragraph 48 above, the annual budget authorised by the Scottish Parliament is the budget for the wider Scottish Administration and includes the funding of activities which are not within the Scottish Government, and therefore outside the required accounting boundary of those accounts; the other bodies within the Scottish Administration report in their own annual accounts.

51. The Auditor General for Scotland is responsible for auditing the accounts, and examining how relevant bodies use resources. The Scottish Parliament's Public Audit Committee is remitted to consider issues arising from SG or public body audits and scrutinise their financial performance. The committee can require Ministers, NDPB Board Chairs, and Accountable Officers to provide written and/or oral evidence.

The Scottish Government Finance and Economy Entities approach to spending and reserves for contingency

52. Budget flexibilities within Scottish Government, including reserve capacity and borrowing arrangements are limited.

53. In overall budget management terms, the *Fiscal Framework (2016)* [AS/0002-INQ000102914] sets out the limits of the Scotland Reserve. Up to £700 million in aggregate may be deposited in the Reserve. Maximum drawdown in any one year from the Reserve is £250 million of resource budget and £100 million of capital budget. Under the Fiscal Framework the drawdown limits are temporarily waived when a Scotland-specific economic shock occurs.

54. As indicated above, the Scottish Government has a limited resource borrowing function. No additional borrowing can be undertaken in response to emergency events (such as the Covid-19 pandemic or the cost of living crisis). The Scottish Government can borrow to support day-to-day (resource) spending only in specific circumstances, primarily to address forecast error in relation to devolved tax receipts and social security spending.

55. The use of resource borrowing is complementary to the use of the Scotland Reserve. The Scottish Government must balance the need for flexibility against the

additional costs of borrowing compared to the Reserve to find a solution that is most appropriate to the circumstances. Borrowing and other funding policies are set out in the Scottish Government's Medium-Term Financial Strategy.

56. In addition to the use of borrowing and reserves, reprioritisation of spending can be undertaken to ensure that resources are targeted on priority needs.

57. It should again be noted that the size of the Scottish budget is impacted by UK fiscal policy and changes to funding for UK Departments for comparable spending, with Barnett consequentials coming to the Scottish budget where additional UK funding is supported through increased taxes or borrowing. (This can increase or result in a negative change to the Scottish budget).

58. In managing an emergency and in the case of the Covid-19 pandemic, the Scottish Government therefore flexes existing budget management and monitoring arrangements to support the funding/spending decisions taken by Scottish Ministers. For the pandemic response, this included the provision of regular management information detailing current budget allocations, spending against individual programmes and available funding.

59. During the pandemic, Budget revisions were regularly presented to the Scottish Parliament (including an additional Summer Budget Revision) transparently setting out all additional funding allocations, with scrutiny at relevant Committee sessions. A detailed overview of Budget revisions throughout the pandemic is provided in the Director General for Exchequer Module 2A statement.

Processes, systems and methodologies put in place relating to the key preparedness and resilience functions

60. The *Scottish Public Finance Manual* (SPFM) is issued by the Scottish Ministers to provide guidance on the proper handling and reporting of public funds. The SPFM contains a dedicated section on *Risk Management* [AS/0009-INQ000102921].

61. The risk section of the SPFM addresses key points and themes across Identifying Risk, Ownership of Risk, Assessing Risk, Risk Appetite, Response to Risk, Reviewing and Reporting, and Communication and Learning.

62. The Scottish Public Finance Manual Risk Management section is largely based on the Orange Book and other HM Treasury Guidance. This is referenced at paragraph 23 of the Risk Management section of the SPFM , alongside links to the National Audit Office Report on Managing risks in Government and the Government Actuary Department's practical guide to strategic risk management.

63. *Risk Management: the Scottish Government Guide (2022)* provides overall guidance on risk management arrangements [AS/0010-INQ000102922].

Monitoring of risks caused by debt, generally, and, in particular, in managing fiscal risks

Debt and cash management

64. The Scottish Government must balance its Budget each year and has very limited borrowing powers. These are set out in the Fiscal Framework between the Scottish and UK Governments published in February 2016. These powers have narrow application and are modest given the size of the annual Scottish Budget. The values have remained static in nominal terms since the 2016 agreement and there is a different approach depending on whether the Scottish Government is borrowing for resource or capital application.

65. The 2016 agreement increased the Scottish Government's statutory limit on borrowing for capital expenditure to £3bn. The annual limit on the amount of borrowing for capital expenditure is set at 15% of the overall borrowing cap, equivalent to £450 million a year.

66. The Fiscal Framework provides the Scottish Government with an overall resource borrowing limit from 2017-18 of £1.75 billion, with a total annual limit of £600 million. Resource borrowing can be used for in-year cash management (maximum £500 million annually) and in cases of forecast error (maximum £300 million annually, increasing to £600 million in the situation of a Scotland-specific 'economic shock'). Details of the circumstances of an economic shock are set out in *Fiscal Framework Technical Note (2022)* [AS/0011-INQ000102923].

67. These combined arrangements allow some limited borrowing to support infrastructure investment and to offset errors in devolved tax and social security forecasts. These are the only circumstances in which Scottish Ministers can borrow.

68. These powers were exercised during 2017-18, 2018-19 and 2019-20, when in each year capital loans were taken out, and in 2020-21, 2021-22 when both capital and resource loans were taken out. All borrowing to date has been from the National Loans Fund (NLF), which is administered through the UK Government by HM Treasury.

69. Given the significant constraints on Scottish Government Borrowing, the associated fiscal risks are limited to the ability of the Scottish Government to repay existing debt and interest payments as they fall due, and the future capacity to borrow within the existing constraints.

70. Refinancing risk is not relevant; under the terms of the agreements with the National Loans Fund the Scottish Government can only borrow using the regular repayments of principal and interest.

71. The Scottish Government is unlikely to use its Cash Management Borrowing facility. This is because as a full member of the UK Cash Management Scheme (see paragraph 76) the contingency options available for emergent cash issues remain available to the Scottish Government. The cash management borrowing facility does not increase the Scottish Government's spending power.

72. The combination of fiscal framework restrictions and practical considerations mean that it is highly unlikely that the cumulative resource borrowing limit of £1.75 billion will be breached.

73. All repayments, including repayments of principal in relation to Capital Borrowing, are scored as reductions to resource funding. Interest rates are updated daily by the Debt Management Office (DMO). NLF rates are priced at 11 basis points above the par Gilt yield on that day.

74. The Scottish Government monitors the contractual and expected future borrowing repayments as part of its regular internal financial management processes. Borrowing policies are outlined in the medium-term financial strategy as set out in

paragraph 92 below, and plans are updated in Scottish Budget documents. Final borrowing decisions are made in year as part of the internal budget management process.

75. The Fiscal Framework Outturn reports detail all borrowing undertaken by Scottish Ministers to date. Capital and Resource borrowing information is set out at section 9, addressing borrowing undertaken, an assessment of how far this remains below various different borrowing limits, and implications of borrowing in terms of estimated profile of future repayments. The latest publication, the *Fiscal Framework Outturn Report (2022)*, is provided [AS/0012-INQ000102924].

76. The Scottish Government (along with other devolved administrations and all UK Departments) is a full member of the UK Government Cash Management Scheme. All cash management takes place within the umbrella provided by the UK Scheme and within the cash authorisation limits agreed with HM Treasury as part of the annual budget process.

77. The scheme seeks to minimise the daily net cash position within the Exchequer Pyramid by balancing overall inflows and outflows, and thereby minimising the extent to which there are Treasury requirements to borrow or deposit funds with the money market.

78. Devolved Governments and UK Departments work within an annual cash authorisation limit which is derived from, and works in parallel to, the annual HM Treasury Budget limit. As the limit is annual and cash is drawn down monthly, the majority of liquidity risk is centralised at a UK level.

79. The Scottish Government undertakes and submits regular cashflow forecasts as part of the scheme. Emergent cash needs can be covered within 48 hours provided there is sufficient cash authorisation headroom remaining. Where no such cash authorisation limit remains, the UK Contingency Fund can be accessed provided the requisite criteria are met, i.e. cash is required in advance of a budget limit increase receiving Royal Assent.

How the debt enables the funding of public finances.

80. The circumstances in which Scottish Minsters can borrow are limited, and the Scottish Government does not have a significant exposure to debt and debt-related risks.

81. Scottish Government budgets are determined through the combination of Block Grant funding from HM Treasury, adjusted to reflect the transfer of social security powers, devolution of taxes and other income devolved to Scotland (through the Scotland Act 2012 and Scotland Act 2016), any planned use of available devolved borrowing powers, and Non-Domestic Rates Income.

82. Capital borrowing supports a portion of the infrastructure investment budget. Resource borrowing is only undertaken to offset negative variances in devolved tax and social security forecasts.

83. The annual budget process reflects planned use of borrowing and associated interest cost, and associated information is set out in the annual budget documentation.

84. Borrowing and outstanding sums are reported in Fiscal Framework Outturn Reports as highlighted in paragraph 75 above.

How debt management policy is formulated by the Scottish Government Finance and Economy Entities and its effect on responding to emergency events.

85. The fiscal relationship between the Scottish and UK Governments is set out in the *Statement of Funding Policy (2021)* [AS/0001-INQ000102912]. The parameters of this statement also govern the ways in which any financial response to an emergency event can be delivered by the Scottish Government.

86. The Statement of Funding Policy (2021) sets out how UK Government funding for the devolved administrations is determined. It contains the arrangements set out when the devolved legislatures were created and changes to these or to the UK Government budgeting regime since the statement was first introduced in 1999.

87. In additional to its limited borrowing powers, the Scottish Government has limited Reserve capacity – again limits are set out in the *Fiscal Framework agreement (2016)* [AS/0002-INQ000102914] and in paragraph 10.26 of the *Statement of*

Funding Policy (2021) [AS/0001-INQ000102912]. This allows the Scottish Government some ability to smooth spending within and between years, carry forward underspend, and assist in the management of tax volatility, within set limits. The Scotland Reserve replaced the previous cash reserve and access to the UK Budget Exchange facility.

88. The Fiscal Framework (2016) sets out the limits of the Scotland Reserve. Up to £700 million in aggregate may be deposited in the Reserve. Maximum drawdown in any one year from the Reserve is £250 million of resource budget and £100 million of capital budget. Under the Fiscal Framework (2016) the drawdown limits are temporarily waived where a Scotland-specific economic shock occurs.

89. As set out from paragraph 52 onwards, the Scottish Government has a limited resource borrowing function. No additional borrowing can be undertaken in response to emergency events (such as the Covid-19 pandemic or the cost of living crisis). The Scottish Government can borrow to support day-to-day (resource) spending only in specific circumstances, primarily to address forecast error in relation to devolved tax receipts and social security spending. For example, this can be where there is a shortfall forecast in tax receipts or an increase in demand-led social security spending.

90. Consequently, the Scottish Government cannot borrow to support discretionary resource spending or to respond to an emergency situation, either with economic stimulus or direct support. The Scottish Government only receives financial resources to respond to an emergency event when the UK Government increases spending on devolved areas in response to that same event or funds the Scottish Government specifically for that purpose.

91. The use of resource borrowing is complementary to the use of the Scotland Reserve. The Scottish Government must balance the need for flexibility against the additional costs of borrowing compared to the Reserve to find a solution that is most appropriate to the circumstances.

92. Borrowing and other funding policies are set out in the *Scottish Government's Medium-Term Financial Strategy*. The latest publication, dated May 2022, is provided [AS/0013-INQ000102925].

93. The Medium-Term Financial Strategy document also contains analysis of fiscal risks and the approach to management. All borrowing decisions are taken in the light of ongoing analysis of the latest financial position.

94. All Scottish Government finance accounting policies are set out in the *Consolidated Financial Accounts*, which are published annually. The "Statement of Accounting Policies" for the most recent consolidated accounts (2021-22) can be viewed in the "Notes to the Accounts" section [AS/0008-INQ000102920].

95. The SPFM contains a section on *Borrowing, Lending and Investment* which is provided [AS/0014-INQ000102913].

96. Individual bodies within the Scottish Government accounting boundary are responsible for managing any debts they have, associated risks, and any related information in accordance with Scottish Government accounting policies and the SPFM.

Monitoring and responding to risks to the economy and public finances

97. Since the Smith Commission, the Scottish Government's budget is increasingly determined by the performance of the Scottish economy, and the Scottish Government's National Strategy for Economic Transformation sets out how the government is delivering sustainable and fairer economic growth.

98. The Scottish Government continuously monitors economic and financial risks that could impact its budget position. Broadly, these risks are:
    - Scotland's economic outlook, in particular its performance relative to the rest of the UK, which is the main determinant of the net impact of devolved tax revenue on the budget position
    - UK Government policy decisions, in particular decisions that affect the Block Grant that compromises a large part of our budget position
    - Financial risks the Scottish Government must manage internally, but which may present additional and unplanned spending obligations.

99. The *Fiscal Framework (2016)* [AS/0002-INQ000102914] provides for when there is a Scotland specific economic shock (SSES) although the flexibilities this affords are

limited and constrained. A shock is triggered if the growth rate of the Scottish economy, on a rolling annual basis, is both below 1% in absolute terms and 1 percentage point slower than the growth rate of the UK economy. Once a shock has been triggered, annual borrowing powers to deal with forecast error are increased from the standard £300 million, to £600 million – for the financial year the shock originates in, and the two following financial years. The annual drawdown limits for the Scotland Reserve are also waived for the same period of time, allowing greater flexibilities in managing resources between years.

100. In practice these additional powers offer limited support. For example, Income Tax is the primary source of forecast error risk given its size relative to other devolved taxes and social security benefits. However, outturn data for Income Tax is published with a three year lag, meaning that any forecast error repayment / reconciliation for Income Tax is made four years after the error occurs. Whereas the SSES powers only cover up to year three, meaning that they no longer apply when the need is likely to be greatest. More broadly, the powers do not enable SG to borrow for discretionary spending to provide additional fiscal support during an economic downturn, or to directly tackle the underlying drivers of the shock.

101. In monitoring economic and fiscal risks, the Scottish Government is supported by the Scottish Fiscal Commission (SFC). Twice a year the SFC publish Scotland's Economic and Fiscal Forecasts which provide their central forecasts of the Scottish economy, revenue from devolved taxes, and discussion of any risks to their forecasts.

102. Outside of SFC publications, the Chief Economist and the Office of the Chief Economic Adviser (OCEA) in DG Economy routinely monitors the state of the Scottish economy through collection and reporting of a wide range of economic statistics including economic output, labour market participation, unemployment, trade, productivity, business performance and consumer sentiment. Economic impacts on different sectors of the economy are also explored.

103. Since 2018, the Scottish Government has published the *Medium-Term Financial Strategy* (MTFS), which is used to report on the risks facing the Scottish Government's Budget position. For example, the most recent publication of the MTFS, published in May 2022 [AS/0013-INQ000102925], presented an upside and downside funding scenario, reflecting risks around the economic forecasts and

funding and spending decisions taken by the UK Government. The MTFS also discusses how the Scottish Government intends to manage these fiscal risks over the medium-term by setting out the tools available to the Scottish Government to manage any adverse risks to its budget position.

104. Any financial risks within the Scottish Government's spending plans are managed in line with the *Scottish Public Finance Manual* guidance on risk management which is provided [AS/0009-INQ000102921].

105. Although economic and public financial risks are monitored extensively, the Scottish Government's ability to borrow in response to these risks, as the UK Government would do, is limited. Resource borrowing powers are restricted to in-year cash management and management of forecast error. In the event of a major adverse impact to the budget position, reductions in spending are the only feasible mechanism to ensure the Budget position balances.

106. In practice the provisions of the Fiscal Framework (2016) [AS/0001-INQ000102912] offer some protection from most macroeconomic risks. As the net impact of devolved tax revenue on the Scottish Budget depends on the relative performance of the Scottish and rest of the UK's tax bases, events which affect the whole of the UK economy (such as the Covid-19 pandemic) should in theory have limited direct impact on the Scottish Budget through the net tax position. However, impacts on the Scottish Budget can emerge when UK-wide events have differential impacts on the Scottish tax base from the rest of the UK. Budget impacts can also emerge if an event generates pressures on devolved areas of spending that either occur disproportionately in Scotland, or which the UK Government chooses not to respond to in the rest of the UK. In this event, the Scottish Government does not have the short-term powers to scale up public spending to respond to these impacts.

Key Roles and Responsibilities

The Scottish Ministers

107. The Scottish Ministers determine policy and account to, and are held to account by, the Scottish Parliament for the policy decisions and actions of the Scottish Administration, including SG Executive Agencies and non-ministerial offices (NMOs).

108. Ministers propose spending plans for scrutiny in accordance with the Written Agreement process and to be authorised by the Parliament in the annual Budget Act. Ministers for Bills being introduced in the Parliament also ensure that these have explanatory notes and a Financial Memorandum which sets out associated costs.

109. SG Executive Agencies, NMOs and bodies sponsored by the SG are distanced from the Scottish Ministers, but the responsible Cabinet Secretary or Minister is accountable to the Parliament for that independence and for the organisation as an instrument of government policy. Ministers therefore remain accountable to the Parliament for these resources, and for performance.

<u>The relevant Ministers/Cabinet Secretaries</u>

Figure 4: Scottish Ministers/Cabinet Secretaries - as at 21 January 2020 (names may have changed over the course of the proposed date range)

First Minister	Nicola Sturgeon
Deputy First Minister	John Swinney
Cab Sec for Finance, Economy and Fair Work	Derek Mackay
Cab Sec for Health and Sport	Jeane Freeman
Cab Sec for Education and Skills	John Swinney
Cab Sec for Transport, Infrastructure and Connectivity	Michael Matheson
Cab Sec for Justice	Humza Yousaf
Cab Sec for Communities and Local Government	Aileen Campbell
Cab Sec for Rural Economy	Fergus Ewing
Cab Sec for the Constitution, Europe and External Affairs	Mike Russell

Special Advisers

110. Special advisers provide political advice to Ministers. Special advisers can be appointed at any point of a parliamentary term but are required to stand down prior to the election for the next parliamentary term. Since the 2007-2008 financial crisis, a range of special advisers have provided advice to Ministers on issues relating to finance and the economy. The following list sets out special advisers who have had lead or partial responsibility for finance and economy issues, with their first date of appointment to Scottish Government. In some circumstances, this appointment may have initially been for another policy area.

- Prior to 11 June 2009 – Stephen Noon
- 25 January 2010 – Jennifer Erickson
- 25 July 2011 – Malcolm Fleming
- 30 January 2012 – Liz Lloyd
- 03 October 2012 – Colin McAllister
- 03 October 2012 – Delancy Johansson
- 08 October 2012 – Alexander Anderson
- 01 April 2015 – Jeanette Campbell
- 09 January 2017 – Stewart Maxwell
- 25 July 2017 – Callum McCaig

The Principal Accountable Officer

111. The Public Finance and Accountability Act states that the most senior member of the staff of the Scottish Administration is the Principal Accountable Officer (PAO).

112. The Principal Accountable Officer has the functions specified in section 14 of the *Public Finance and Accountability (Scotland) Act 2000* (the Act) [AS/0015-INQ000102926] In summary, these are:

- Signing the accounts of the expenditure and receipts of the Scottish Administration or any part of it
- Signing any account prepared in pursuance of section 19(2) of the Act
- Ensuring propriety and regularity of the finances of the Scottish Administration
- Ensuring that Scottish Administration resources are used economically, efficiently and effectively

- Designating staff as Accountable Officers for parts of the Administration (for example, DGs and Chief Executives of Executive Agencies) and determining their functions
- Ensuring the performance of those functions by Accountable Officers.

The Accountable Officer (AO) Role

113. The responsibilities of designated AOs are set out in the SPFM and cover all aspects of propriety, regularity and value for money.

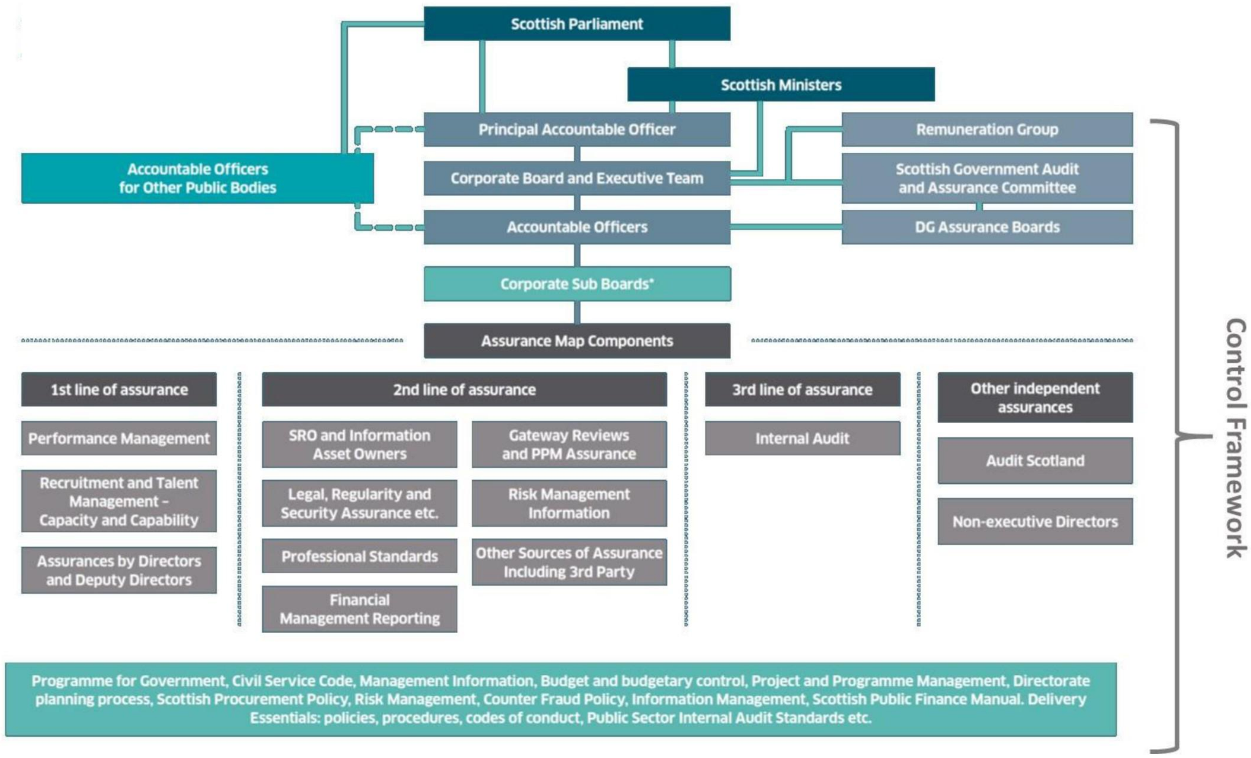
114. In particular, Accountable Officers:
    - Answer to the Scottish Parliament and have personal responsibility for the finances under their stewardship
    - Give evidence before the Public Audit Committee about the expenditure and performance of their areas of responsibility
    - Ensure the propriety and regularity of the finances under their control – complying with relevant legislation and SPFM guidance issued by Ministers and signing the annual accounts of the relevant body
    - Secure value for money: the economic, efficient and effective use of all resources
    - Empower staff through effective management systems and provide support for undertaking designated roles
    - Ensure risks and opportunities are identified, assessed and managed
    - Ensure sponsored bodies have robust controls and reporting processes.

Overview of Governance and Accountability in the Scottish Government

115. The Scottish Government's corporate governance system provides advice and support to the Permanent Secretary to discharge responsibilities as Principal Accountable Officer. See Figure 5, in paragraph 116.

116. The system is overseen by Corporate Board, chaired by the Permanent Secretary, which delegates responsibility to a number of sub-boards chaired by Directors-General. There is also the Scottish Government Audit and Assurance Committee (SGAAC) which consists of non-executive directors (NXDs).

Figure 5: Diagram to illustrate assurance roles and functions for the Scottish Budget



117. Overall information on the roles of ministers, the Permanent Secretary, DGs and Directors can also be found in the Scottish Government's consolidated accounts [AS/0008-INQ000102920]

Overview of DG Exchequer

118. The Scottish Exchequer came into existence on 1 July 2017 to lead on fiscal policy, Scotland-wide Budget strategy, tax and spend, reflecting the country's growing fiscal autonomy and responsibilities. Alyson Stafford CBE has been the DG since the role was created. Prior to this she held the role of DG Finance from October 2010. The Scottish Exchequer brought together key functions of Government: Budget, public spending, taxation, fiscal policy and fiscal sustainability. It led work to strengthen the impact of government spending on outcomes and the effective use of SG resources, supporting the Scottish Government to ensure a wellbeing approach to spending and taxation that improves lives across Scotland, now and for future generations.

119. In 2017/18 a new Tax Directorate was established to lead on strategy and policy advice on Scottish Government revenues along with a new Performance and

Strategic Outcomes Directorate with responsibility for enhancing cross-Government strategic coherence, performance and impact over the short, medium- and long-term. These two directorates joined the Budget and Public Spending Directorate, responsible for policy advice on overall fiscal sustainability and public spending. These three directorates formed the core of the DG Scottish Exchequer. For administrative purposes, Internal Audit also sits within DG Scottish Exchequer but, in line with its charter, it is independent and reports functionally to the Principal Accountable Officer of the Scottish Government.

120. This structure has evolved since its creation in response to the development of the Scottish Exchequer role, changes in the structure of the wider Scottish Government and to external events. As at January 2020, the Scottish Exchequer included four Directorates:

121. The Directorates and Directors within DGSE (January 2020)[3]

i. Directorate for Budget and Public Spending: (remit at January 2020)

The directorate is responsible for leading the annual Scottish Budget process and periodic multi-year spending reviews, public sector pay and pensions policy, infrastructure investment policy and strategy, analysis of public spending and engagement with HM Treasury and the other devolved administrations on strategic finance issues.

ii. Directorate of Taxation and Fiscal Sustainability: (remit at January 2020)

The directorate is responsible for tax strategy and policy and the negotiation, development, provision of policy advice, legislation and implementation of the enlarged set of fiscal powers set out in the Scotland Act 2012 and the Scotland Act

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[3]**Changes since January 2020 - The Directorates and Directors within DGSE as at 2022:**

Director	Area
Andrew Watson	Budget and Public Spending
Lucy O'Carroll	Fiscal policy and Constitution
Jennie Barugh	Fiscal Sustainability & Exchequer Development
Andrew Scott	Tax and Revenues
Sharon Fairweather	Internal Audit and Assurance

2016. It is also responsible for Scotland's *Fiscal Framework* [AS/0001-INQ000102912].

iii. Directorate for Performance and Strategic Outcomes (remit at January 2020)

Performance and Strategic Outcomes Directorate aims to promote an impact and delivery focused approach across Scottish Government and Scotland more widely, including through the development of the Scottish Exchequer as a whole. It is also responsible for producing the annual Programme for Government

iv. Directorate of Internal Audit and Assurance: Director Sharon Fairweather

The directorate provides independent and objective assurance and consulting to the Scottish Government, departments and agencies. The Directorate sits within the Exchequer for administration purposes but operates independently of it and the core Exchequer activity.

122. The Scottish Exchequer also works closely with:

- ***Office of the Chief Economic Advisor*** to ensure there's strategic and operational collaboration on tax, fiscal and public spending analysis. This is the main dedicated resource for economic analysis and sits outside the Exchequer in DG Economy.
- ***Financial Management Directorate*** to ensure that there is a strategic overall approach to financial management, and to ensure close coordination across public spending and taxation, and the processes of budgeting, accounting, treasury management, and corporate governance. This day-to-day management of public money sits outside the Exchequer and is part of DG Corporate. The Financial Management Directorate is led by the Chief Financial Officer (CFO) who provides advice to Ministers and officials on sound financial management and the delivery of financial operations.

123. DG Scottish Exchequer directorates and Financial Management Directorate provide the overall mechanism through which the Scottish Government budget is set and managed, associated reporting, and support for others to fulfil their accountability roles and responsibilities.

124. Separate arrangements are in place for financial management within the DG Health and Social Care portfolio, financial management of NHS Boards, and related financial

performance and activities. DG Communities hosts the team that leads on Local Government Finance and local taxes.

125. Alongside the work of DG Scottish Exchequer in setting the Scottish Budget and tax, budget and public spending, and fiscal sustainability roles, the Financial Management Directorate within DG Corporate (previously DG Organisational Development and Operations) provides a range of services to support financial management and associated controls.

126. The Financial Management directorate works alongside directorates within DG Scottish Exchequer, with a particular focus on **in-year** finance management processes and delivering a balanced budget against the plan for the year, corporate reporting and treasury management, monitoring / reporting of the financial position, and delivery of financial services, including accounts payable, banking services and related systems. This includes:

- Financial advice and support, aligned with Director General areas, to support Accountable Officers with the principles of financial management and governance, and to support the Cabinet Secretary for Finance and the economy
- Delivery of the Scottish Government's formal financial reporting outputs, including the consolidated accounts and audit, and outturn statements
- Technical accounting resource for the Scottish Government and related bodies
- In-year corporate monitoring and reporting to inform financial decision-making
- Related reporting to inform Scottish Parliament and UK HM Treasury budget processes.

127. Controls in place to support this include monthly budget monitoring covering all entities in the boundary of the annual budgeting process, processes to manage in-year actual versus forecast analysis, monthly financial reporting to governance forums, and resource prioritisation exercises. These processes collectively also inform and interact with active management of resource borrowing powers.

128. Accountable Officers are responsible for the management of their budgets in pursuit of relevant priorities. The Annual Statement of Assurance process is designed to underpin the effective operation of these processes and procedures in line with the

SPFM and associated requirements. Further information about the role of Accountable Officers, the Scheme of Delegation and associated processes is detailed in paragraphs 44 and 45.

129. A full list of Personnel at Directorate level with responsibilities relating to finance and the economy in Scotland between 2012-2020 is set out in the document provided. This document covers DG Economy, DG Scottish Exchequer and DG Organisational Development and Operations (which became DG Corporate in March 2021) [AS/0016-INQ000102892].

130. Public Bodies associated with the Scottish Exchequer are:

- The Scottish Fiscal Commission (Non-Ministerial Department) is an independent statutory body, producing official fiscal and economic forecasts twice every financial year
- Revenue Scotland (Non-Ministerial Department) is responsible for the administration and collection of the fully devolved taxes in Scotland. HMRC is responsible for the administration and collection of Scottish Income Tax.
- Scottish Futures Trust (Non-Departmental Public Body) is responsible for improving the efficiency and effectiveness of infrastructure investment and use in Scotland

131. Scottish Exchequer is part of a wider set of fiscal institutions in Scotland that have been created over recent years as new fiscal powers have been devolved:

- The *Scottish Fiscal Commission* – Scotland's equivalent of the Office of Budget Responsibility – It provides independent forecasts of taxes, social security expenditure and GDP forecasts in Scotland. The Scottish Exchequer uses the Fiscal Commission's forecasts to develop the Scottish Budget when setting tax rates and spending envelopes for the Scottish Government and the Medium-Term Financial Strategy
- *Revenue Scotland* manages and collects revenues from the devolved taxes for the Scottish Government
- *Audit Scotland* provide an independent check that public money is being spent properly, efficiently and effectively.

Statement of Truth

I believe that the facts stated in this witness statement are true. I understand that proceedings may be brought against anyone who makes, or causes to be made, a false statement in a document verified by a statement of truth without an honest belief of its truth.

Signed: **Personal Data**

Dated: 18 April 2023