The 2016/17 audit of the Scottish Government's Non-Domestic Rating Account

AUDITOR GENERAL

Prepared for the Public Audit and Post-Legislative Scrutiny Committee
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Key messages

- **Non-domestic rates are a significant source of funding for local government and form a key part of the Scottish budget. In 2016/17, non-domestic rates accounted for around 29 per cent of total revenue funding provided to councils by the Scottish Government as part of the local government financial settlement. In overall terms, non-domestic rates accounted for around nine per cent of the total Scottish revenue budget in the same year. The Non-Domestic Rating (NDR) account prepared annually by the Scottish Government shows the amount of non-domestic rates collected by councils and redistributed back to them by the Scottish Government during the year. In 2016/17, the auditor issued an unqualified opinion on the NDR account.**
- **Each year, the Scottish Government determines the amount to be redistributed to councils as part of the Scottish budget. This is a policy decision made before it knows how much will be collected by councils for that year. The Scottish Government guarantees this amount to councils and therefore holds the financial risk which it manages as part of its overall budget.**
- **Due to forecasting and timing differences between collection and distribution, the balance on the Non-Domestic Rating account is either in surplus or deficit. At the end of 2016/17, the NDR account showed a deficit balance of £297 million. This means the Scottish Government has redistributed more to councils in recent years than councils have collected in receipts. In February 2017, the Scottish Government signalled its intention to bring the account into balance over a number of years but there is no formal plan in place. The success of any plan depends on future non-domestic rates income being greater than the amounts redistributed by the Scottish Government. The Scottish Government needs to develop and maintain a strategic plan of future non-domestic rates distribution levels as part of its commitment to longer-term financial planning. This should include the impact of addressing the deficit balance on its overall financial position.**
- **The arrival of new financial powers brings significant changes and increasing complexity to the Scottish budget. These enhance the Government's ability to manage and control spending but also introduce a greater element of financial risk. Better and more transparent information about the key components of the budget, including non-domestic rates, is essential to supporting effective decision making in this new environment. Information about non-domestic rates, including budget and financial information, is fragmented across a number of different accounts and budget documents. The Scottish Government needs to increase the transparency of its financial reporting on non-domestic rates. In addition, the establishment of the Scottish Fiscal Commission to provide independent forecasts of non-domestic rates provides an opportunity to increase transparency. Together, these will help the Parliament to build a comprehensive picture of non-domestic rates and better understand how it contributes to the Scottish budget and its impact on longer-term financial sustainability.**

Introduction

1. I have received the audited accounts and the independent auditor's report for the Scottish Government's Non-Domestic Rating (NDR) Account for 2016/17. I am submitting these financial statements and the independent auditor’s report under section 22(4) of the Public Finance and Accountability (Scotland) Act 2000, together with this report that I have prepared under section 22(3) of the Act.

2. The purpose of this report is to support the Scottish Parliament in its scrutiny of public finances in Scotland. In particular, it is to support the Parliament's scrutiny and understanding of non-domestic rates at a time when Scotland's public finances are becoming increasingly complex with the introduction of new financial powers. The report brings to Parliament's attention issues raised by the auditor relating to the financial position and transparency of the NDR account. The report is based on information provided through the 2016/17 audit of the NDR account and additional work undertaken by Audit Scotland.

3. The auditor issued an unqualified opinion on the 2016/17 financial statements. This means he is content that the account properly presents the receipts and payments of the account for the year ending 31 March 2017 and the balances as at that date.

Background

4. Non-domestic rates are a tax charged on properties that are used for non-domestic purposes, for example, private businesses, and public and third sector properties. The tax is collected by individual councils and pooled by the Scottish Government. It is then redistributed to councils as part of the overall annual local government funding settlement. This pooling arrangement allows the Scottish Government to smooth variances in councils' revenue raising abilities by determining the balance of revenue grant funding and non-domestic rates income made available to individual councils each year. It also provides councils with greater certainty over annual funding levels as it transfers the risk of lower-than-anticipated receipts to the Scottish Government to manage within its overall budget.

5. The Scottish Government, on behalf of Scottish Ministers, is required to prepare a NDR account at the end of each financial year, in accordance with the Local Government Finance Act 1992. The purpose of the account is to demonstrate that the non-domestic rates receipts collected by councils are redistributed to them by the Scottish Government.

6. In 2016/17, non-domestic rates income redistributed to councils was £2,768.5 million. This accounted for around 29 per cent of total revenue funding provided by the Scottish Government as part of the local government financial settlement. The remaining 71 per cent (£6,924.9m) is made up from general and specific revenue grants.[1] Overall non-domestic rates accounted for nine per cent of the total Scottish revenue budget in 2016/17.[2]

[1] *Local Government Finance Circular No. 1/2016*, Scottish Government, February 2016.
[2] Based on the Scottish Government's consolidated revenue budget of £31,890 million in 2016/17.

7. The Scottish Parliament has seen its financial powers increase substantially, with new responsibilities for taxes, social security, borrowing and reserves flowing from the Scotland Acts 2012 and 2016. These changes have significant implications for public financial management in Scotland, as they enhance the Government's ability to manage and control spending but also introduce a greater element of financial risk. Comprehensive, transparent and timely reporting of the key components of Scotland's public finances, including non-domestic rates, is essential in supporting Parliament in its important scrutiny role in this new environment.

The operation of the Non-Domestic Rating account

8. The Local Government Finance Act 1992 requires the Scottish Government to prepare an annual Non-Domestic Rating account. The purpose of the account is to demonstrate that the non-domestic rates receipts collected by councils are redistributed to them by the Scottish Government.

9. The NDR account is made up of two key components:
   - Receipts from non-domestic rates income collected by councils; and
   - Payments redistributed to councils from the Scottish Government.

10. The amounts received from and redistributed to councils are subject to timing differences as, in any year, the amount raised by non-domestic rates will only become known once the financial year is over. To help manage variances, each council provides an estimate of what they expect to raise in non-domestic rates, less any retentions from relief schemes, and submits this to the Scottish Government at the start of each financial year.[3] This is known as the Provisional Contributable Amount (PCA). During the year councils are required to pay the Scottish Government their estimated PCA amount. At the end of each financial year a reconciliation process is carried out where if a council's PCA is:
    - less than the amount received in non-domestic rates income, the council is required to pay more to the Scottish Government, or
    - more than the amount received in non-domestic rates income, the Scottish Government is required to reimburse the council.

11. The PCAs from councils and the redistributions to councils from the Scottish Government, including any adjustments, are reflected in the Receipts and Payments statement within the NDR account (page 8).

12. The Scottish Government assesses the total contributable amount based on councils' own estimates of non-domestic rates income as well as the anticipated impact of changes to the tax base, tax rates and any business rate relief scheme where councils retain part of the income.

[3] Relief schemes include the Business Rates Incentivisation Scheme and Tax Increment Finance.

13. Each year, the Scottish Government makes a policy decision about the amount to be redistributed to councils. This is outlined in the draft Scottish Budget and subsequent local government finance circulars. Due to the timing differences noted in paragraph 10 above, the amounts redistributed to councils are unlikely to match the amounts raised during the year. Redistributed amounts are made in proportion to councils' prior-year estimates of their contributable amount.[4] For example, Aberdeen City Council's estimate of their 2016/17 non-domestic rates income accounted for 7.7 per cent of all councils' estimated contributions. This meant they were allocated 7.7 per cent of the 2017/18 distributable amount determined by the Scottish Government.

14. The level of funding provided to councils during the financial year is not affected by differences between the PCA and actual amounts received. The Scottish Government guarantees the combined amount of revenue grant funding and non-domestic rates distributions provided to councils each year and manages the financial risk of variances within its budget. Where variances in non-domestic rates occur, the Scottish Government adjusts the council's general revenue grant to ensure funding levels to local government align to the levels agreed in the local government finance settlement for that year.

15. Differences arising between amounts paid by councils during the year and the amount redistributed to councils mean that the NDR account will hold either a surplus (more money paid in by councils, than paid to councils) or a deficit (more money paid to councils than paid in by councils). The surplus or deficit balance on the account at the end of the year is carried forward to the following year as per the requirements of the Local Government Finance Act 1992.

Financial position

16. The 2016/17 NDR account shows the Scottish Government received £2,799 million in non-domestic rates income from councils and redistributed £2,807 million back to councils, leaving a deficit balance for the year of £8 million. This includes prior-year adjustments relating to 2015/16 variances between councils' PCAs and actual non-domestic rates receipts (Exhibit 1).

17. This is the fourth year in a row an annual deficit balance has occurred and the third year in a row that a cumulative deficit balance position remains on the account. This means that over time, the Scottish Government has redistributed more to councils than it has received in non-domestic rates contributions from councils. Overall, the cumulative deficit balance is £297 million at 31 March 2017 (Exhibit 2). The overall balance is reflected on the Statement of Balances on page 9 of the NDR account.

[4] This is based on councils' mid-year estimates.

Exhibit 1

Non-domestic rates contributions and distributions 2016/17

The difference between contributions from councils and amounts distributed back to councils is reflected in the annual NDR account.

	£m
Provisional Contributable Amounts (from councils to Scottish Government)	2,754
Additional receipts from prior year, 2015/16	45
Total contributions	**2,799**
Distributable amount (from Scottish Government to councils)	2,768*
Additional payments from prior year, 2015/16	39
Total distributions	**2,807**
Annual surplus/(deficit)	**(8)**

* Set by the Scottish Government as part of the 2016/17 Scottish budget.

Source: NDR account 2016/17, Scottish Government

Exhibit 2

Non-domestic rates contributions and distributions, 2011/12 to 2017/18

Any surplus or deficit on the NDR account is carried forward to the following financial year.

	2011/12 £m	2012/13 £m	2013/14 £m	2014/15 £m	2015/16 £m	2016/17 £m	2017/18 £m
Contributions (from councils to Scottish Government)	2,259	2,442	2,501	2,554	2,628	2,799	*2,895**
Distributions (from Scottish Government to councils)	2,238	2,311	2,513	2,781	2,843	2,807	2,666
Surplus/(deficit)	21	131	(12)	(227)	(215)	(8)	*229**
Cumulative surplus/(deficit)	**34**	**165**	**153**	**(74)**	**(289)**	**(297)**	***(68)****

Notes: Both contributions and distributions include any in-year adjustments over and above the provisional contributable amount (PCA) estimated by councils and the distributable amount included in the local government funding settlement. The Appendix provides information on non-domestic rates contributions and distributions back to 2007/08. Figures marked (*) are based on the Scottish Government's estimate of contribution levels being £2,895m in 2017/18.

Source: Scottish Government

18. The Scottish Government determines the time it will take to rectify the deficit as it decides on the level of distributable amount set each year as part of its annual budget. For example, the Scottish Government has the option to set a distributable amount at a level that intends to bring the account back into balance each year. To reduce the current deficit, the Scottish Government needs to set the distributable amount lower than expected NDR income. In the draft 2017/18 Scottish budget, the redistributable amount was set at £2,606 million which would have significantly reduced the deficit balance to £8 million. Following revised forecasts of NDR contributions, the Scottish Government increased the distributable amount in the final approved budget by £60 million to £2,666 million, therefore leaving an anticipated deficit balance of £68 million at the end of 2017/18 (Exhibit 2). Beyond 2017/18, the Scottish Government has no formal plan to bring the account into balance. The Scottish Government will need to manage the impact of addressing the deficit balance on its overall financial position.

19. The Scottish Government should develop and maintain a strategic plan of how it plans to manage the NDR account balance in the future. This should include scenario planning or sensitivity analysis to outline the potential impact on the overall account balance of any changes in contributions or distributions as a result of revised estimates or policy decisions. Scenario planning and sensitivity analysis would provide decision makers with greater information of how any fluctuations in non-domestic rates contributions or distributions may impact on decisions about how local government is funded as part of the annual budget process or the development of longer-term financial plans.

20. In September 2017, the Scottish Government agreed to adopt the recommendations of the Budget Process Review Group, established by the Finance and Constitution Committee. The group's remit was to carry out a fundamental review of the budget process in light of the Scottish Parliament's new financial powers. The group's recommendations included the introduction of a Medium-Term Financial Strategy to outline the Scottish Government's high-level financial plans and projections for at least five years and to help inform detailed budget proposals in each year.

21. The Scottish Government should be clear about the policy choices it is making when setting the distributable amount and how it plans to manage these as part of its commitment to longer-term financial planning. This should include how the distributable amount is calculated and set by the Scottish Government and the implications for future budgets. This would also help to provide a better understanding and awareness on how the Scottish Government plans to fund local government and the financial risk implications for the wider Scottish budget.

Transparency

22. In March this year, I reported that the Scottish Government is taking steps to enhance financial reporting of Scotland's public finances, but more work is required to provide a clear overall picture.[5] The increasingly complex nature of Scotland's public finances increases the

[5] *Managing new financial powers: an update*, Audit Scotland, March 2017.

importance of clear and consistent budget and financial reporting. Greater transparency is important in promoting public trust and confidence in Government.

23. Non-domestic rates play an important role in local government funding and form a key component of the Scottish budget. Information about how non-domestic rates operate, including budget and financial information, is fragmented across a number of different financial statements, finance circulars and budget documents. For example:

- the distributable amount for each year is outlined in the draft Scottish budget each year but does not include details on how the figure is calculated or details on any assumptions used.
- the annual NDR account shows the overall account balance but there is no publicly available information about how the Scottish Government expects the NDR account balance to change over time or how it is affected by policy decisions.
- there is no information available outlining how changes between non-domestic rates estimates and receipts changes the balance of local government funding between non-domestic rates and general revenue funding.

24. The establishment of the Scottish Fiscal Commission (SFC) provides the opportunity to increase the transparency of non-domestic rates. From April 2017, the SFC is responsible for providing independent five-year forecasts of non-domestic rates income. For the 2017/18 budget, the SFC was responsible only for scrutinising the buoyancy and inflation elements of the Scottish Government's non-domestic rates forecasts.[6]

25. The SFC will publish its independent forecast alongside the Scottish Government's draft budget for 2018/19 onwards. The SFC will focus on forecasting the contributable amount. The model used to forecast the contributable amount of non-domestic rates will draw on the size of the tax base and tax liability, deductions from relief schemes and any other adjustments such as the impact of refunds from appeals. The SFC inherited the model used by Scottish Government economists and statisticians to produce the forecasts for the 2017/18 draft budget and is currently reviewing all parts of the model to see if improvements can be made.

26. It remains the responsibility of the Scottish Government to determine what the distributable amount for each year will be. For this reason, in September 2017, the SFC stated in its forecasting approach paper that it will not provide independent forecasts of the distributable amount.[7]

27. The Scottish Government needs to increase the consistency and transparency of financial information and reporting on non-domestic rates to provide the Parliament and the wider public with the information they need to have a fuller understanding of how non-domestic rates funding operates. This should also be demonstrated in the Government's financial reporting on the current non-domestic rates position, future forecasts and its plans to address the underlying deficit balance. It is important that information is presented in a way that is easy to

[6] Buoyancy is defined as the growth in the tax base after adjusting for the effect of revaluation appeals.
[7] *Current Approach to Forecasting*, Scottish Fiscal Commission, September 2017.

understand and navigate. Together, with the establishment of the SFC, these will help the Parliament to build a comprehensive picture of non-domestic rates and better understand how it contributes to the Scottish budget and its impact on longer-term financial sustainability.

28. The Scottish Government should increase financial transparency on non-domestic rates by:

- improving the information provided in annual budget documents and published accounts allowing the user to see how non-domestic rates are budgeted for and reflected in annual accounts.
- publishing details of how the distributable amount paid to councils is calculated and set as part of the Scottish budget including underpinning assumptions.
- publishing details of future non-domestic rates distributions and how it expects the overall NDR account balance to change over time as part of its wider commitment to longer-term financial planning.

Conclusion

29. The purpose of this audit report is to support Parliament and the public in their scrutiny and understanding of non-domestic rates at a time of significant changes to Scotland's public finances. The report highlights that the auditor is content that the 2016/17 NDR account properly presents the receipts collected by councils and the amounts redistributed back to them by the Scottish Government. The account balance at the end of 2016/17 means that over time the Scottish Government has redistributed £297 million more to councils than it has received in contributions.

30. To help improve its management and the overall transparency of non-domestic rates, the Scottish Government should:

- develop and maintain a strategic plan of future non-domestic rates distribution levels as part of its commitment to longer-term financial planning
- improve the information provided in annual budget documents and published accounts, allowing the user to see how non-domestic rates are budgeted for and reflected in annual accounts.
- publish details of how the distributable amount paid to councils is calculated and set as part of the Scottish budget, including underpinning assumptions.
- publish details of future distributions and how it expects the overall NDR account balance to change over time.

Appendix

10-year NDR contributions and distributions, 2007/08 to 2016/17

	2007/08 £m	2008/09 £m	2009/10 £m	2010/11 £m	2011/12 £m	2012/13 £m	2013/14 £m	2014/15 £m	2015/16 £m	2016/17 £m
Contributions	1,950	2,030	2,075	2,186	2,259	2,442	2,501	2,554	2,628	2,799
Distributions	1,874	1,984	2,244	2,139	2,238	2,311	2,513	2,781	2,843	2,807
Surplus/(deficit)	76	46	(169)	47	21	131	(12)	(227)	(215)	(8)
Cumulative surplus/(deficit)	**89**	**135**	**(34)**	**13**	**34**	**165**	**153**	**(74)**	**(289)**	**(297)**

Source: Scottish Government

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