Dear Linda

Scotland Bill Committee

Thank you for your letter of 4 October 2011. I am very happy to respond to the questions that weren't covered during my appearance in front of the Scotland Bill Committee on 27 September.

Crown Estate

You asked about the level of the Crown Estate's investment in Scotland compared to the income and assets that it has in Scotland. As part of this, you asked for a table of figures showing the Crown Estate's annual investment in Scotland as a percentage of that in the UK.
In 2010-11 the Crown Estate’s gross investment in Scotland was £7.4m, 1.3% of the UK total.

The historic investment data you requested is below. As you might expect from a property company, the investment pattern is not flat. The table shows that, on average over the period, 6% of the Crown Estate’s annual capital investment was in Scotland.

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<td>Scotland as % of UK</td>
<td>34.7</td>
<td>18.2</td>
<td>3.3</td>
<td>4.7</td>
<td>1.9</td>
<td>1.6</td>
<td>0.8</td>
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Over the same period, this was higher than Scotland’s share of the Crown Estate’s UK assets and gross surplus.

At 31 March 2011 the property value of The Crown Estate in Scotland (excluding joint ventures), was £207.1m, 3.1% of the UK total. Over the period 1999-2000 to 2010-11 Scotland accounted for an average of 3.8% of the UK total property value (excluding joint ventures).

The Crown Estate’s activities in Scotland accounted for £9.9m, or 3.7%, of the Crown Estate’s total gross surplus for 2010-11. Over the period 1999-2000 to 2010-11 Scotland accounted for an average of 5.4% of total gross surplus.
In addition, The Crown Estate has minimum future commitments of £20m over the next five years in the development of offshore renewable energy in Scotland including wind, wave, tidal stream energy, and carbon capture and storage.

You asked about the statement by the Crown Estate Commissioners that Scotland benefits indirectly from their operations in Scotland, because of the small percentage contribution from Scotland to the surplus revenue they transfer to the Treasury each year, means that “through the Barnett formula, there is a return to Scotland at a level which exceeds, in percentage terms, the money coming from Scotland”.

The Crown Estate’s annual revenue surplus contributes to the Consolidated Fund and so helps finance the block grant paid to Scotland.

As stated above, last year the Crown Estate’s activities in Scotland contributed £9.9m, or 3.7%, to the total UK gross revenue surplus. For that year the Crown Estate paid £231m to the Consolidated Fund. If all of that surplus were distributed according to the Barnett formula, some £23m, or 10.06%, would have been devoted to Scotland. This is more than double the Scottish contribution to the Crown Estate’s surplus.

As you acknowledged in your letter, the relationship between these two percentages is not direct. The comparison is broad brush since it
does not take into account a number of other calls on the Contingencies Fund such as debt interest. But the contrast does demonstrate an indirect benefit to Scotland from the Crown Estate’s presence and investment in Scotland.

You asked for information on the implications for the block grant if the Crown Estate Commissioners’ responsibilities in Scotland were devolved.

It is impossible to say what effect devolution would have on the block grant, without specifying how devolution, were it agreed, would take place. The mechanism would have to be developed and agreed jointly with the Scottish Government in line with the principles for adjusting the block grant (see below).

Finally, you asked whether there would be any particularly adverse financial implications for the rest of the UK, if the Crown Estate Commissioners no longer operated in Scotland.

The Crown Estate has a statutory duty to act commercially with due regard to good management and in accordance with good governance. The Treasury expects that overall strategy to comprehend both sustainability and the long term welfare of the property portfolio. If the Crown Estate were to decide to withdraw investment from any region of the UK, it would have to do so against that backdrop and with proper assessment of the benefit of portfolio
diversity. This criterion is demanding since the long term benefit of diversity is considerable.

The Treasury respects the recommendation of the Eve report of 1955, that The Crown Estate should make independent commercial decisions on investment or disinvestment based on its expertise.

You also asked for an update on the Government’s thinking and detailed analysis on financial modelling and the question of deflationary bias, plus the merits of the 10p figure (relative to any other figure) for the proposed Scottish income tax.

**Impact of the changes on the Scottish Government’s budget**

I fully appreciate the desire to understand the full implications of the changes on the Scottish budget. For the benefit of this new committee, I have provided alongside this letter the technical note prepared for the last committee in December 2010. As noted by the committee, this contains a hypothetical example, which was put together by the UK Government in response to misleading figures published by the Scottish Government.

It is hypothetical because the UK Government has stated that it will work collaboratively with the Scottish Government to agree the final block grant adjustment, although the UK Government believes the set of figures it has produced will be significantly closer to the final outcome than those published by the Scottish Government.
Indeed, in the spirit of collaborative working, UK Government Ministers agreed a set of principles for the block grant adjustment with Scottish Government Ministers at the first meeting of the Joint Exchequer Committee on 27 September.

However, the adjustment being made to the block grant is only one part of the picture – the most important drivers of the long-term impact of these changes on the Scottish budget are a) the performance of the Scottish economy and b) policy decisions made by the Scottish Government using the economic levers already devolved to them, plus the new powers proposed in the bill.

Year on year, there can be variations between growth in receipts and growth in public spending. Where tax receipts grow faster than public spending (whether this be as a result of economic growth or as a result of Government policy decisions on e.g. rates), the Scottish Government will receive more revenue than it would have done under the current block grant/Barnett model. Where public spending grows faster than tax receipts, the Scottish Government will receive less revenue than it would have done under the current funding model.

That is why picking particular points in time for short term comparisons with what would have happened under the existing arrangements can be misleading – choosing years where public spending grew faster than tax receipts suggests that the Scottish
Government would be worse off, whereas if the changes were to be made now, during a period of fiscal consolidation and public spending restraint, the Scottish Government would be better off.

Therefore, it is not possible to say definitively what the impact of the changes will be year on year – it will depend on the performance of the Scottish economy and the policy decisions made by the Scottish Government. This is a feature of being responsible for raising part of your own revenue and is something all governments responsible for raising their own revenue are exposed to.

It is worth the Committee noting, that if Scotland were responsible for raising all of its own revenue, this exposure would be substantially greater. However, under the proposed model, the block grant will continue to make up the majority of the Scottish budget and will limit the overall risk that the Scottish budget is exposed to.

**Deflationary bias**

The term deflationary bias has been used to describe two claims about the proposed Scottish rate of income tax:

- income tax receipts have grown less quickly than total tax revenues or public sector expenditure therefore the Scottish Government will receive less revenue over time than it would have done under the block grant/Barnett formula;
• receiving 10p from each income tax rate means that Scotland will receive 50% of the basic rate, 25% of the higher rate of 20% of the additional rate. The criticism is that, due to fiscal drag, as incomes increase over time, Scotland will receive a declining share of tax receipts.

It is important in this debate to distinguish between the rhetoric and the reality. The Scottish Government figures, which have also formed the basis of arguments by some external commentators, have been used to try to create doubt about the robustness of the income tax proposals.

However, the reality, as demonstrated by the UK Government, is that the block grant can be adjusted such that yearly distortions are smoothed over time, with no significant impact on the block grant.
Indeed, we would be surprised if the Scottish Government argued for a block grant adjustment mechanism that reduced their budget by £8bn as opposed to a mechanism similar to that set out by the UK Government which would increase their budget by c.£400 million.

Further, it is not the case the income tax revenues have grown less quickly than total tax revenues. Income tax receipts as a share of public sector receipts are broadly the same now as they were in the 1970s (see chart 1a above) and in real terms, income tax receipts have increased (see chart 1b below).

**Chart 1b: Real (2009 prices) Income tax receipts (£bn)**

Historically, personal tax receipts have been among the most stable of all major taxes, fluctuating only moderately in response to changes

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1 Source (charts 1a and 1b): Public Sector Finances (August 2011)
in GDP. As a share of GDP, total personal tax receipts are currently at approximately the same level as in the late 1970s.

The claim that fiscal drag will lead to an overall declining share of total income tax receipts over time is based on the assumption that the personal allowance and tax bands will not be uprated in line with growth in income. There is a statutory requirement that personal allowances and rate bands are automatically raised by at least the rate of inflation, unless Parliament acts to set them at a different level.

While it is the case that a greater proportion of tax receipts are now generated by higher and additional rate taxpayers, fiscal drag also has the effect of more taxpayers moving into the basic rate, for which the Scottish Government will receive a 50% share.

10p rate

You asked about the merits of a 10p rate of income tax across all the bands as opposed to any other figure. I refer you to my response to the Committee – 10p represents a straightforward, easy to understand amount which aims to strike a balance between a real increase in the powers of the Scottish Government compared to the Scottish Variable Rate and at the same time, limit the extent of exposure to risk for the Scottish budget. As Anton Muscatelli from the Calman Expert Group commented when he appeared in front of the previous Scotland Bill Committee:
“A 10p tax that is fixed across the range is a simple device that in many respects makes the whole tax structure a bit simpler to handle than allowing full action across the full range of thresholds and tax rates. That is one reason why we made the proposal.”

Anton Muscatelli to Scottish Parliament Committee 18/1/11

Devolving more of the higher and additional tax bands would import greater volatility to the Scottish budget. In times of growth, receipts from the higher rates would be expected to increase by more than receipts from income tax at the basic rate, but conversely, higher tax rate receipts fell by more than basic rate receipts during the recent downturn.

Were the whole of income tax to be assigned to the Scottish Government, income tax receipts would represent 36% of their total budget, as opposed to 15% under the current proposals – a significantly increased risk, given that currently the Scottish Government has very limited responsibility for revenue raising. The Government’s judgment is that the Scotland Bill proposals represent a sensible balance of risk while providing the Scottish Government with increased accountability and responsibility.

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2 See HM Treasury’s submission to previous Scotland Bill Committee: Volatility of higher rate of income tax – a technical note by the UK Government prepared for the Scottish Parliament’s Scotland Bill Committee (January 2011)
I hope that you find this response useful and I have copied this letter to the Secretary of State for Scotland. I am happy to respond to any other questions the Committee may have.

David Gauke MP