1. This evidence concentrates on two of the questions identified in the call for evidence: namely, questions 4 and 7.

**Question 4: effect of income tax proposals on finances of Scottish government, and its ability to stimulate growth.**

2. In this part of our evidence, we will concentrate on three aspects of the income tax provisions in the Scotland Bill. These are: a) how the tax provisions will affect the judgement of the Scottish government in setting its tax rate; b) evidence on the dangers posed by fiscal drag; and c) the effect of the proposed transitional arrangements. Our conclusion is that the proposed tax arrangements are flawed, in such a way that the Scottish government will be under pressure to set a tax rate which is too high: and the outcome is likely to be seriously deflationary for the Scottish economy.

3a) **How the tax provisions will affect the judgement of the Scottish government in setting its tax rate.**

3. It is convenient to illustrate the main point we wish to make in this part of our evidence by reference to the so-called Laffer curve: that is, a notional curve relating the total amount of revenue raised from a particular tax, (on the y-axis), to the tax rate, (the x-axis). This curve is conventionally regarded as being in the shape of an inverted “U”: with total revenue first of all increasing when tax rates are raised, until diminishing returns set in at some point, and thereafter revenues decline as rates are raised higher. We should stress that our use of the Laffer curve as an illustrative device does not imply any view as to where we actually are on the Laffer curve relating total income tax revenues collected in Scotland to the tax rate.

4. What we have done is compare the position of a Scottish government operating under the Scotland Bill rules, with a government facing the same Laffer curve, but without the filter of the Scotland Bill tax arrangements. Suppose the Scottish government operating under the Scotland Bill rules set the Scottish rate of income tax at x pence in the £: then the comparison could be with either:

   a) an independent Scottish government, assumed to be facing exactly the same Laffer curve, and which starts off with an equivalent tax rate: that is, 10+x for the basic rate, and so on. (So that, as far as the Scottish taxpayer is concerned, the same overall rate of tax is being levied under the “Calman” and “independence” scenarios).

   Or b) a UK government, assumed to be facing, proportionately, the same shape of Laffer curve.

5. The basic question is: how much extra revenue will the Scottish government operating under Scotland Bill rules get, if it increases the Scottish rate of tax by 1 pence, compared with the amount the independent Scottish government would get if it raised its tax by 1 pence? Mathematically, it turns
out that, no matter where we are on the Laffer curve, then under all feasible scenarios the Scottish government operating under the Scotland Bill rules would get more revenue from a 1 pence increase in the tax rate than an independent Scottish government would from a 1 pence increase in its tax rate. Moreover, the evidence suggests that the difference between the amounts of revenue raised is, in most circumstances, likely to be material. The relevant algebra proving this result can be found in the technical note at Annex 1.

6. The crucially important implication is that no matter where Scotland is on the hypothetical Laffer curve, the implementation of the Calman proposals significantly distorts the judgement of the Scottish government in setting its tax rate, compared with an independent Scottish government facing the same Laffer curve, (or, for that matter, compared with a UK government facing a Laffer curve of a similar shape). It will always be more worthwhile for a government operating under Calman to increase its rate of tax: and conversely, a Scottish government operating under Calman would always suffer a greater penalty, if it lowered its rate of tax. As a result, a Scottish government operating under Calman is likely to set a higher rate of tax than an independent or UK government facing the same shape of Laffer curve. And if we assume that the independent (or UK) government achieves a close to optimum tax rate, the implication is that the government operating under Calman is likely to set a tax rate which is too high – and which is therefore deflationary for the Scottish economy.

7. We first published the above result on the distorting effects of the Calman proposals in our paper published in the Scottish Left Review in March 2011: (this paper is Annex 2 to this evidence.) This paper was published after the report of the previous Scotland Bill committee, and was not available as evidence to that committee. What had been available to that committee was earlier work of ours, published in the Fraser of Allander Economic Commentary in 2010, (Cuthbert and Cuthbert, 2010), which highlighted a special case of the more general later result. This related to the position where a Scottish government might, by means of a package of income tax cuts combined with other stimulatory measures, be able to grow the economy and increase the overall income tax revenues collected in Scotland. The point we made in that paper was that, in these circumstances, a Scottish government would probably find itself receiving smaller revenues: in other words, the growth in total tax revenues would be to the benefit of the Treasury but to the detriment of the Scottish government. This earlier work of ours attracted criticism in evidence to the previous Committee, particularly from Iain McLean. What he argued was that, for the claimed flaw in our earlier paper to hold, then the country would have to be positioned beyond the highest point of the Laffer curve: that is, in the area where an increase in tax rate led to a decrease in overall revenues. But, McLean argued, available evidence indicates that the UK is placed well on the left hand side of the income tax Laffer curve, in the position where increases in tax rate yield increases in overall revenue.
8. As we explain in detail in the paper at Annex 2, this criticism by McLean is, in any event, misplaced. But the important point we should stress here is that our later result, on the distorting effect of the Calman proposals on the incentive to set tax rates, applies no matter where on the notional Laffer curve Scotland is actually placed.

9. Finally, in this section, we comment on a claim made by Professor Midwinter, in a paper he published in the Fraser of Allander commentary, (Midwinter, 2011), that the implementation of the Calman tax proposals would not result in any long term deflationary bias. We discuss Professor Midwinter’s paper in detail in our paper which is attached at Annex 3, (which is scheduled to be published in a future Fraser of Allander Commentary). The main point we wish to make here is that in his paper Midwinter is solely concerned with a very narrow definition of “deflationary bias”. The issue Midwinter addresses is whether (assuming the proposed changes were implemented, and the Scottish government set a neutral 10p tax rate), the changes would have an overall detrimental effect on the Scottish Budget in the long term, compared with what would have been available to the Scottish government under continued operation of the existing Barnett formula. Midwinter does not address at all the issue we are concerned with here, which is the effect the Calman tax arrangements will have on the Scottish government’s judgement as to what is the appropriate tax rate.

b) Evidence on fiscal drag.
10. As we, and others, have pointed out in earlier papers, the proposed tax arrangements could interact with fiscal drag to adversely affect the finances of the Scottish government. The danger is that, since the Scottish government’s income tax revenues constitute a lower percentage of the higher rate bands, then the Scottish government would receive a decreasing percentage of the income tax revenues collected in Scotland, if fiscal drag led to an increasing percentage of the overall income tax take being collected from the higher bands.

11. This argument was disputed in evidence given to the previous Scotland Bill Committee by Professors McLean and Muscatelli. What Iain McLean said was that fiscal drag would not be a problem, because a rational government would always re-index tax allowances and rates from time to time to keep up with inflation. Anton Muscatelli went further, and claimed that governments will ultimately adjust tax to GDP and government spending to GDP ratios to be relatively constant in the long-run. But even if the UK government did indeed ensure that the overall ratio of income tax to GDP was constant in the long term, this could still be perfectly consistent with a higher proportion of the overall tax take coming from the higher rate tax bands. And if this were to happen, then the tax take for a Scottish government operating under Calman would indeed decline relative to GDP – since under Calman the Scottish government receives a lower proportion of higher rate band tax revenues.

12. What this means is that McLean and Muscatelli’s arguments do not, in fact, answer our concerns about the effect of fiscal drag. Moreover, empirical evidence is now available, which actually confirms our concerns. This
evidence comes from the Secretary of State for Scotland and sponsor of the Scotland Bill, Michael Moore: he produced for the previous Scotland Bill committee estimates of what the yield of a 10 pence Scottish rate of tax would be, for each of the years 1999/2000 to 2007/08. Unfortunately the figures were not in a very helpful form – since what he gave the committee was the estimated yield for a 10 pence Scottish rate of tax, expressed as a percentage of total income tax receipts for the UK as a whole. Perhaps he did this because, expressed in this way, the figures are relatively stable: as a percentage of UK income tax receipts, the Scottish 10 pence yield starts at 2.8% in 1999/2000, rises to 3% by 2003/04, and then declines to 2.8% again by 2007/08 – that is, back to where it started at the beginning of the period.

13. If, however, the figures are re-calculated on a different basis to express the yield of a Scottish 10 pence rate as a percentage of Scottish income tax receipts, then a very different picture emerges. The relevant figures are given in the following table:

<table>
<thead>
<tr>
<th>Year</th>
<th>Yield (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999/00</td>
<td>40.0</td>
</tr>
<tr>
<td>2000/01</td>
<td>40.1</td>
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<tr>
<td>2001/02</td>
<td>41.7</td>
</tr>
<tr>
<td>2002/03</td>
<td>41.7</td>
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<tr>
<td>2003/04</td>
<td>41.0</td>
</tr>
<tr>
<td>2004/05</td>
<td>40.05</td>
</tr>
<tr>
<td>2005/06</td>
<td>38.1</td>
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<tr>
<td>2006/07</td>
<td>37.8</td>
</tr>
<tr>
<td>2007/08</td>
<td>37.8</td>
</tr>
</tbody>
</table>

It is necessary to take into account any major changes in tax rates or bands which occurred during this period: (that is, apart from normal marginal adjustments to tax bands). In fact, there were two major changes: taking effect in 2000/01, there was a 1 pence reduction in the previous 23 pence basic rate of tax to 22 pence: and taking effect in 2001/02, there was a 23.7% increase in the upper threshold for the 10 pence lowest rate of tax. Both of these changes would have had the effect of increasing the yield of a Scottish 10 pence rate as a percentage of Scottish tax receipts.

14. It is likely that these major changes account for the initial increases in the 10 pence yield as a percentage of Scottish receipts in the above table. But thereafter, the percentages fall consistently year by year – and end up well below the initial percentage. This is entirely consistent with the anticipated effects of fiscal drag on the yield of a Scottish 10 pence rate: the implication is that the income tax revenues coming to the Scottish government would grow more slowly than total income tax revenues in Scotland – meaning that the finances of the Scottish government would not benefit proportionately from growth in the Scottish economy.

c) Transitional arrangements

15. It is proposed that there should be a transitional arrangement for introducing the Calman tax proposals, whereby, instead of there being a once and for all initial adjustment of the Scottish Block Grant, this adjustment would be periodically recalibrated during the transitional period, so that the Block Grant as it would have been calculated by Barnett would be reduced by the estimated current yield of a 10p tax rate. Professor Midwinter, in his paper already referred to, went further, and in effect argued that this transitional arrangement should be permanently retained.
16. As we pointed out in our earlier paper, (Cuthbert and Cuthbert, 2010), these transitional arrangements have a perverse, and damaging, side effect. A Scottish government operating under the transitional arrangements would always be better off, whatever Scottish tax rate was in effect, if it raised the Scottish tax rate further: and conversely it would always be worse off if it lowered the Scottish tax rate. Thus the effective Laffer curve facing a Scottish government under the transitional arrangements would always be upward sloping – no matter what the slope of the true underlying Laffer curve. A proof of this result is given in Annex 3 to our 2010 paper. As we point out in our comment on Midwinter’s paper, (Annex 3 to this evidence), a Scottish government operating under these arrangements would be placed in an extremely bizarre situation. First of all, it would be under absolutely no budgetary incentive to grow the Scottish economy in order to increase the income tax base, since any adjustments to the Block Grant would be continuously recalibrated so that any growth in Scottish income tax receipts would be offset by a corresponding reduction in the Block Grant. Conversely, the Scottish government would suffer no budgetary penalty if the Scottish income tax base declined. But it is not just that the Scottish Budget would be insulated from the growth or decline of the income tax base: as already noted, the distortion of tax incentives under the transitional arrangements would mean that a Scottish government would always be under budgetary pressure to raise its tax rate – which would always raise more revenue for the Scottish Budget – even if the Scottish economy was being pushed into decline. Far from giving a Scottish government an active interest in the success of the Scottish economy, the transitional arrangements place a Scottish government in a position where it is under a strong incentive to take action which will damage the economy. The proposal made by Midwinter that these arrangements should continue permanently is, therefore, misplaced.

**Question 7: Accountability of the Crown Estate and its Commissioners.**

17. Attached at Annexe 4 is a paper, which we recently published in the Scottish Left Review, examining the details surrounding the Crown Estate Commissioners’ (CEC) involvement in the Fort Kinnaird shopping complex in Edinburgh. This deal involved the CEC forming a partnership, (The Gibraltar Limited Partnership), with the Hercules Unit Trust: (Hercules is registered in Jersey and is spun out from and is partly owned by British Land). As a partnership, there is no need for the Gibraltar Limited Partnership’s accounts to be filed with Companies House. The deal involved the CEC taking on £100 million of debt, (which incidentally was raised in the Republic of Ireland), despite the explicit provision of the 1961 Crown Estate Act which forbids the CEC from incurring debt. This debt was taken on with treasury approval but without the involvement of Ministers.

18. This situation is unsatisfactory. Apart from the breach of the restriction on CEC debt, it means that the CEC is getting involved in a form of partnership which removes its activities from full public scrutiny. It would be of particular concern to Scotland if at some future time key strategic assets, (like the sea bed or foreshore), were effectively privatised by the CEC through a similar deal.
19. In our view, the CEC needs to be brought much more closely under the democratic accountability of the Scottish Parliament, to ensure better management in general, and specifically to prevent any repeat of Fort Kinnaird type deals. The proposals in the Scotland Bill for a more formally recognised Scottish Crown Estate commissioner seem a totally inadequate form of public accountability.

Summary.
a) The effect of the Scotland Bill income tax proposals is to distort the judgement of a Scottish government when it comes to setting the Scottish rate of income tax. This arises because, as the result at Annex 1 proves, it will always be more worthwhile for a Scottish government operating under the Scotland Bill rules to raise its rate of tax, as compared with an independent Scotland facing the same Laffer curve, (or, indeed, as compared with a UK government facing proportionately the same shape of Laffer curve.)

b) Available evidence on the yield of the Scottish 10p rate of tax suggests that the dangers posed by fiscal drag are indeed real, and not just theoretical. The effect is likely to be that a Scottish government operating with a fixed rate of tax would receive a declining proportion of the overall Scottish income tax take: this would reduce the Scottish government's stake in the success of the Scottish economy, and would also contribute to increased financial pressure on the Scottish government.

Both of the above factors are likely to lead to a Scottish government operating under the Scotland Bill rules setting a tax rate which is too high. This is likely to have adverse deflationary effects on the Scottish economy.

In addition

c) The transitional arrangements proposed when the Scotland Bill is implemented have severely perverse effects, which mean that a Scottish government operating under these arrangements will always be better off if it raises its rate of tax – no matter how severe the resulting deflationary effect might be on the Scottish economy. The transitional arrangements therefore need to be handled with great caution: and, counter to certain suggestions, they should certainly not be maintained permanently.

d) As regards the Crown Estate, the unsatisfactory situation highlighted in our paper at Annex 4, as regards the Crown Estate Commissioners’ involvement in the Ford Kinnaird deal, highlights substantial weaknesses in the oversight of the Crown Estate, as far as Scotland’s interests are concerned. The Scotland Bill proposals for strengthening Scottish representation on the Crown Estate Commission seem an inadequate response.

References

Annex Papers.
Annex 1: “Technical note: Why a Scottish Government, operating under Calman, will always raise more in tax for a given increase in tax rate than an independent or UK government facing the same Laffer curve.” J. R Cuthbert, March 2011.
ANNEXE 1

Annex 1: Technical note: Why a Scottish Government, operating under Calman, will always raise more in tax for a given increase in tax rate than an independent or UK government facing the same Laffer curve.

J. R Cuthbert.
March 2011

For a given tax band, let a+10 be the UK tax rate for that band.
Let f(y) denote total revenues collected in Scotland from that band, at tax rate y:
and let S(x) denote the revenues received from that band by a Scottish government operating under the Calman rules, when it sets the Scottish rate of tax at x:

\[ S(x) = \frac{x}{a+x} f(a+x). \]

Then the first derivative, \( S'(x) \), is given by

\[ S'(x) = \frac{a}{(a+x)^2} f(a+x) + \frac{x}{(a+x)} f'(a+x). \]

Therefore

\[ S'(x) - f'(a+x) = \frac{a}{(a+x)^2} f(a+x) - \frac{a}{(a+x)} f'(a+x) : \]

hence

\[ 100(S'(x) - f'(a+x)) = \frac{100a}{f(a+x)} \left[ \frac{1}{(a+x)} - \frac{f'(a+x)}{f(a+x)} \right] . \quad (1) \]

(i) Suppose first of all we are on the right hand side of the Laffer curve: that is, \( f'(a+x) \leq 0 \): then it follows from equation (1) that

\[ \frac{100S'(x)}{f(a+x)} \geq \frac{100 f'(a+x)}{f(a+x)} + \frac{100a}{(a+x)^2} : \quad (2) \]

that is, the change in the revenues coming to a Scottish government operating under Calman, when it increases its tax rate by 1, (expressed as a percentage of overall tax revenues collected in Scotland), will be greater than the percentage change in the revenues coming to an independent Scottish government facing the same Laffer curve, by an amount which is at least as large as the extreme right hand term in equation (2). When x=10, (the natural starting value), then the term on the extreme right of equation (2) takes on the values of 2.5%, 1.9%, and 1.6% for a= 10, 30 and 40 respectively. So on the right hand side of the Laffer curve, there is a very marked differential incentive to increase tax rate for a Scottish government operating under Calman, as compared with an independent Scottish government, (or a UK government facing a similar shape of Laffer curve.)

(ii) Suppose, on the other hand, that we are on the left hand side of the Laffer curve: that is \( f'(a+x) > 0 \). Under all feasible scenarios, tax revenues will rise less than proportionately as the tax rate increases: that is, \( \frac{f'(a+x)}{f(a+x)} \leq \frac{1}{(a+x)} \).
Suppose that, in fact, \( \frac{f'(a + x)}{f(a + x)} = \frac{\theta}{(a + x)} \), for some \( \theta \leq 1 \).

Then substituting into equation (1), it follows that

\[
\frac{100(S'(x) - f'(a + x))}{f(a + x)} = \frac{100(1 - \theta)a}{(a + x)^2} \geq 0. \tag{3}
\]

In other words, in this case as well, the change in the revenues coming to a Scottish government operating under Calman, when it increases its tax rate by 1, (expressed as a percentage of overall tax revenues collected in Scotland), will be greater than the percentage change in the revenues coming to an independent Scottish government facing the same Laffer curve. This establishes the desired result.

This then raises the further question: how material is the differential incentive to change tax rate for a Scottish government operating under Calman, as compared with an independent Scottish government, when we are operating on the left side of the Laffer curve. This depends on the magnitude of the \( \theta \) term in equation (3). If \( \theta \) is close to 1, (which corresponds to the case when the elasticity of taxable income is close to 0), then the differential incentive effect is small. But if \( \theta \) is materially less than 1, (which corresponds to the case when the elasticity of taxable income is relatively high), then the differential incentive effect will be important. Evidence from the UK suggests that the elasticity of taxable income for high earners in the UK is relatively high: (Institute for Fiscal Studies Briefing Note BN 84, 2009). Moreover, taxable income elasticities for Scotland are likely to be a good deal higher than for the UK, because of greater opportunities for shifting tax residence. This suggests that differential tax incentives are likely to be significant on the left hand side of the Laffer curve for a Scottish government operating under Calman, as compared with an independent Scottish government—certainly for the upper tax bands, and possibly for all tax bands.

(iii) The conclusion is that, at all points on the Laffer curve, a Scottish government operating under Calman will always raise more in tax for a given increase in tax rate as compared with an independent or UK government facing the same Laffer curve: and at all points on the Laffer curve, this differential incentive is likely to be large.
In 2010, the Westminster coalition government introduced the Scotland Bill – a bill proposing new powers for the Scottish Parliament, set firmly in the context of the Union. The Bill incorporated most of the recommendations of the Calman committee set up by Wendy Alexander. The major proposals in the Bill are those concerning fiscal accountability – in particular, the introduction of income tax powers.

Although this is a Westminster Bill, under the terms of the Sewel convention its principles must be approved by the Scottish Parliament. This makes it crucial that the Bill is subject to detailed, independent scrutiny in Scotland. To provide this scrutiny the Scottish Parliament set up a Scotland Bill committee. The committee has now reported, with the majority endorsing the income tax proposals.

In this paper we directly challenge the findings of the committee on the income tax proposals. Scottish Left Review readers may recall that in an article last November we argued that there were serious technical flaws in the Calman income tax proposals. In this paper we will show that the committee did not adequately address these points. Secondly, we will show how our latest work in fact strengthens our original concerns. Overall, the committee has not adequately addressed the effect which the operation of the proposed tax system will have in distorting the incentive to raise taxes - in a way which will almost certainly lead to higher taxes in Scotland than would otherwise be the case.

First, however, we give some background on the procedures of the Scotland Bill committee. The committee had Wendy Alexander, the person who had instituted the Calman commission, as its Chair: and as its advisors, it appointed the former Secretary to the Calman commission, and a member of its expert group. Without any reflection on the individuals concerned, it is difficult to see how this is compatible with the committee being seen to carry out an independent scrutiny of the Calman proposals. We accordingly declined to appear in front of the committee. We submitted the committee our already published papers on Calman, but made it clear that we would not give further evidence, or report on our ongoing work.

In our original paper we demonstrated two technical flaws in the Scotland Bill. Given Scotland’s poor economic performance relative to the UK and EU competitors, it is likely that Scottish governments will be interested in stimulating the economy. We hypothesised that to do so a Scottish government might use a combination of some of the considerable powers it already has, in conjunction with a reduction in the Scottish rate of income tax: and that it is possible that this could result in an increase in economic activity.
and an actual increase in total income tax revenues in Scotland. However, the tax revenues coming to the Scottish government would almost certainly fall in these circumstances, because under Calman, the Scottish government would get a decreasing share of the total income tax take. Conversely, an increase in the Scottish rate of tax, even if it deflated the Scottish economy, and lowered overall tax revenues, would nevertheless almost certainly increase the tax coming to the Scottish government. So a Scottish government which was short of revenue would be under considerable pressure to raise tax rates. And a Scottish government operating under Calman would indeed be under severe financial pressure: not just because of the current prospects for public expenditure, but also because of the second Calman flaw, which means that, through the effects of fiscal drag, the Scottish government would receive a decreasing proportion of the overall income tax revenue raised in Scotland.

The evidence given to the committee dealing with our specific arguments came mainly from Iain McLean, and Anton Muscatelli: the first was a member, and the second the Chair, of the Calman expert group. Iain McLean argued in his evidence, and at greater length in a Scotsman article of 11th January, that we were mistaken as regards both of the flaws that we had pointed out. We will now examine Iain McLean’s arguments in detail – and show how he, in fact, got it wrong. But first, since McLean developed his criticism of our first argument in terms of something known as the Laffer curve, we explain what this is.

The Laffer curve describes the notional relationship between tax revenues raised and the tax rate. The way the thinking goes is as follows. Suppose a government set a zero rate for income tax: then clearly it would raise no revenue. If, however, it set an income tax rate of 100 pence in the £, then the population would not find it worthwhile to work, so again the government would raise virtually no revenue. So as the tax rate is increased, from the lower to the upper of these two extremes, and with everything else assumed unchanged, the total of tax revenues raised must first of all rise, until reaching a maximum at a particular tax rate, before declining from then on. This notional relationship, something like an inverted “U”, between tax rate and tax revenue is the Laffer curve – usually ascribed to the Chicago economist Arthur Laffer.

Iain McLean chose to criticise our original argument in terms of the Laffer curve, even though we did not postulate our original argument in terms of it. What he said was that, for our first claimed flaw to hold, then the country would have to be positioned beyond the highest point of the Laffer curve: that is, in the area where an increase in tax rate led to a decrease in overall revenues. But, McLean argued, available evidence indicates that the UK is placed well on the left hand side of the income tax Laffer curve, in the position where increases in tax rate yield increases in overall revenue. So, while our first claimed Calman flaw was indeed a technical possibility, it did not arise in practice.

Even in terms of the material available in our published papers, Iain McLean’s argument is wrong. What we argue is that a Scottish government might be
able to stimulate the economy, and increase total income tax revenues collected in Scotland, by a combination of an income tax cut and a package of other measures, like action on utility prices and business rates. It is perfectly feasible to envisage such a combined package being successful, even if the “pure” Laffer curve at that point was upward sloping. But if tax revenues increased as a result of such a package, the Scottish government itself would almost certainly receive less revenue – since it would, under the Calman rules, be receiving a decreased share of the increased tax take. So McLean was wrong to claim that our first flaw only operated to the right of the peak of the Laffer curve.

Work we have done subsequently provides more insight into the effect which the Calman proposals will have on a government’s incentive to raise tax. And since McLean has introduced the concept of the Laffer curve it is convenient to illustrate this point by using it. What we want to do is compare the position of a Scottish government operating under the Calman rules, when it sets the Scottish rate of income tax at x pence in the £, with the position of an independent Scottish government, which we assume is facing exactly the same Laffer curve, and which starts off with an equivalent tax rate: that is, 10+x for the basic rate, and so on. (So that, as far as the Scottish taxpayer is concerned, the same overall rate of tax is being levied under the “Calman” and “independence” scenarios).

Now consider the question: how much extra revenue will the Scottish government operating under Calman get, if it increases the Scottish rate of tax by 1 pence, compared with the amount the independent Scottish government would get if it raised its tax by 1 pence? Our latest work demonstrates that, no matter where we are on the Laffer curve, then under all feasible scenarios the Scottish government operating under Calman would get more revenue from a 1 pence increase in the tax rate than an independent Scottish government would from a 1 pence increase in its tax rate. Moreover, the evidence suggests that the difference between the amounts of revenue raised is, in most circumstances, likely to be material. The relevant algebra is set out at www.cuthbert1.pwp.blueyonder.co.uk .

The crucially important implication is that no matter where we are on the hypothetical Laffer curve, the implementation of the Calman proposals significantly distorts the incentive to change the tax rate, compared with an independent Scottish government facing the same Laffer curve, (or, for that matter, compared with a UK government facing a Laffer curve of a similar shape). It will always be more worthwhile for a government operating under Calman to increase its rate of tax: and conversely, a Scottish government operating under Calman would always suffer a greater penalty, if it lowered its rate of tax. This consistent and significant shift in the incentive to raise tax is likely to have an entirely predictable outcome in practice: namely, a Scottish government operating under Calman is likely to set a higher rate of tax than an independent or UK government facing the same shape of Laffer curve. And if we assume that the independent (or UK) government achieves a close to optimum tax rate, the implication is that the government operating under
Calman is likely to set a tax rate which is too high – and which is therefore deflationary for the Scottish economy.

Now consider our second point, which relates to the effects of fiscal drag. What Iain McLean said was that fiscal drag would not be a problem, because a rational government would always re-index tax allowances and rates from time to time to keep up with inflation. Anton Muscatelli went further, and claimed that governments will ultimately adjust tax to GDP and government spending to GDP ratios to be relatively constant in the long-run. But even if the UK government did indeed ensure that the overall ratio of income tax to GDP was constant in the long term, this could still be perfectly consistent with a higher proportion of the overall tax take coming from the higher rate tax bands. And if this were to happen, then the tax take for a Scottish government operating under Calman would indeed decline relative to GDP – since under Calman the Scottish government receives a lower proportion of higher rate band tax revenues.

What this means is that McLean and Muscatelli’s arguments do not, in fact, answer our concerns about the effect of fiscal drag. Moreover, empirical evidence is now available, (which was not available when we wrote our earlier papers), which actually confirms our concerns. Surprisingly, this evidence comes from the Secretary of State for Scotland and sponsor of the Scotland Bill, Michael Moore: he produced for the Scotland Bill committee estimates of what the yield of a 10 pence Scottish rate of tax would be, for each of the years 1999/2000 to 2007/08. Unfortunately the figures were not in a very helpful form – since what he gave the committee was the estimated yield for a 10 pence Scottish rate of tax, expressed as a percentage of total income tax receipts for the UK as a whole. Perhaps he did this because, expressed in this way, the figures are relatively stable: as a percentage of UK income tax receipts, the Scottish 10 pence yield starts at 2.8% in 1999/2000, rises to 3% by 2003/04, and then declines to 2.8% again by 2007/08 – that is, back to where it started at the beginning of the period.

If, however, the figures are re-calculated on a different basis to express the yield of a Scottish 10 pence rate as a percentage of Scottish income tax receipts, then a very different picture emerges. The relevant figures are given in the following table:

<table>
<thead>
<tr>
<th>Year</th>
<th>1999/00</th>
<th>2000/01</th>
<th>2001/02</th>
<th>2002/03</th>
<th>2003/04</th>
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<th>2005/06</th>
<th>2006/07</th>
<th>2007/08</th>
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<tbody>
<tr>
<td>Yield of a Scottish 10 pence rate as a percentage of Scottish income tax receipts</td>
<td>40.0</td>
<td>40.1</td>
<td>41.7</td>
<td>41.7</td>
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<td>38.1</td>
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It is necessary to take into account any major changes in tax rates or bands which occurred during this period: (that is, apart from normal marginal adjustments to tax bands). In fact, there were two major changes: taking effect in 2000/01, there was a 1 pence reduction in the previous 23 pence basic rate of tax to 22 pence: and taking effect in 2001/02, there was a 23.7% increase in the upper threshold for the 10 pence lowest rate of tax. Both of
these changes would have had the effect of increasing the yield of a Scottish 10 pence rate as a percentage of Scottish tax receipts.

It is likely that these major changes account for the initial increases in the 10 pence yield as a percentage of Scottish receipts in the above table. But thereafter, the percentages fall consistently year by year – and end up well below the initial percentage. This is entirely consistent with the anticipated effects of fiscal drag on the yield of a Scottish 10 pence rate: and is strong evidence in support of the view that fiscal drag would put the finances of a Scottish government operating under Calman under consistent pressure.

Overall, therefore, the arguments put forward against our position by McLean and Muscatelli do not stack up: and the further work we have undertaken, and Michael Moore’s figures on 10 pence tax receipts, in fact strengthen our original concerns. The consistent effect which the Calman arrangements have in increasing the incentive to raise tax, over effectively the whole range of the Laffer curve, is likely to mean that a Scottish government operating under Calman will be forced to set tax rates too high.

This should not be regarded as a surprising, or outlandish, conclusion. What we are talking about here, where a “federal” government shares the same tax base with a constituent state, gives rise to the potential for what is known in the literature as “vertical tax competition”. There is no overall consensus on what the effects of such vertical tax competition will be: but there is certainly a strong strand in the literature which takes the view that the likely outcome will be that taxes will be set at an inefficiently high level. This is illustrated by the following excerpt from a recent paper by Chernick and Tennant, from the journal Publius, (an academic journal concerned with the theory of federalism).

“The more harmonized revenue systems are—i.e. the more the national and provincial/state level share the same tax bases—the greater the potential for competition between levels of government, and the greater the potential for overall rates of taxation to be inefficiently high.”

This clearly indicates that the sorts of effect we have identified are regarded as constituting a very active danger, and not something to be brushed away, (as some members of the expert group did), as highly unlikely to happen. In terms of this quotation, the Calman arrangements could almost have been designed to maximise the danger – since what we have under Calman are tax bases which, by design, are totally aligned.

Further, a factor which will tend to inhibit states from raising taxes in a usual federal/state system will not apply under the Calman implementation. Where there are multiple states in a federation, each with the ability to set its own tax rate, these states will tend to be inhibited from raising taxes by the prospect of other states lowering their tax rates in response. This game theoretic inhibition does not apply in the Calman context, because the only subsidiary state with the ability to change its tax rate will be Scotland. This last point suggests that
the Scotland Bill committee should have been much more cautious than they were about accepting the Canadian example as a guide.

The upshot is that the Scotland Bill committee report contains an altogether inadequate discussion of the nature of the distorted incentives which the Calman proposals introduce for the tax setting government: and gravely underestimates the danger of the Scottish tax rate being set at too high a level. Unfortunately, such a flawed outcome was almost inevitable, given the procedural inadequacies which were built into the arrangements for the committee – with those with major responsibility for the Calman process being, to a large extent, judge and jury in their own case. The consequences will be borne by the Scottish people as regards the damage which will result to the economy: and in political terms, largely by the Labour Party. Unless, of course, the Scottish Parliament surprises us all, refuses to vote on purely Party lines, and does not simply rubber stamp the existing flawed tax proposals before they are passed back to Westminster.
ANNEXE 3

Annex 3: Would the Impact of the Scotland Bill Tax Proposals be Deflationary?
A Comment on Professor Midwinter’s Note
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In the Fraser of Allander Economic commentary Vol. 35 Number 1, Professor Midwinter [1] argued:

a. that implementation of the Calman income tax proposals, as incorporated in the Scotland Bill, would not result in any long term deflationary bias.
b. that instead of there being a permanent adjustment to the Block Grant when the new income tax powers are introduced, the practice of forecasting and assigning revenues to the Scottish Budget should be retained in the long term. (In other words, the kind of transitional arrangement currently proposed to operate while the new tax powers are being phased in should be maintained in the long term.) This, according to Midwinter, would reduce potential problems arising from future volatility of tax receipts.

In this brief comment, we dispute both of Midwinter's conclusions.

Will the impact of the Scotland Bill tax proposals be deflationary?
A major part of Midwinter’s note is a critique of the Scottish government’s analysis, [2], of the effects of the Scotland Bill proposals on the Scottish budget. Midwinter reached his conclusions by comparing two estimates of the annual yield of a Scottish ten pence income tax rate between 1999 and 2007: namely an estimate produced by the Scottish government, and an estimate produced by HMRC. Since the HMRC estimate of the total yield over the period was approximately £1 billion higher, Midwinter concluded that the Scottish government had correspondingly over-estimated the extent to which the introduction of the new tax powers would have reduced the Scottish Budget: and hence Midwinter concluded that the introduction of the new income tax powers would not be deflationary.

We do not wish to go into the details of this argument per se. However, it is relevant to point out that it is not appropriate to base any long term conclusion about the effects of the proposed changes on the size of the Scottish Budget on evidence based only on an eight year run of estimated income tax receipts. It is also relevant to note that Midwinter has not addressed another factor identified in [2] as likely to have an adverse impact on the Scottish budget under the Scotland bill proposals: namely, the effect of fiscal drag.

Our main purpose here, however, is to point out just how narrow a definition of “deflationary” Midwinter is using in his note. The issue Midwinter covers in his note is whether, (assuming the proposed changes were implemented, and the Scottish government set a neutral 10p tax rate), the changes would have an overall detrimental effect on the Scottish Budget in the long term,
compared with what would have been available to the Scottish government under continued operation of the existing Barnett formula. Believing that there is no long term significant reduction in the Budget, Midwinter then concludes that “Whilst the new funding mechanism will create a degree of volatility in tax revenues, this will not result in the deflationary bias as suggested by the Scottish government.” So Midwinter is implicitly working to a definition where “deflationary bias” equates to significant long term reduction in the Scottish Budget.

However, such a definition of deflationary bias is inherently limited. There are other ways in which the proposed tax changes could contribute to deflating the Scottish economy, whether or not they result in a significant reduction in the Scottish Budget.

In particular, if tax rates in Scotland were set too high - either in relation to some optimal level, or relative to other parts of the UK, this could well lead to a disincentive effect on enterprise and economic activity, hence deflating the Scottish economy. A proper consideration of whether the Scotland Bill proposals are deflationary would have to involve consideration of such wider issues. Such analysis is completely lacking from Midwinter’s note.

In fact, as earlier work by us has established, the implementation of the Scotland Bill tax proposals would result in a major risk of the Scottish tax rate being set at too high a level. See in particular, the technical note, [3], by one of the present authors. This note shows that a Scottish government operating under the Scotland Bill tax proposals would always experience a larger increase in tax revenues from a given increase in tax rate than either a UK government or an independent Scottish government, facing the same tax revenue curve. As the algebra in the technical note demonstrates, this will occur whenever an increase in tax rate leads to a less than proportional increase in tax revenues – which will be the case under all feasible real world scenarios.

Faced with a pressing need to raise extra revenue, (as all governments will be for the foreseeable future), a government operating under the Scotland Bill tax powers would therefore be under a greater incentive to increase its tax rate, than a government in similar circumstances not operating under the same tax arrangements. In other words, implementation of the Scotland Bill proposals will fundamentally distort the incentive structure for setting tax rates which will face the Scottish government – and it will do this in a way that will give a strong incentive for the income tax rate to be set higher than an optimal level.

Our conclusions are:
1) that it is not possible to draw from Midwinter’s note any general conclusion about whether the Scotland Bill tax proposals will be deflationary or not, since he completely fails to address the question of how the proposals will affect the incentive to set the rate of tax.
2) there is substantial evidence that the proposed changes will lead to a strong incentive for a Scottish government to set the Scottish rate of income tax too high, which would indeed have a deflationary effect on the Scottish economy.
Midwinter's proposal that there should be a permanent “transitional” mechanism

The second main conclusion in Midwinter’s note is the recommendation for “maintaining the practice of forecasting and assigning revenues to the Scottish Budget, whilst reducing the Block Grant accordingly from the conventional Barnett spending assessment.” In other words, instead of there being a once and for all initial adjustment of the Scottish Block grant, the adjustment would be continuously recalibrated, so that the Block Grant as it would have been delivered under Barnett would be reduced by the estimated current product of a Scottish 10p tax rate. This would imply that the sort of transitional arrangement currently proposed as the new tax arrangements bed in should be retained permanently.

One implication of this system is that a Scottish government would always be better off if it raised its tax rate above 10p than it would have been under the pure Barnett system: and conversely, would always be worse off than under the pure Barnett system if it lowered its tax rate below 10p. Midwinter himself is aware of this point: as he states in his note “A reduction from 10p would reduce the allocation, whilst an increase above 10p would increase spending.”

In fact, the algebra of this mechanism was analysed in detail in Annex 3 of our paper, [4], published in the Fraser of Allander Commentary: and it was shown there that an even stronger consequence of this arrangement holds. Namely that, for all tax rates that are feasible in practice, whenever the Scottish government increases the Scottish rate of tax, its Budget will increase. This will happen even if the tax rate in Scotland had been increased to the point where the effect of a further tax rise would be to reduce total tax revenues collected.

A Scottish government operating under the arrangement proposed by Midwinter would be placed in an extremely bizarre situation. First of all, it would be under absolutely no budgetary incentive to grow the Scottish economy in order to increase the income tax base, since, under Midwinter’s proposals, any adjustments to the Block Grant would be continuously recalibrated so that any growth in Scottish income tax receipts would be offset by a corresponding reduction in the Block Grant. Conversely, the Scottish government would suffer no budgetary penalty if the Scottish income tax base declined. But it is not just that the Scottish Budget would be insulated from the growth or decline of the income tax base: as already noted, the distortion of tax incentives under Midwinter’s proposal would mean that a Scottish government would always be under budgetary pressure to raise its tax rate – which would always raise more revenue for the Scottish Budget – even if the Scottish economy was being pushed into decline. Far from giving a Scottish government an active interest in the success of the Scottish economy, the proposal places a Scottish government in a position where it is under a strong incentive to take action which will damage the economy.

Our conclusion is that implementing Midwinter’s proposal would be very damaging for Scotland’s economy in the long term.
References


The Crown Estate has recently moved to the forefront of the political debate in Scotland, with Alex Salmond, the First Minister, making reform of the Crown Estate one of six demands for revision of the Scotland Bill. Currently, its management is carried out by the Crown Estate Commissioners (CEC). In this article we report on fresh research we have undertaken concerning the CEC’s partnership in a major property deal in Edinburgh: this research raises a number of further questions regarding the activities of the CEC, and their future potential adverse impact on economic development in Scotland.

We begin by looking at some general background on the Crown Estate, and we briefly summarise some of the issues raised by researchers, in particular the considerable work carried out by Andy Wightman.

As the Scottish government put it “The Crown Estate is the collection of property, rights and interests belonging to the Crown - and, ultimately to the people - that are managed by the Crown Estate Commissioners.”[1] Or, as a working group of Highland Authorities put it more pithily when they reviewed the Crown Estate, "The Crown Estate is a form of public land managed by a public body for public benefit". [2]

In Scotland, the property that makes up the Crown Estate includes the rights to the seabed within Scotland's territorial seas out to the 12 nautical mile limit, and rights over the continental shelf up to the 200 nautical mile limit (excluding hydrocarbons). It also includes a number of large rural estates and urban properties. But it is the marine elements of the Scottish Crown Estate which are potentially hugely valuable as wind and alternative energy sources are developed.

The role of the CEC was set out in the Crown Estate Act of 1961. The act defined their duty as being “to maintain and enhance its value and the return obtained from it, but with due regard to the requirements of good management.” This form of words actually gives the CEC considerable latitude: it is by no means clear whether their primary function is to manage the estate as good socially conscious landlords, or to be profit maximisers. And it was this confusion which became one of the main subject areas of discussion in the review of the management of the Crown Estate carried out by the House of Commons Treasury Committee in 2009–10. [3] For example,
with regard to the management of the marine estate, the Committee reported “In the marine environment, stakeholders are concerned by the emphasis the CEC are placing on revenue rather than long-term development and by CEC’s monopoly position.” and “We consider that the CEC ought to be able to adopt an approach that is more sympathetic to facilitating the development of local socio-economic benefit.”

Two other aspects of the 1961 Act are important. First, the Act specifically precludes the CEC from borrowing. The Act does not indicate why this was thought necessary, but restricting the CEC in this way makes sense, for a number of very good reasons. In particular, it avoids the danger of the CEC becoming highly debt geared property speculators, with the attendant risk of incurring large losses. Second, the Act specifies that the CEC should comply with directions from either the Chancellor of the Exchequer or the Secretary of State for Scotland. In practice, it appears that the Secretaries of State for Scotland have never availed themselves of this power. As we shall see, however, this is potentially a very important issue.

The management of the Crown Estate in Scotland and its revenues are both reserved under the Scotland Act 1998 with the revenues going directly to the Treasury. The Scottish Law Commission gave guidance as follows: “The constitutional aspects of the Crown and the management of the Crown Estate are reserved matters. However, the Crown's prerogative functions are not reserved nor is property belonging to the Crown. The Crown's interest as proprietor of the foreshore and sea bed and the public rights held by the Crown in trust for the public are therefore not reserved”. Matters concerning ownership and regulation are therefore devolved. However, in 2002, despite the Crown property, rights and interests in Scotland that are managed by the CEC being legally different from those forming part of the Crown Estate in the rest of the UK, the CEC ceased to treat Scotland as a separate business division. Thus, the CEC has become less rather than more devolved: for example, the urban estate is considered by the CEC for the UK as a whole, is handled by the London office, and there are no separate detailed accounts available for Scotland. As a result, although ownership is devolved, there have been cases where Scottish crown estate assets have been sold and the receipts to purchase assets in England: although this means that the Scottish estate was diminished, there was no involvement from the Scottish parliament.

In fact, under its present leadership, the CEC has not made it clear in its literature and in its statements that its role is fairly clearly defined as being in management, not ownership. Not only do the CEC market themselves as being the Crown Estate, but, in his appearance before the Scotland Bill Committee of the Scottish Parliament, Roger Bright, the chief executive of CEC said, “Perhaps it is worth bearing in mind that there is a clear distinction between ownership of the sea bed and the regulation of it, which clearly lies with the Scottish Government and Marine Scotland. We do not have a regulatory role; we are just the landowner. In that capacity, we seek to work closely with the Scottish Government so that we can understand its policy
objectives and try to work out how we can best work with them.” In fact, the CEC are not the landowner: they manage the estate for the landowner – which is the public in Scotland.

Andy Wightman, an independent writer and researcher on issues of land, and author of Who Owns Scotland, has been one of the most diligent writers on the operation of the Crown Estate Commissioners with regard to the Scottish Crown Estate. He has pointed to the opaqueness of the CEC’s accounts: and to their being little detail in their Scottish accounts. More recently he has analysed George Osborne’s Sovereign Grant Bill which provides for a new method of financing the Monarchy linked to the revenue of the Crown Estate. As Andy Wightman says, “Importantly, however, this is merely a formulaic link. The Crown Estate revenues will still be paid directly to the Treasury and there will be no hypothecation to the Royal Household…The formula might just as easily be tied to the profits of the Stilton Cheese industry. The link is illusory, misleading and designed to re-establish a relationship that is purely historic. It is worth noting that this plan was not dreamt up by the Treasury on its own and has the fingerprints of a certain senior Royal all over it. It also provides a clever way of frustrating the ambitions of the Scottish Government to devolve the administration and revenues of the Crown Estate.” [4]

In fact, in this, Andy Wightman is too generous to the Sovereign Grant Bill. When the Crown did receive the revenues from the crown estates, they were also responsible for running major functions of state, like defence. So historically, crown estate revenues were never used or intended solely for the upkeep of the monarchy: so it is misleading to imply that the present Bill is restoring any historic relationship.

Among other contributions to an analysis of the CEC handling of the Scottish Estate is the report of the working group of six local authorities in the Highlands and Islands and Highlands and Islands Enterprise. The report concluded: “There are relatively few public benefits in Scotland from the way these Scottish resources are managed at present, most notably the CEC’s management of Scotland’s territorial seabed and continental shelf rights and approximately half of Scotland’s foreshore. The very limited accountability in Scotland over the management of these Scottish resources has also become worse since devolution.”[2]

In the Press and Journal in September 2010, Brian Wilson wrote “In the early-1980s, it (the Crown Estate) blundered into my consciousness through its leasing of west-coast sea lochs to multinational salmon-farming companies without consulting anyone. Quite literally, people whose families had lived and worked in these places for generations woke up to find that the entire rights to use of a loch had been flogged off to Unilever or some such outfit. It was an astonishing saga that gave rise to decades of problems and resentments. So I became interested in the Crown Estate and concluded that its role as controller of Britain’s marine resources was an intolerable anomaly. Nothing has changed in the interim and there are now urgent reasons for the issue to be addressed.”
We now turn to a specific CEC activity which we have researched. This is the matter of CEC involvement in the ownership of Fort Kinnaird: a major retail development on the outskirts of Edinburgh.

In April 2007, the CEC and a company called the Hercules Unit Trust formed a £680 million joint venture limited partnership. The 50/50 partnership was named the Gibraltar Partnership Limited, and is an English limited partnership established under the Limited Partnership Act 1907. As a partnership, there is no need for accounts to be filed with Companies House. The joint venture incorporates three properties – the Fort Kinnaird Shopping Park in Edinburgh, which was owned by Hercules before the creation of the partnership, and was valued at £480 million, and two properties in England, owned by the Crown Estate before the partnership, and valued together at £200 million. The CEC saw the deal as “possibly the best example to date of how The Crown Estate has adapted and extended its reach in the last couple of years as part of a plan to diversify our portfolio and balance our exposure to the central London property market.”

Clearly the value of the properties owned by the Crown Estate were significantly less than the value of the Fort Kinnaird property. The deal would therefore involve some complex financial transactions, and it is here that we need to give some further background information.

But first, it is important to clear up the status of the partnership that was set up as there is some confusion over the name “Gibraltar Limited Partnership”. There actually is a specific type of partnership called a "Gibraltar limited partnership": this type of partnership confers certain benefits including stamp duty land tax benefits. We asked the CEC specifically (a) is The Gibraltar Limited Partnership, the joint venture between the Commissioners of the Crown Estate and the Hercules Unit Trust, such a "Gibraltar limited partnership". And (b) is the Gibraltar General Partner Limited a "Gibraltar limited partnership". The CEC confirmed that neither was a Gibraltar limited partnership but that both were English limited partnerships.

As the CEC are charged with the management of public assets, it is important to have some background information on its chosen partner, that is, on Hercules Unit Trust.

The Hercules Unit Trust (HUT) is a Jersey property unit trust which invests in properties in major retail warehouse or shopping park locations in the United Kingdom. It is 36.6% owned by British Land which is one of the UK’s largest real estate investment trusts. According to British Land, HUT is not an authorised unit trust scheme, OEIC or recognised scheme within the meaning of the Financial Services and Markets Act: it therefore constitutes an unregulated collective investment scheme. All or most of the protections provided by the UK regulatory system do not apply to investment in the HUT and compensation under the Financial Services Compensation Scheme is not available to investors. [5]

Further, unlike for a Jersey company or for a UK real estate investment trust, for a Jersey property unit trust there is no prohibition on financial assistance,
no maintenance of capital rules, and no restrictions on distributions. It is possible to make distributions out of capital without the need to meet solvency or other tests. [6]

Note too that British Land, as well as being property advisor to Hercules, and a 36.6 per cent holder in the Hercules trust, acts as property adviser to the new limited partnership. The Gibraltar Partnership has its registered office at the offices of British Land.

As noted the CEC property contribution to the partnership was valued at £200 million. The CEC made an additional contribution in cash of £45 million. However, the Partnership also needed further funds to meet an outstanding debt of £200 million specifically on the Fort Kinnaird property. The funding to meet this debt was provided by the issue of Secured Floating Rate Notes due 2015 using the Emerald Funding (Gibraltar) Plc on the Irish Stock Exchange. Emerald Funding used the note issuance proceeds to advance a loan to Gibraltar General Partner Ltd. acting as general partner of The Gibraltar Limited Partnership. The advance was made under the terms of a loan agreement structured by Bank of America Securities Ltd. and secured on the retail properties. Gibraltar General Partner Limited used the note proceeds to repay an existing facility of £200 million.

Effectively, therefore, the CEC was involved in a debt financed deal. Its share of the debt, financed by notes due for repayment in 2015, is shown directly in the CEC annual accounts as an outstanding “long term bank loan” of £100 million. So, although the CEC in terms of the 1961 Act are not allowed to borrow, the vehicle they used meant that they were indeed taking on debt.

By December 2008, Moodys, the credit rating agency, valued the retail parks at the reduced figure of £464.6 million compared to the original valuation of £680 million. However, among the covenants placed on the CEC by the Treasury, the amount of the loan drawn by the Gibraltar Partnership must not exceed 35% of the value of the partnership’s properties. The Partnership was therefore forced to place £37 million of cash as at March 2009 in a blocked account in order to maintain compliance with this covenant. This had risen to £55 million as at March 2010, that is, more than 25% of the loan has been sterilised, with the Partnership having to pay interest on it, but without being able to use these funds. As the Crown Estate noted in its Annual Accounts for 2009, “The largest writedowns in value have been the Gibraltar Limited Partnership, the only property interest which carries gearing”.

This chain of events raises a number of very interesting questions.

1. As we have seen, the effect of the deal is that CEC, who are statutorily barred from borrowing, have nevertheless acquired a significant amount of debt. CEC did get approval from the Treasury: the Treasury approved the transaction, with the caveat of the limitations on gearing ratio, but without officials going to Ministers. (House of Commons Treasury Committee The management of the Crown Estate Eighth Report of Session 2009–10 Volume II)
Why did Treasury officials approve such a significant breach in the spirit of the 1961 Act, without taking Ministerial guidance?

2. The Gibraltar Limited Partnership has not filed any accounts with Companies House, and, since it is a limited partnership, actually has no requirement to do so. This means that it is impossible for members of the public to scrutinise what is going on with major assets of the Crown Estate. This lack of openness sits very ill with the role of the Crown Estate as "a form of public land managed by a public body for public benefit". Why were the CEC allowed to place public assets in such an opaque partnership?

3. The methods used to set up the 50/50 partnership with Hercules Unit Trust may be standard practice in the private sector. However, it seems odd that a body entrusted with the management of public assets, of which in this case a substantial part was in Scotland, should use a newly constructed special purpose vehicle, Emerald, as the issuer of notes on the Irish Stock Exchange to raise the necessary finance to cover the partnership's debt.

4. Although the Fort Kinneard joint venture was an important development in Scotland, there is nothing to suggest that the Secretary of State for Scotland knew what was happening, and he certainly did not give any direction to the CEC on this deal even though it was within his statutory right to do so. The implication is that what should have been an important check and balance in the system is missing. Effectively, the current arrangement puts Scotland in a lose – lose situation. If the deal had been successful, and a large profit had been realised by the CEC, none of this would have come to Scotland. But on the other hand, if as a result of an unsuccessful deal the CEC find themselves in a position where they need to recoup their finances, then this means that they are likely to take a very hard nosed view in order to maximise short term profits from other aspects of the management of the Crown Estate. But short term revenue maximisation may well be inconsistent with realising Scotland’s long term economic potential of, for example, renewable energy developments. So, this raises the important question of why the Secretary of State for Scotland was not directly involved.

Overall, the situation we have outlined as regards Fort Kinneard gives rise to considerable cause for concern. Looking to the future the implications are more serious. The big potential for Crown Estate activity is going to be sea bed revenues from various activities concerning the generation and transmission of renewable energy. If CEC become involved in joint ventures of the Fort Kinneard type with regard to their sea bed activities, then this could move a large part of these activities out of proper public scrutiny, and could effectively amount to the back door privatisation of large parts of the sea bed. Moreover, if there is as little political oversight from Scotland as there was the Fort Kinneard deal, then the process could be completely inimical to Scotland’s interest in achieving sustainable economic development. It is time that the management of these public properties in Scotland returned to Scotland under the proper scrutiny of the Scottish Parliament.
This whole issue is given additional urgency because of the terms of the Sovereign Grant Bill which is currently going through Westminster. Tying the finances of the Royal Family to a share of Crown Estate profits will inevitably have an effect on the incentives of those who manage the Crown Estate – the temptation will be to maximise profits in order to stand in the good books of the Crown. Such a change in incentives could well see the Crown Estate Commissioners acting in a way which is even less mindful of their social responsibilities, and less mindful of the need to take a long term, rather than a short term, view. Given this, it is even more important that the whole matter of the Crown Estate, particularly in relation to Scotland, is sorted out.

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