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In his talk at the Fraser of Allander Scotland’s Budget 2016 Seminar on 13th September, the Institute’s Director Graeme Roy touched on an important point about the Common Agricultural Policy (CAP), and the implications of Brexit for Scotland’s new fiscal framework signed as part of the Smith Commission. Since the point was not picked up in the discussion, it is worth expanding here. What will be argued here is that, while the CAP adjustment will indeed pose problems, it also offers an opportunity to re-open wider issues about the post-Smith fiscal settlement.

The point that Graeme made was that, post-Brexit, responsibility for agricultural support payments under the former CAP would revert to Scotland, since agriculture is a devolved responsibility under the Scotland Act. The funding arrangements for the Scottish Parliament would therefore have to be adjusted to allow for these payments, which are currently funded out of receipts from the EU. And, as Graeme noted without going into the details, the required adjustments to the new fiscal settlement would not be straightforward.

There will indeed be significant problems in adjusting the fiscal settlement to allow for CAP.

CAP is not merely large – the 2016 Scottish Budget indicates that income from the EU in relation to agriculture would be approximately £500 million in 2016/17 – but in addition, agricultural payments are relatively large in Scotland as compared to rUK. According to the Treasury’s Public Expenditure Statistical Analyses, identifiable expenditure on agriculture and related functions in Scotland is 17.6% of the UK total, more than double our population share.

Against this background, what are the options for modifying the post-Smith fiscal settlement in the light of the CAP changes?

It must be taken as given that the initial transfer of monies to Scotland needs to match existing CAP budgets. To not do so, would greatly penalise Scottish farmers.

But from this point on, how should the equivalent post-Brexit CAP budgets evolve?

One option which can be rejected out of hand would be to treat agricultural support
payments as Annually Managed Expenditure (AME): i.e., they would be funded by the Whitehall exchequer in the same way as the bulk of social security expenditure in Scotland, without going through the controlled, (Departmental Expenditure Limit), part of the Scottish budget – see Box 2.1 of the FAI report. However, if Scotland has responsibility for determining the nature and level of agricultural support payments then treating them as AME will amount to Westminster giving Scotland a blank cheque, which would clearly be inappropriate and unacceptable.

This implies that the CAP successor payments should be brought within the Scottish DEL budget. But this, too, poses problems.

One possibility would be having increased the initial Scottish DEL budget by the current level of CAP payments, to simply then increase them in future in line with the Barnett consequentials (i.e. a population share) of corresponding payments in England. In these circumstances, the differential relative scale of agricultural support payments in Scotland and England would be problematic. If expenditure was rising, then Scotland would feel itself penalised because the smaller size of the programme in England would generate insufficient Barnett consequentials. In effect, Scotland would only be receiving a population share of any increase despite accounting for a much larger share of the overall UK resource. Conversely, if expenditure was being cut, Scotland would experience windfall gains. Either way, the situation would be unacceptable for one or other of the parties.

It might have been possible to finesse the problem if an appropriate tax resource could be identified which was likely to be highly correlated with CAP payments. In this case, devolving both CAP successor payments and the relevant tax resource to Scotland would mean that the problems identified in the previous paragraph would be largely self-canceling. However, there does not appear to be any tax resource which would fulfil the necessary conditions.

The problem of adjusting the fiscal settlement for CAP post-Brexit is therefore indeed likely to be difficult. But in one sense, this may actually be no bad thing. The problem with CAP is actually symptomatic of a wider problem with the post-Smith fiscal settlement – namely, that it is very badly designed to handle asymmetries between Scotland and the rest of the UK. Things could go very badly wrong for Scotland under the new system if Scotland suffers an asymmetry either in the form of chronic economic under-performance relative to rUK or if it suffers an asymmetric economic shock. In either case, the way in which the abatement to the Scottish government’s block grant is indexed, in line with the growth in rUK per capita “devolved” tax receipts, will destabilise the system, rather than stabilising it. Scotland’s new fiscal settlement is very unusual internationally in the extent to which it
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exposes Scotland to risk from this kind of asymmetry – risks that the new and existing devolved powers can do very little about.

Scottish ministers signed up to the new system in what could best be described as an act of economic bravado – confident that they could always match rUK economic performance. But they did this just as Scotland was experiencing a major asymmetric shock in the shape of the problems in the North Sea oil sector.

We really ought to be giving active consideration now to the weaknesses in the current fiscal settlement, and the dangerous potential instability posed by asymmetries. If the problems posed by Brexit and CAP force consideration of such issues sooner, rather than waiting five years for the scheduled review of the fiscal settlement, this in itself would be a very positive development.