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Independent Scotland might get away with a high deficit – if it's feeling lucky

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'Well do ya punk?' Ariel Dovas, CC BY-SA

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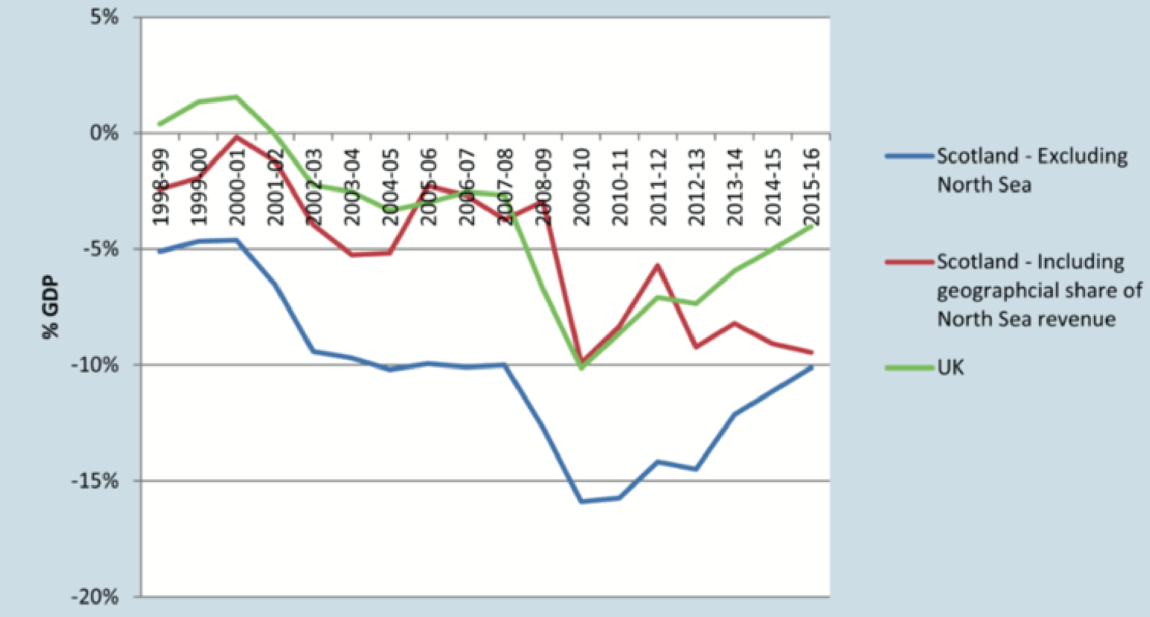
The predictable result of Scotland's expenditure and revenue data for 2015-16 is that its fiscal deficit is much worse than the UK as a whole. Why predictable? Well, the Scottish economy is much more dependent on the oil industry than the UK overall and the collapse in the oil price since 2014 has led to a massive collapse in the UK government's revenues from taxing the industry's profits.

Since most of the oil is produced from Scottish territorial waters, this collapse affects Scotland's territorial accounts. In the past, higher tax revenues from oil broadly compensated for Scotland's higher public spending per head to the tune of £1,200 a year, so that the Scottish deficit did not differ substantially from that of the UK. Now that the oil effect has virtually disappeared, Scotland's fiscal deficit of 9.5% of GDP (or £14.8 billion) is more than double the UK equivalent of 4% of GDP.

Scottish and UK deficits, 1998-2016

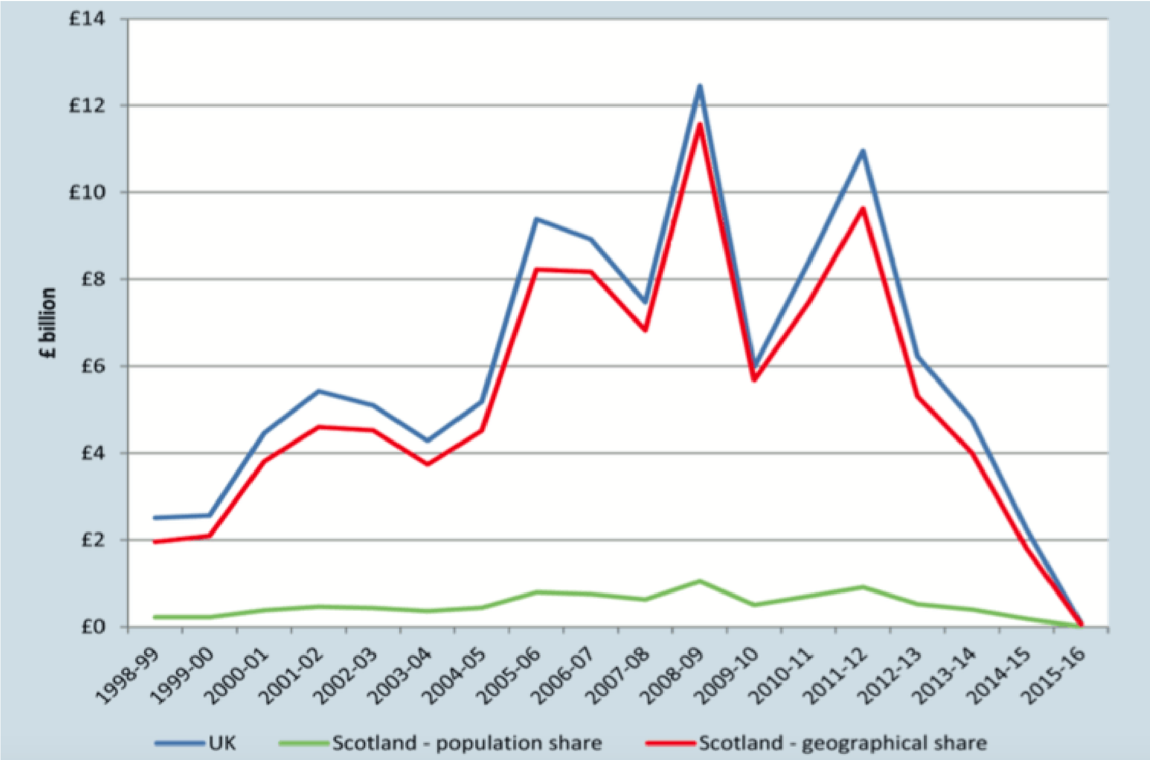


Scottish government

Some of the spending attributed to Scotland is not under the control of the Scottish government. In the latest calculations, for example, Scotland is assumed to spend £3 billion on defence – its population share of total UK defence spending. An independent Scotland might choose to spend less on defence, but this could only make a modest dent in the total deficit.

For a more significant turnaround, Scotland would need to look to some of the bigger budget items such as health (£12.2 billion) and/or benefits and the state pension (£18.3 billion). On the revenue side, it could consider increasing existing taxes or introducing new ones. With the demise of North Sea oil, income tax (£12.2 billion) and VAT (£11.2 billion) account for 43% of Scotland's total tax revenue of £53.7 billion.

North Sea oil revenue 1998-2016



Scottish government

Abnormal possibilities

Would an independent Scotland have to reduce this deficit? Obviously some countries run quite high deficits and function adequately even though they are highly indebted (Italy and Japan are good examples). But if it is running a deficit at all, Scotland would be dependent on loans from the money markets to keep its public services functioning.

In normal times, budget deficits around the current level would mean substantial, and probably unsustainable, debt interest charges for an independent Scotland. Eventually, if the market is unwilling to provide loan finance, bodies like the IMF pick up the pieces. But their medicine is likely to be pretty unpleasant involving tax increases and spending cuts.

Mmmm, austerity. Vectomart

On the other hand, these are not normal times in the money markets. The cost of government borrowing is currently at an historic low. Perhaps the Scottish government could borrow at rates that are higher than most other leading economies but are still affordable due to the generally low yields on sovereign bonds.

Caution might suggest this would be a risky strategy given that we have no idea how long these “abnormal” conditions will persist. Some supporters of independence will no doubt believe that it is a risk worth taking.

Scottish independence SNP Scotland Deficit North Sea oil Oil price Scottish Government indyref

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