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Cyllid Cymru

Wales Fiscal
Analysis

Welsh Budget Update: Outlook ahead of Spending Review 2021

BRIEFING REPORT

Preface

Declaration of funding

Wales Fiscal Analysis is hosted by the Wales Governance Centre and the School of Law and Politics at Cardiff University, and funded through a partnership between Cardiff University, the Welsh Government, the Welsh Local Government Association and Solace Wales. The programme continues the work of Wales Public Services 2025 hosted by Cardiff Business School, up to August 2018.

About us

Wales Fiscal Analysis (WFA) is a research body within Cardiff University's Wales Governance Centre that undertakes authoritative and independent research into the public finances, taxation and public expenditures of Wales.

The WFA programme adds public value by commenting on the implications of fiscal events such as UK and Welsh budgets, monitoring and reporting on government expenditure and tax revenues in Wales, and publishing academic research and policy papers that investigate matters of importance to Welsh public finance, including the impact of Brexit on the Welsh budget and local services, options for tax policy, and the economics and future sustainability of health and social care services in Wales.

Working with partners in Scotland, Northern Ireland, the UK and other European countries, we also contribute to the wider UK and international debate on the fiscal dimension of devolution and decentralisation of government.

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Executive Summary

On 27 October, the UK government will publish its Budget and accompanying Spending Review. Changes in the economic and fiscal outlook, as well as significant policy announcements, have already transformed the outlook for the Welsh budget and Welsh public services.

- **Covid-19 funding for 2021-22:** At the time of the UK government's main estimates in May 2021, Covid-19 funding for day-to-day spending in 2021-22 stood at £2.6 billion. Subsequent announcements by the UK government will have increased the amount available. The Welsh Government had allocated £1.47 billion by the 1st Supplementary Budget for 2021-22, and has since made significant funding commitments, such as a £551 million package for the Welsh NHS. These allocations would leave uncommitted Covid-19 funding of £532 million, not including unconfirmed consequentials from UK government announcements, which could amount to over £300 million.
- **Implications of the Health and Social Care Levy:** A newly announced Health and Social Care Levy will apply across the UK, and Barnett consequentials from the additional spending will be confirmed at Spending Review 2021. Relative to March 2021 Budget plans, we project that Welsh Government funding will increase by £659 million in 2022-23 and £497 million in 2024-25, though actual consequentials may be lower than this if a share of the additional spending goes towards UK-wide reserved spending.
- **The fiscal outlook ahead of Spending Review 2021:** The economic and fiscal outlook for this year has improved significantly since the March 2021 budget, with borrowing so far in 2021-22 running below the Office for Budget Responsibility's forecasts. The Institute for Fiscal Studies project that current spending plans and tax rises announced by the UK government would result in borrowing being £20 billion below forecast in 2024-25, with the current budget (excluding investment) being in surplus by 2023-24.
- **Spending Review 2021 and the outlook for the Welsh Budget:** The overall spending 'envelope' published on 7 September – alongside previous and new commitments – gives a clearer idea of the path of the Welsh Government's budget over coming years. Day-to-day spending is set to grow by approximately 3% per year on average in real terms. This represents a significant improvement from March 2021 plans, though UK government spending on public services in 2024-25 will still be below pre-pandemic plans.
- **Choices facing the Welsh Government:** We project that increases in Welsh Government funding will be broadly sufficient to meet post-pandemic spending pressures in the NHS over coming years. Funding for local government could also increase if consequentials from social care and schools spending in England are passed on and relatively modest council tax increases may be sufficient to meet spending pressures. In this scenario however, funding for all other areas of spending will need to be cut in 2022-23, before increasing slightly in real-terms in 2024-25.

Welsh Budget Update: Outlook ahead of Spending Review 2021

19 OCTOBER 2021

Introduction

On 27 October, the UK government will publish its Budget and accompanying Spending Review. Changes in the economic and fiscal outlook, as well as significant policy announcements, have already transformed the outlook for the Welsh budget and Welsh public services. The details of the UK government's plans will leave the Welsh Government with key decisions to make, from allocating funding for its Covid-19 response for the remainder of this financial year, to balancing a range of competing spending pressures on services over coming years.

This briefing firstly examines the position of the Welsh Budget for 2021-22, analysing recent commitments made for Covid-19 spending by both the UK and Welsh Governments. Secondly, it sets out the implications from the recently announced Health and Social Care Levy, and the outlook implied by the UK's government's overall spending envelope for the Spending Review 2021. We lastly explore some of the main choices and trade-offs facing the Welsh Government over the next three years.

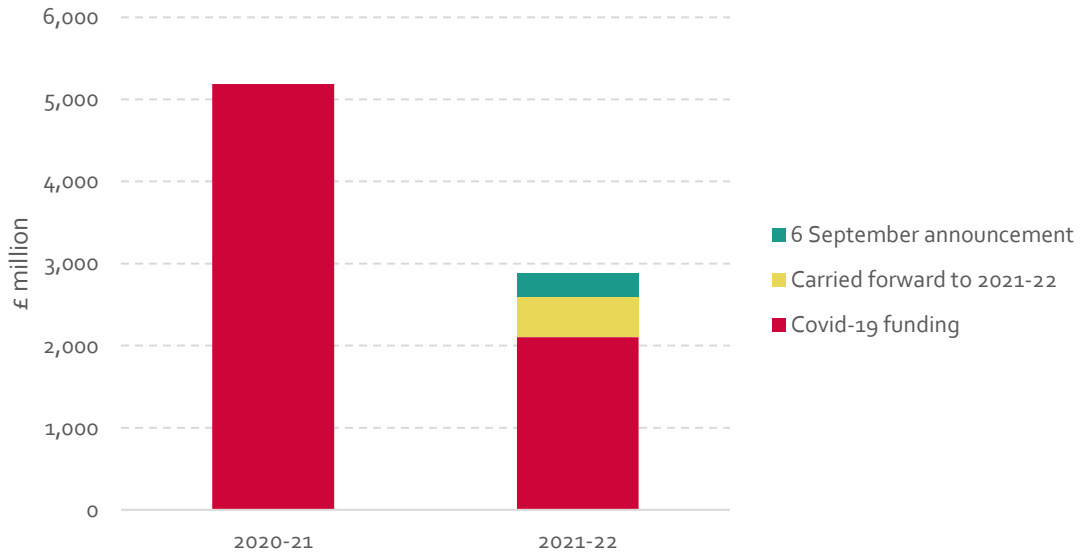
Covid-19 funding for 2021-22

As was the case in 2020-21, the Welsh Government's budget position in 2021-22 has continued to evolve throughout the year. **Figure 1** provides an update on the funding available to the Welsh Government for day-to-day spending on its Covid-19 response. At the time of the UK Government's main estimates in May 2021, Covid-19 funding for day-to-day spending in 2021-22 stood at £2.6 billion - £497 million of which was funding carried forward by the Welsh Government from 2020-21. Subsequent announcements by the UK government will have increased the amount available in 2021-22, although the extent of these consequential has not yet been confirmed. The main source of consequential will have been the additional £5.4 billion for the NHS in England for the next 6 months, announced on 6 September, which will have resulted in approximately £286 million of resource funding.¹ Other unconfirmed consequential may come from the UK government's education funding announcement on 2 June, along with £25 million as a result of the UK government's new Household Support Fund.

¹ <https://www.gov.uk/government/news/additional-5.4-billion-for-nhs-covid-19-response-over-next-six-months>

Figure 1

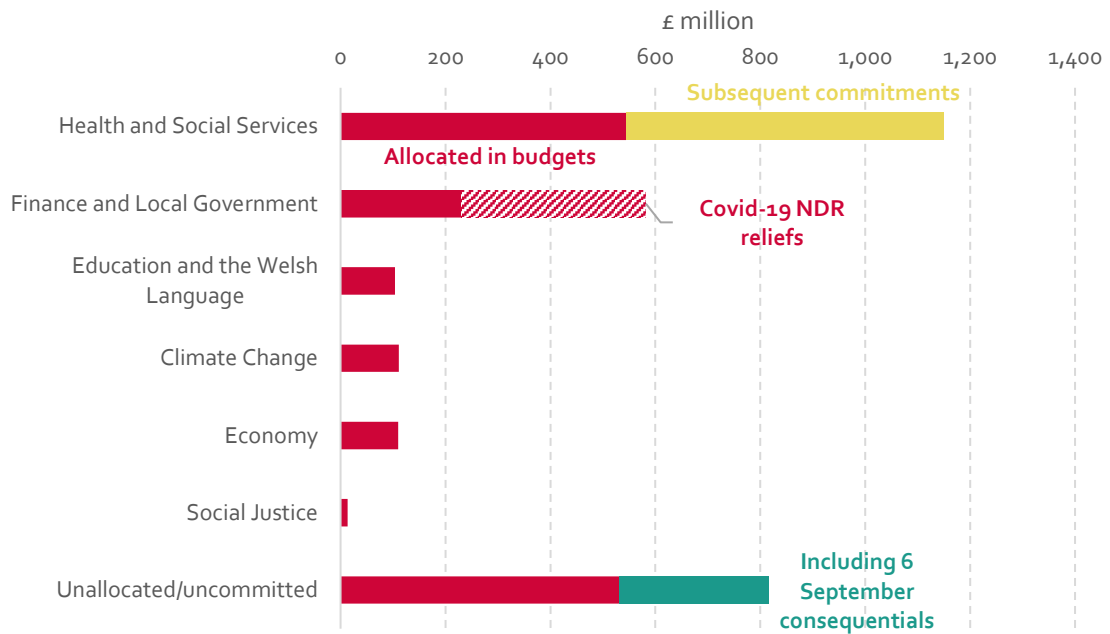
Welsh Government Covid-19 funding for day-to-day spending, 2020-21 and 2021-22



Source: HM Treasury (2021) Block Grant Transparency 2021; and authors' calculations

Figure 2

Welsh Government Covid-19 allocations for day-to-day spending by Main Expenditure Group, 2021-22



Source: Welsh Government budget documents; and authors' calculations

Figure 2 shows the resource spending allocations made by the Welsh Government for its Covid-19 response in 2021-22, by Main Expenditure Group. At the 1st Supplementary Budget for 2021-22, the Welsh Government had allocated £1.47 billion, including support for the NHS and local governments for the first six months of the financial year and a NDR reliefs package costing £352 million. This left £1.1 billion of day-to-day spending unallocated in the budget. The Welsh Government has also made significant funding commitments, mainly a £551 million package for the Welsh NHS (covering the remainder of the financial year) and £48 million for the Social Care Recovery Fund.²³ These allocations would leave uncommitted Covid-19 funding for day-to-day spending at £532 million, not including subsequent consequential from UK government announcements (shown in yellow in **Figure 2**).

Implications of the Health and Social Care Levy for the Welsh Government budget

On 7 September, the UK government announced a significant tax increase - a new Health and Social Care Levy of 1.25% on earnings from employment and on employer wage costs, as well as an increase to the rates of dividend tax from April 2022, which will raise £14 billion a year across the UK. The overall spending 'envelope' for years 2022-23 to 2024-25 has been topped up by this amount relative to March 2021 plans, with the "net" amount raised by the tax (after accounting for the additional employment costs to the public sector) being allocated to the Department of Health and Social Care resource DEL.

The levy will apply across the UK. The implications of the announcement for the Welsh Government are still uncertain – Barnett consequential will be confirmed at Spending Review 2021. **Figure 3** provides an estimate of potential consequential for the Welsh Government, based on figures provided in Table 2 of the UK government's published command paper.⁴ The NHS England budget has been allocated an additional £6.6 billion in 2022-23, which would result in £388 million for the Welsh Government. The command paper also states that £5.4 billion will be invested in adult social care in England over the next three years. Assuming this means £1.8 billion being spent in 2022-23, that would result in £106 million a year for the Welsh Government. It is unclear how the remaining funding for the Department of Health and Social Care will be spent, though some may be UK-wide spending (such as on vaccines) and would therefore not be subject to the Barnett formula.

The command paper states that, in 2024-25, Wales "will benefit from an additional ... £700 million ... which includes UK-wide spending such as vaccines as well as Barnett funding". However, this seems to include a share of the £1.8 billion set aside as compensation to the public sector for employer costs of the Health and Social Care Levy. The amount of funding coming to the Welsh Government in 2024-25 may also be lower because of the baseline used

² <https://gov.wales/ps551m-extra-covid-funding-health-and-social-services>

³ <https://gov.wales/ps48m-covid-recovery-fund-support-social-care-wales>

⁴ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1015736/Build_Back_Better_-_Our_Plan_for_Health_and_Social_Care.pdf

for NHS England spending. The £5.6 billion of ‘additional’ funding announced for NHS England in 2024-25 assumes funding would otherwise have stayed flat in real terms, though it could reasonably have been expected to increase substantially more than that before the additional levy funding. This essentially allows more funding for other areas of spending than would have been expected - if spent on non-devolved areas, some of this funding will not lead to additional funding for the Welsh Government.⁵

Figure 3

Estimated consequentials for the Welsh Government by source from 7 September announcement

	2022-23	2023-24	2024-25
From allocated NHS England spending	388	212	329
From assumed increase in adult social care	106	106	106
From other H&SC spending (may not all be devolved spending)	165	212	159
Total	659	529	594

Source: HM Government (2021) Build Back Better. Our plan for health and social care; and authors’ calculations. Note: figures based on table 2 (page 30) and amounts (in £bn) allocated to the Health and Social Care resource DEL. We assume additional funding for adult social care will amount to £5.4 billion over three years (page 16) and this is split evenly across years. Some remaining additional funding to the Department for Health and Social Care may be UK-wide not be subject to the Barnett formula. Figures do not include potential consequentials to cover the estimated compensation to the public sector for employer costs of the Health and Social Care Levy.

The command paper stated that there will be a “legal requirement” to allocate the Levy revenues on health and social care in Wales, and the Prime Minister said that they “will direct money raised through the levy to their health and social care services”. The Welsh Government are currently required to allocate funding they receive from the National Insurance Fund to the NHS (£1.3 billion in 2019-20), so in theory, a similar arrangement could be put in place for the new levy. In practice, however, this intended hypothecation will mean very little, since the additional consequentials in 2022-23 will account for a very small share of the total spent by the Welsh Government on health and social care (around 6% of the projected allocations in 2022-23). The Welsh Government will be free to allocate the rest of its budget as it wishes and allocate non-levy funding to other areas of the budget. However, given pressures on health and social care services in Wales – and the stated intention for social care reform over coming years – it is likely additional allocations to these services will far exceed the amount of revenue coming from the new levy.

⁵ Based on our projections, the difference in the Welsh Government resource budget in 2024-25 after the announcements is £497 million, compared to previous indicative spending plans and the NHS England budget growing in line with GDP growth in 2024-25. However, some of this projected increase may be lower still depending on the amount of UK-wide spending not subject to the Barnett formula in 2024-25.

The fiscal outlook ahead of Spending Review 2021

The economic and fiscal outlook for this year has improved significantly since the March 2021 budget. Government borrowing so far in 2021-22 has been significantly below the Office for Budget Responsibility's forecasts.⁶ The Institute for Fiscal Studies project borrowing in 2021-22 to be £50 billion below the £233.9 billion forecast back in March, driven by higher growth and revenues, alongside underspending by government departments.⁷ Current spending plans and tax rises of around £40 billion announced by the UK government would result in borrowing in 2024-25 being £20 billion a year below March forecasts, with the current budget (excluding investment) being in surplus by 2023-24.

These projections for borrowing are highly uncertain, and alternative economic scenarios could result in a significantly different fiscal outlook. The Institute for Fiscal Studies point to the probability of policy changes, with the relatively tight spending plans and/or the substantial tax rises likely to be revised over coming years. The forecasts presented alongside the Budget next week may also be impacted by the decision not to update forecasts beyond 24 September, which means some large positive revisions to economic data will be excluded from the picture.⁸ On the other hand, some recent factors – such as supply disruptions and mooted Bank of England interest rate rises – will have worsened the economic outlook over recent weeks. Some of these macroeconomic trends in the labour market and supply chains may also have significant cost pressures for public services over coming months and years.

Spending Review 2021 and the outlook for the Welsh Budget

On the same day as the health and social care announcement, the Chancellor of the Exchequer launched Spending Review 2021, which will set the Welsh Government's block grants from 2022-23 to 2024-25. Confirmation of spending totals beyond the coming year will allow the Welsh Government to set a multi-year budget for the first time since October 2017 (when it published spending totals for 2018-19 and 2019-20).

The overall spending 'envelope' published on 7 September – alongside previous and new commitments – gives a clearer idea of the path of the Welsh Government's budget over coming years. **Figure 4** shows our projection of Welsh Government funding for day-to-day spending to 2024-25 and the impact of the consequentials from the 7 September announcements.

Funding for the core Welsh resource budget (excluding Covid-19 funding) is projected to grow by 5.7% in nominal terms from 2021-22 to 2022-23, or by 6.4% if the Welsh Government again draws down the full amount from the Wales Reserve. Over the three years covered by the Spending Review, day-to-day spending is set to grow by approximately 3% per year on average in real terms. This growth in spending contrasts sharply with the planned spending cuts of the

⁶<https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/bulletins/publicsectorfinances/august2021#borrowing-in-the-financial-year-to-august-2021>

⁷<https://ifs.org.uk/publications/15692>

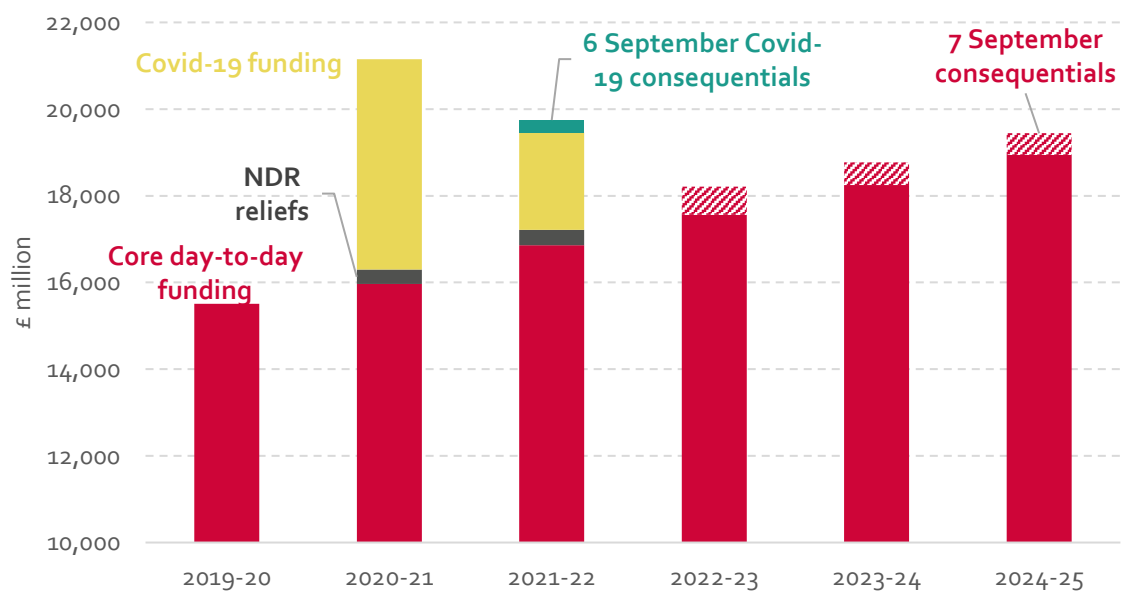
⁸<https://www.ft.com/content/0c160b29-02f7-4b14-9f72-11df6b5e68fa>

Spending Reviews in 2010 and 2015 and would be broadly in line with the spending growth seen between 2004 and 2010. By 2024-25, on a broadly consistent basis, day-to-day spending would be 10% above 2010 levels, and 5% higher on a per-person basis (see **Figure 5**).

The budget outlook has therefore significantly improved with the recent announcements, particularly for 2022-23. However, the new plans still leave overall UK government spending on public services some £3 billion lower in 2024-25 than those published in March 2020.⁹ This means projected funding for the Welsh Government is similar (or slightly below) what could have been expected before the Covid-19 pandemic, even though spending pressures have increased significantly across a number of areas.

Figure 4

Projected funding for Welsh Government day-to-day spending, 2019-20 to 2024-25 (nominal terms)



Source: Authors' calculations based on Welsh Government budget documents; HM Treasury (2021) Block Grant Transparency 2021; HM Government (2021) Build Back Better. Our plan for health and social care; and authors' calculations. Projection assumes Health and Social Care allocations are fully devolved but excludes funding for the additional costs for public sector employers.

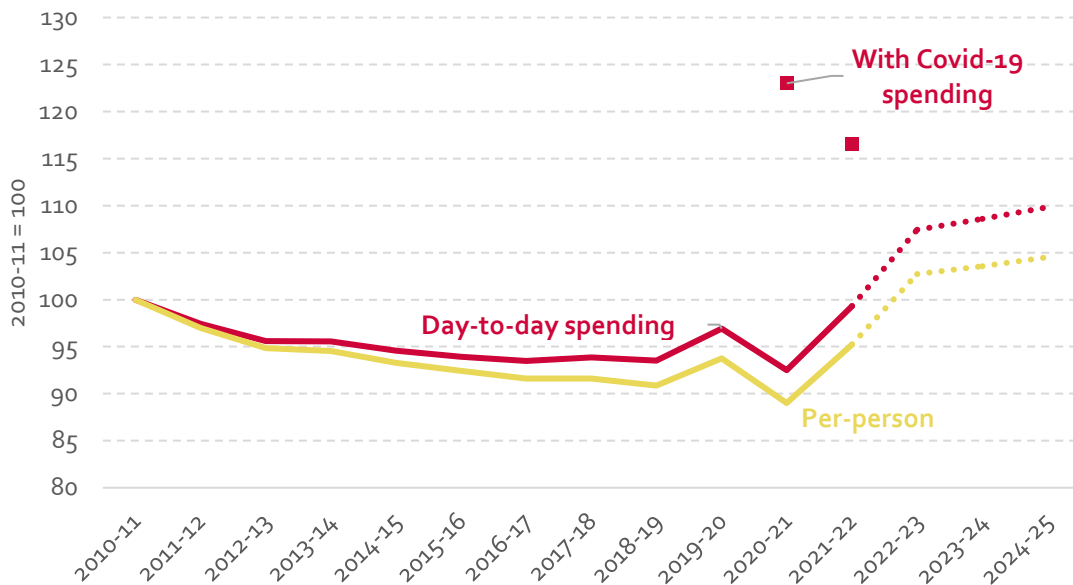
There are still significant uncertainties surrounding these projections. The Office for Budget Responsibility will publish updated forecasts for devolved tax revenues and comparable revenues which will determine block grant adjustments. The exact spending decisions made by the UK government across departments will also influence the ultimate level of consequentials coming to the Welsh Government. Current spending plans allow for additional spending to address pandemic-related spending pressures for the NHS in England over the next three years, but not for pressures on any other public services. The 'Covid-19 Reserve' – which

⁹ <https://ifs.org.uk/publications/15694>

has funded virus-related spending in 2020-21 and 2021-22 - could be extended to 2022-23, which may lead to further consequential for the Welsh Government to use next year.

Figure 5

Projected funding for Welsh Government day-to-day spending, 2019-20 to 2024-25 (nominal terms)



Source: Authors' calculations based on Welsh Government budget documents; HM Treasury (2021) Block Grant Transparency 2021; HM Government (2021) Build Back Better. Our plan for health and social care; and authors' calculations. Projection assumes Health and Social Care allocations are fully devolved but excludes funding for the additional costs for public sector employers.

The outlook for the Welsh Government's capital budget remains the same as at the March 2021 budget, having grown considerably over the course of the last Senedd term.¹⁰ The Welsh Government's core capital budget (excluding Financial Transactions) funding is set to stay at around £2.5 billion a year in real terms over the course of the next five years. Although not growing in real terms, this would amount to the highest sustained level of capital funding for the Welsh Government over a number of years.

Choices facing the Welsh Government

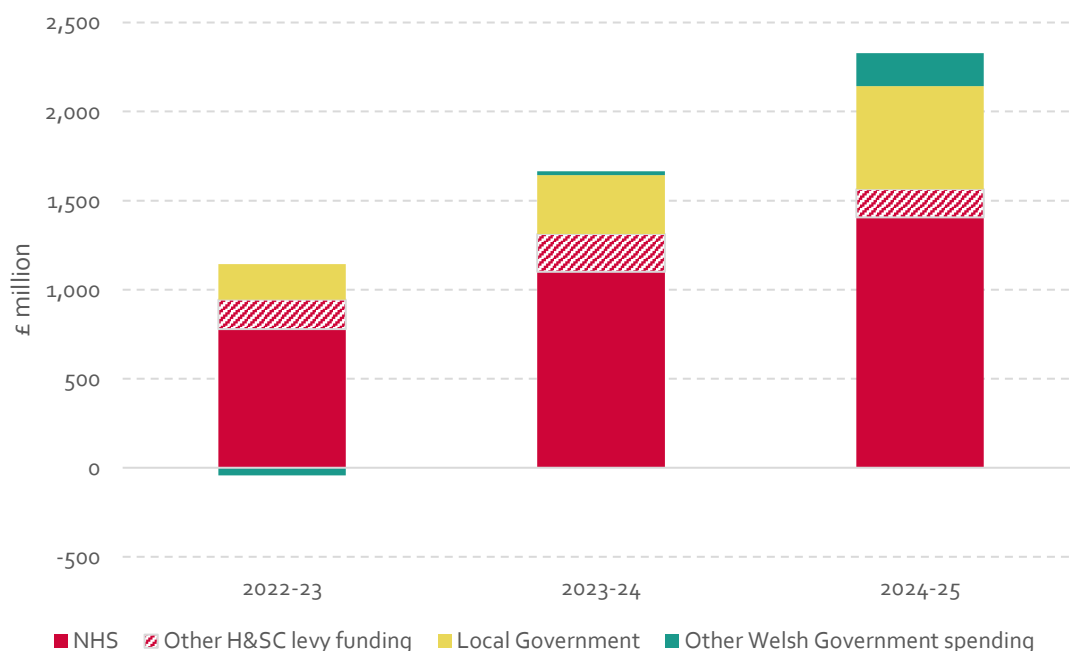
Even though the outlook for the Welsh budget has improved significantly since the time of the March 2021 budget, there are still difficult choices and trade-offs to be made, in the face of likely huge post-pandemic pressures.

¹⁰https://www.cardiff.ac.uk/_data/assets/pdf_file/0009/2514834/election_outlook_2021_FINAL_19042021.pdf

Chief amongst these pressures is the indirect impact of the pandemic on the NHS in Wales. In July 2021, the total waiting list for elective care reached 643,000 patient pathways, 39% above levels recorded in July 2019. The number of patients being referred for treatment has broadly recovered from the very low levels seen in 2020 and the beginning of 2021. Meanwhile, the number of closed patient pathways – patients being treated, no longer wanting to be seen, or deceased patients – has recovered more slowly, leading to increased waiting lists. The situation could deteriorate if the “missing” patients of the last year return over coming months and years; from March 2020 to February 2021, there were over 446,000 fewer referrals to treatment in Wales relative to the same months of 2019. Clearing the elective care backlog over coming years would require significantly higher levels of hospital activity.

In April, we projected that the cost of clearing the backlog, along with some continuing direct Covid-19 costs, the loss of productivity, and new mental health demands, could require additional spending of approximately £370 million in 2024-25, over and above projected underlying spending pressures, though this estimate varied depending on numerous assumptions. Our current projections suggest that if the Welsh Government passed on consequentials resulting from health spending in England to the NHS in Wales over coming years, this should be broadly sufficient to meet these spending pressures.

Figure 6
Modelled increases to day-to-day spending allocations relative to the 2021-22 core budget (excluding Covid-19 spending)



Source: Authors' calculations based on Welsh Government budget documents; HM Treasury (2021) Block Grant Transparency 2021; HM Government (2021) Build Back Better. Our plan for health and social care; and authors' calculations. Projection assumes Health and Social Care allocations are fully devolved but excludes funding for the additional costs for public sector employers.

Based on our projections for the Welsh Government budget, **Figure 6** shows a potential funding scenario for three areas of the Welsh budget – namely, core NHS spending, total funding for local government, and all other Welsh Government spending. We assume the Welsh Government “passes on” consequential for the NHS in England (including the new levy funding) to the NHS in Wales. We also assume £106 million a year of consequential for additional social care spending in England are also passed onto local authorities. Consequential from schools spending in England are also passed onto Welsh local authority budgets. All other areas of the budget are then grown uniformly with the remainder of the budget.

In this indicative scenario, allocations to the core NHS by 2024-25 would increase by £1.4 billion from 2021-22, while a further £159 million would be available from the Health and Social Care levy if fully devolved. This would mean health spending taking over two-thirds of the overall increase in day-to-day spending to 2024-25.

Funding for local government would also increase driven by consequential from social care and schools spending in England. But at the same time, we project local government spending will need to increase by more than £1.1 billion between 2019-20 and 2024-25 to maintain the same level of services, equivalent to 3.1% each year.¹¹ We further assume that additional spending allocated to social care will be accompanied by new spending responsibilities or cost pressures, given it is likely the Welsh Government will introduce reforms to the social care offer in Wales. Our projections for funding and spending pressures for local governments suggest council tax increases of 2.0% for the next three years would be sufficient to avoid a funding gap for Welsh local authorities in 2024-25 – significantly below recent increases. Crucially, however, this assumes Welsh local authorities are able to transfer funding resulting from schools-related consequential to other areas of spending, where spending pressures are more acute. The extent to which this will be possible given the impact of Covid-19 on schools and the need for ‘catch-up’ spending remains to be seen.

As shown in **Figure 6**, spending on the remainder of the budget – some £3.1 billion, covering post-16 and higher education, housing support grants, transport, farm payments, central services and administration etc. – would fall in nominal terms in 2022-23, before increasing slightly in real terms in 2024-25. Many areas of spending included in this category also face significant spending pressures, especially in the context of deep spending cuts since 2010 – overall spending outside the NHS and local government funding remains around 13% below pre-austerity levels. There will also likely be other post-pandemic pressures on these public services, for example, the need to support public transport providers.

There are numerous other areas in which the Welsh Government faces difficult decisions; for example, on the future path of public sector pay, which will also be influenced by any UK government policies announced at the Spending Review. Roughly half of day-to-day spending by the Welsh Government and local authorities in Wales goes towards the public sector pay

¹¹ See page 319, of: <https://ifs.org.uk/uploads/7-What%E2%80%99s-happened-and-what%E2%80%99s-next-for-councils-.pdf>

bill.¹² Pay increases will be a big part of the pressures facing public services in Wales over coming years, in the context of slow growth or declining pay over the last decade and recruitment and retention challenges in many service areas.

As well as influencing the overall path in the Welsh budget over coming years, other decisions taken by the UK government will have a knock-on effect on Welsh Government choices. For example, in the reserved area of social security spending, the recent cut to Universal Credit will have a huge impact on the incomes of the poorest households in Wales.¹³ In the context of the squeeze in living standards, the Welsh Government will need to consider which levers it could use to support lower-income households over coming months and years. The Spending Review 2021 will also hopefully provide more information on funding schemes replacing EU regional funding over coming years. New UK-wide arrangements for funding schemes, or a shortfall in funding, may mean existing delivery arrangements to support skills, business and regional investment previously funded by the EU may need to be funded from within the Welsh Government's existing budget, or be closed down.¹⁴ The Welsh Government also point to several other areas of spending – from the costs of dealing with coal tips to the costs of post-Brexit Border Control Posts in Wales – which may lead to additional unfunded pressures on the Welsh budget if not addressed by the UK government. The Welsh Government's multi-year capital budget will also need to detail its planned action on climate change over coming years, from efforts to deliver net zero carbon, to various mitigation measures.

In conclusion, the overall outlook for the Welsh budget has improved significantly over recent months. The Spending Review will provide a clearer picture of the path of the Welsh budget over coming years, allowing a return to multi-year budgeting for the Welsh Government. As it deals with the legacy of the pandemic over coming years, it will need to balance a range of competing spending pressures and difficult choices and trade-offs remain.

¹² https://www.cardiff.ac.uk/_data/assets/pdf_file/0010/1517176/public_sector_june_final.pdf

¹³ https://blogs.cardiff.ac.uk/thinking-wales/when_ends_dont_meet_part1/

¹⁴ <https://gov.wales/written-statement-welsh-governments-priorities-uk-government-spending-review-2021>

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