Dadansoddi Cyllid Cymru
Wales Fiscal Analysis

Spring Statement Briefing

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Another small step out of austerity - before a giant leap into the unknown

Amidst the political drama of crucial Brexit votes this week, the Chancellor of the Exchequer delivered his Spring Statement on the UK's economy and public finances. Usually the big news story of the day, this (semi) fiscal event scarcely made it into the top ten headlines.

The Chancellor claimed the improved picture for the public finances marked 'another step on Britain's road out of austerity'.[1] Most importantly, the Chancellor confirmed that there will be a Spending Review taking place this year - subject to a deal on leaving the EU – to conclude at the 2019 Autumn Budget. He did not, or could not, set the overall amounts he intends to spend over coming years.

This briefing looks at what the Spring Statement and forecasts from the Office for Budget Responsibility (OBR) tell us about future Welsh budgets and Welsh public services.

OBR forecasts

The OBR revised real GDP growth in 2019 from 1.6 to 1.2 per cent, citing weakness in business investment and net trade – a reflection of uncertainty surrounding Brexit and a slowing world economy.[2] Though growth will pick up slightly, the economy is expected to only grow at around 1.6 per cent by the end of the forecast period. The UK economy is now forecast to be 2.7% smaller at the end of 2020 than what was forecast in March 2016.

However, defying anaemic economic growth, the public finances have continued to improve and outperform expectations.

[1] https://www.gov.uk/government/speeches/spring-statement-2019-philip-hammonds-speech
[2] The OBR's Economic and Fiscal Outlook document for March 2019 is available here: https://obr.uk/efo/economic-fiscal-outlook-march-2019/

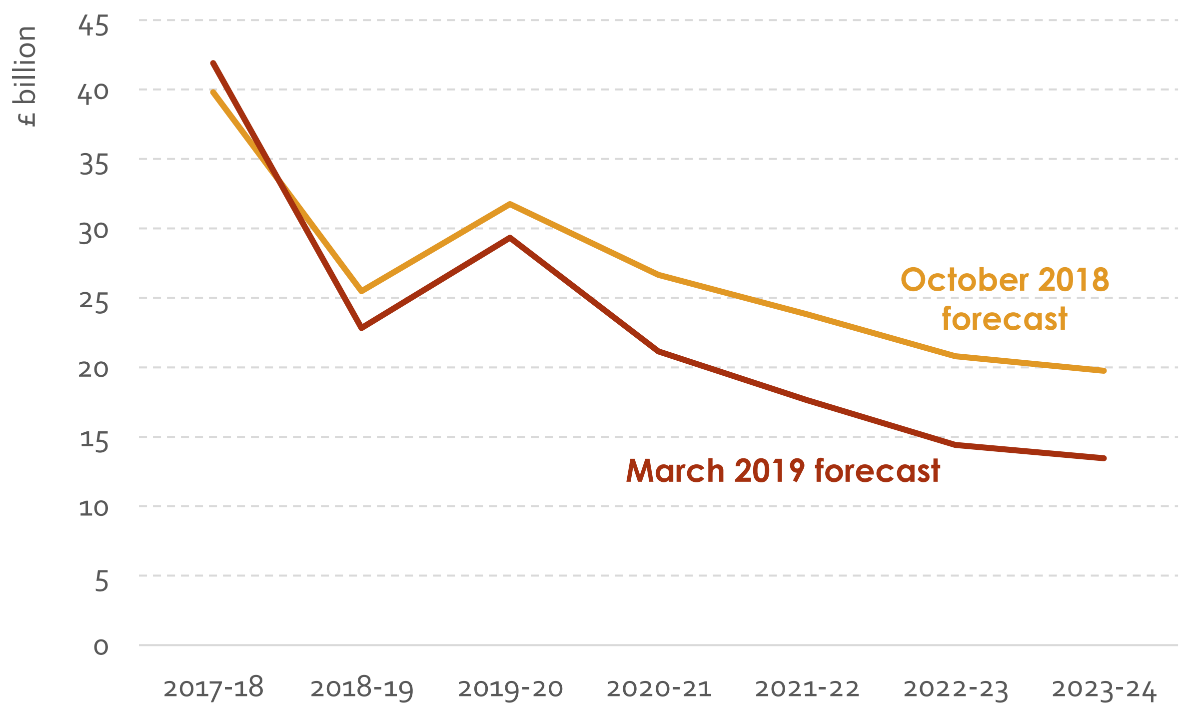
On the spending side, forecast debt interest payments were £3.6 billion a year lower than forecasted in October, reflecting lower interest rates and RPI inflation.

The forecast for receipts was also revised upwards by £3.5 billion a year on average. PAYE income tax and National Insurance Contributions (NICs) receipts were revised up by £2.3 billion in 2018-19, reflecting stronger than expected earnings growth and further strong employment growth.

Real-time information (RTI) from the HMRC indicates that earnings growth for very high earners has been particularly strong compared with all other earners. Unlike the UK tax system as a whole, the income tax system is very progressive, with higher earners paying a larger share of their incomes in income tax. Very fast growth of nearly 6% in the incomes of the top 0.1 per cent has provided a welcome boost to total tax receipts and the public finances. It does however signal a worrying increase in income inequality.

Public sector net borrowing is now expected to be £22.8 billion this year (or 1.1 per cent of GDP), and the forecast for 2023-24 was revised down by £6.3 billion. Figure 1 shows the trend in public sector net borrowing to 2023-24, under the October 2018 and March 2019 forecasts.

Figure 1: Public sector net borrowing over forecast period



Source: HM Treasury (2018 and previous) *Public Expenditure Statistical Analyses*; OBR (2019) *Economic and Fiscal Outlook March 2019;* and authors' calculations

It is forecast that the structural deficit – excluding the temporary effects of the economic cycle – will comfortably meet the Government's 'fiscal mandate', which requires it to be below 2 per cent of GDP by 2020-21. On current OBR forecasts, the structural deficit in 2020-21 will be around £26.6 lower (1.2 per cent of GDP) than this target.

However, this borrowing figure is likely to increase by approximately £12 billion when changes are made to the way student loans are treated on the government's books (to reflect that many students will never fully repay their loans). The change will be incorporated into the public finance statistics from September 2019.

Spending Review 2019 and future Welsh budgets

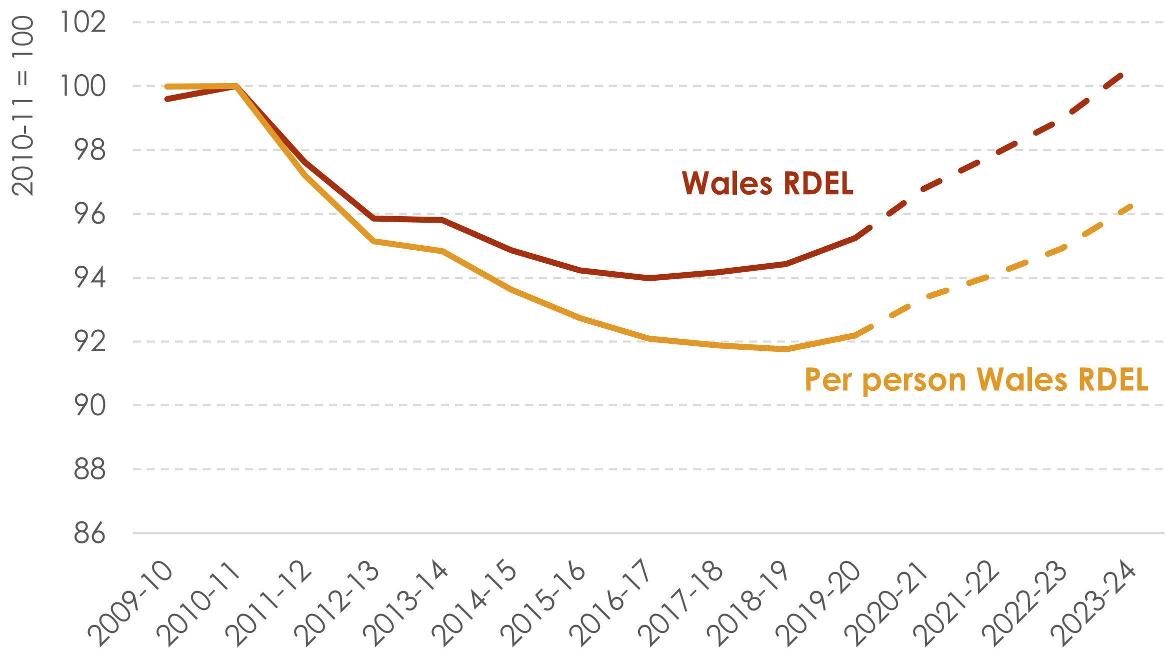
No significant spending decisions were made at this Spring Statement. In contrast to last October, the windfall from better-than-expected public finances was banked rather than spent.

The Chancellor confirmed that provided the UK leaves the European Union with a deal, a Spending Review would commence before the summer recess, to be concluded at the Autumn Budget later in the year. Departmental spending totals will be set for three years, up to 2022-23. He said that the UK government would have 'genuine and sustainable choices about the future', offering prospects of further funding to public services, investment in infrastructure projects and/or lower taxes.

The government already committed an extra £20.5 billion a year to the NHS in England by 2023-24. Given existing commitments on defence and international aid, the path for over half of day-to-day spending has already been decided. On the indicative total departmental spending plans provided by the Treasury to the OBR, spending outside these areas would continue to fall slightly in real terms.

Figure 2 projects what current plans would mean for the path of the Welsh block grant for day-to-day spending to 2023-24, assuming increases in spending on unprotected areas are spread evenly across other UK government departments. Under these projections, the amount available for the Welsh Government to spend on day-to-day spending would grow by approximately 1.3% a year over the Spending Review period. This increase in spending would lead to the Welsh Government's day-to-day spending reaching its 2010-11 level in real terms by 2023-24 (red line). On a per person basis however, it will remain well below its 2010-11 level (orange line).

Figure 2: Welsh block grant for day-to-day spending (Wales resource DEL excluding depreciation, 2010-11 = 100)



Source: HM Treasury (2018 and previous) *Public Expenditure Statistical Analyses*; OBR (2019) *Economic and Fiscal Outlook March 2019;* and authors' calculations

Note: Several adjustments have been made to the underlying data to produce a consistent series, such as the devolution of Council Tax Benefit and non-domestic rates. Figures are shown before any adjustments for tax devolution from 2018-19.

Given the size of the fiscal 'headroom' outlined in the previous section, spending on public services could be increased by around £15 billion a year, and the Chancellor would still fulfil his fiscal mandate on current forecasts. The Spring Statement mentioned the pressure on stretched public services such as social care, local government and police, and there will be an expectation that at least some of these 'unprotected' services will benefit from any increased spending.

Avoiding further per-person cuts to unprotected spending over the Spending Review period would take approximately £5 billion a year by 2022-23. If the Chancellor decided to do so in the autumn, the Welsh Government budget would increase by approximately of 1.6% a year in real terms from 2019-20 to 2022-23.[3]

From the perspective of the Welsh Government, this would allow it to match per-head increases in NHS spending in England, and still protect spending per head on other services, such as the funding it provides to local authorities in Wales.

[3] Assuming the extra spending is spread evenly across all UK government departmental spending (on both reserved and devolved functions).

The Chancellor could go further, for example by growing unprotected spending in line with economic growth – which would take £9 billion of further spending a year by 2022-23. This would provide firmer ground to any claim that the Spending Review 2019 marks the end of austerity for public services.

However, the OBR's forecasts and the promised use of the fiscal 'headroom' are predicated on a smooth and orderly Brexit outcome.

Brexit

UK legislation mandates that the OBR base its economic and fiscal forecasts on current government policy (but not necessarily to assume that those policy objectives will be met). This means that the most recent forecasts are underpinned by details laid out in the White Paper on the future relationship between the UK and the EU published in July 2018.

The key assumptions underpinning the forecasts are that the UK will leave the European Union on 29 March 2019 and enter a transition period until December 2020, during which time, there will be no change to the terms of trade between the two partners. Over the 10 years following this transition period, the OBR assume slower import and export growth and lower inward migration trends.

Of course, it is still far from certain that there will be an orderly withdrawal from the EU. Moreover, it is almost unforeseeable that the UK will enter a transition period on 29 March as OBR forecasts assume. If the UK Parliament fails to ratify the Withdrawal Agreement and Article 50 is not extended nor revoked prior to the March deadline, the UK leaves the EU with no deal by default.

In a recently published discussion paper on Brexit, the OBR noted that a disorderly exit from the EU would have a 'severe short-term impact on the economy'.[4] Renewed uncertainty would further depress demand, raise inflation and the combination of a weaker pound and higher tariffs would result in higher import prices. Given the uncertainty both around the economic impact and around the nature and effectiveness of any fiscal and monetary policy response, the OBR conclude that the effect on the public finances are currently unknowable.

The Chancellor used the Spring Statement to reiterate that a no deal Brexit would mean 'significant disruption in the short and medium-term' and a 'smaller, less prosperous economy in the long-term'. He will hope that his promised mix of increased public spending, tax cuts and investment persuades MPs to back the government's Withdrawal Agreement (potentially at a third vote).

[4] OBR (2018) *Brexit and the OBR's forecasts*: https://obr.uk/download/discussion-paper-no-3-brexit-obrs-forecasts/

Devolved tax revenue forecasts

Because of newly-devolved tax powers, the next Spending Review period will be the first during which the Welsh Government could substantially change the size of its budget. The devolved elections which will fall in the middle of the period may well be fought on competing tax and spend policies. Even without major changes in Welsh tax policy, relative growth in the Welsh tax base will influence the funding available to the Welsh Government, through the operation of the block grant adjustment (BGA) mechanism.[5]

Alongside the Spring Statement, the OBR produced its bi-annual forecasts of devolved taxes. This provides an opportunity to assess the strength of the devolved tax base and the likely effect of tax devolution over coming years.

The biggest change since October is an upward revision of projected revenue accruing from devolved income tax. As shown in figure 3, devolved income tax revenues are now expected to be higher in each financial year from 2019-20 to 2023-24, resulting in a cumulative increase of £350.8 million by the end of the period compared to previous forecasts. Comparable revenue forecasts for England and Northern Ireland have also been revised upwards. Strong self-assessment receipts in January 2019 and real-time PAYE income tax data are likely to have contributed to this increases. The percentage upward revision has been greater for Wales (3.0%) compared to England and Northern Ireland (1.5%).

Increases in income tax revenues have been partially offset by a downward revision of forecasted Land Transaction Tax (LTT) revenues. The OBR has reduced projected takings by an average of £21.6 million a year between 2019-20 and 2023-24, citing lower-than-expected receipts and weaker house prices. For the first time, 10 months' worth of receipts data from the Welsh Revenue Authority inform the forecasts.

Compared with previous forecasts, total revenue from devolved taxes is now projected to be £21.9 million higher in 2019-20, £45.3 million higher in 2020-21 and on average £60.5 million higher in each subsequent year until 2023-24.

[5] As a result of tax devolution, a downward adjustment has been made to the Welsh block grant reflecting the revenues being devolved. In future years, this BGA will change according to growth in comparable UK government revenues in England and Northern Ireland. For further details, see Poole et al. (2017), available at: https://www.cardiff.ac.uk/__data/assets/pdf_file/0008/1287233/Fair-Funding-for-Taxing-Times-Assessing-the-Fiscal-Framework-Agreement.pdf

Figure 3: Devolved tax revenue forecasts, March 2019 (changes with October 2018 forecasts)

£ million

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Income Tax	**-**	**2,101**	**2,229**	**2,313**	**2,398**	**2,487**
Change since October forecast	*0.0*	*41.2*	*65.8*	*80.4*	*82.7*	*80.7*
Land Transaction Tax	**234**	**234**	**247**	**270**	**296**	**323**
Change since October forecast	*-4.5*	*-20.7*	*-21.7*	*-20.0*	*-20.7*	*-24.7*
Landfill Disposal Tax	**45**	**41**	**38**	**35**	**33**	**32**
Change since October forecast	1.5	1.4	1.2	1.1	1.0	1.0
Total	**279**	**2,376**	**2,513**	**2,618**	**2,727**	**2,841**
Change since October forecast	*0.0*	*21.9*	*45.3*	*61.5*	*63.0*	*56.9*

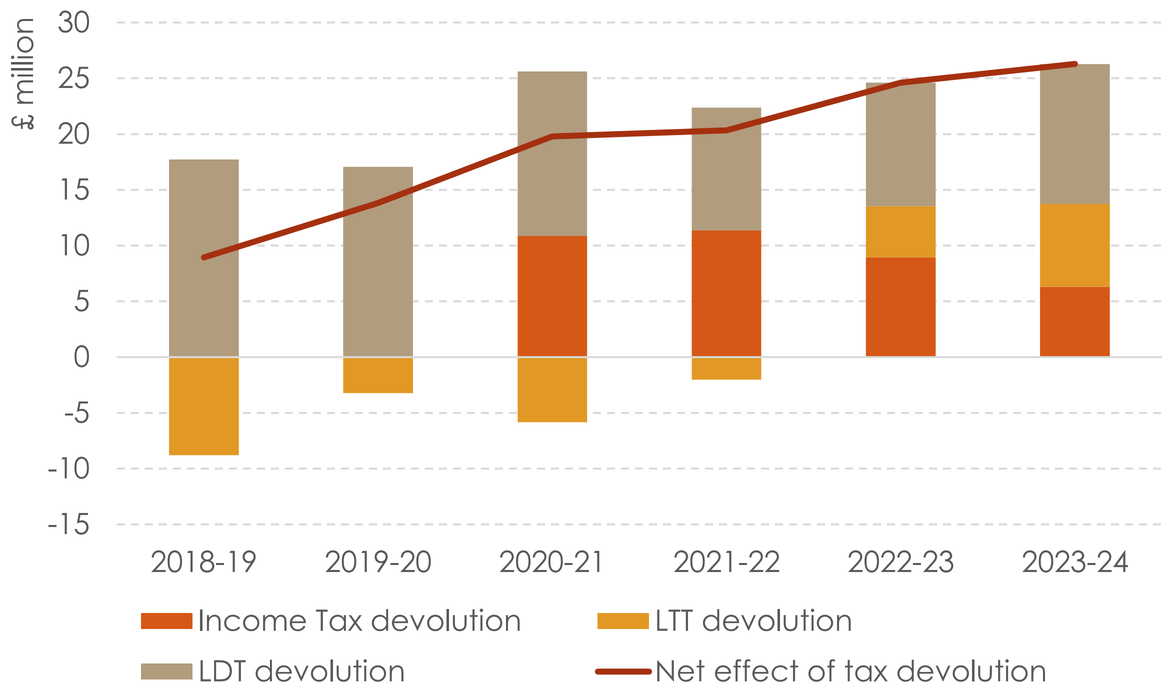
Source: OBR (2018 and previous) *Devolved Taxes Forecast March 2019;* and authors' calculations

Using forecast revenues for comparable UK government revenues in England and Northern Ireland, we can calculate projected BGAs and the net effect of tax devolution compared to a baseline scenario where taxes had not been devolved. As shown by the red line in figure 4, the Welsh Treasury is projected to be progressively better off as a result of tax devolution in each year up to the end of the forecast period. The net effect is projected to be £13.8 million in 2019-20. Higher forecast income tax revenue means income tax devolution is now projected to have a small but positive net effect on Welsh finances.

On current forecasts, the Welsh budget is projected to be cumulatively better-off by just under £100 million by the end of 2023-24, as a result of tax devolution. Although this projected net effect of tax devolution is relatively modest, it is a timely reminder the spending decisions of the UK chancellor will not be the only determinant of future Welsh budgets.

As well as devolved income tax revenues and non-domestic rates, Council Tax revenue also funds spending on local public services in Wales. The OBR forecasts council tax revenues in Wales to increase strongly by over 5% a year over the forecast period, boosting local authority spending by £370 million a year by 2023-24 (in nominal terms). The forecast growth in Council Tax levels for 2019-20 is 4.2%. However, the (weighted) average increase for 2019-20 from budgets set by Welsh local authorities this month was approximately 6.3%, suggesting Council Tax growth could outstrip this forecast.

Figure 4: Projected net effect of tax devolution, based on March 2019 forecasts



Source: OBR (2018 and previous) *Devolved Taxes Forecast March 2019;* and authors' calculations

Conclusion

The Spring Statement 2019 and the accompanying OBR's forecasts for the public finances opens the door for sustained increases in public spending over future years. This is in stark contrast with the UK government spending plans laid out in March 2018.

The commitment to a Spending Review also offers potential fiscal certainty for departments and the devolved administrations. A Spending Review later this year would set out departmental spending limits to 2022-23. This would allow better multi-year planning of future devolved public spending, provide a clearer picture of the prospects for key public services and local authorities, and help frame discussions about the possible use of devolved tax powers.

However, as with so much else, the extent to which this increased spending and fiscal certainty materialises depends heavily on what happens to the Brexit process, its economic impact and the potential policy responses.