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Wales Fiscal Analysis

Covid-19 and the Welsh Government Budget

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Wales Fiscal Analysis

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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

- The Covid-19 pandemic has triggered unprecedented budgetary responses from the UK and Welsh governments. Welsh Government budget measures to date have focused on offering **support for businesses through the non-domestic rates system (costing approximately £1.3 billion)** and a **£1.1 billion support package for the economy and public services** in Wales. These measures include a £500 million Economic Crisis fund for businesses, charities and social enterprises, as well as targeted support for local government, public transport, the voluntary sector, and Wales' creative industries, culture and sport sectors.
- Funding for these measures mainly derive from 'Barnett consequentials' triggered by policy announcements in England. However, **approximately £526 million of revenue spending announced in response to the crisis is not being funded by consequentials**. The Welsh Government has only limited other options to fund its fiscal response.
- The Welsh Government's plans were already drawing down the maximum of £125 million a year of revenue funding from the Wales Reserve but may use the **£105 million of unallocated resource funding contained in its 2020-21 budget plans**. The Welsh Government is currently restricted from borrowing to cover the cost of new planned day-to-day spending that includes its financial response to Covid-19.
- This leaves the Welsh Government with the option of reallocating spending from other budget lines and reallocating funding from EU projects which are no longer taking place. However, the extent to which the Welsh Government will be able to find further significant savings from other areas of the budget to fund its coronavirus response is uncertain.
- The virus' relative impact on Wales over the course of the pandemic is not yet known. However, a population share of spending in England (as determined by the Barnett formula) may not be a fair reflection of the additional demands the crisis may place on Welsh public services. For instance, **Wales has a significantly older population with much higher levels of ill-health and disabilities**. Barnett – a population-based rather than a needs-based funding formula – could therefore fall short of the Chancellor's 'whatever it takes' ambitions.
- The UK could introduce temporary reforms of the Barnett formula. One option would be to introduce a coronavirus-related 'needs-based factor', following the precedent set in the Welsh fiscal framework agreement of 2016. Increments coming to Wales from Covid-19 measures could be multiplied by a factor which better captures the demographic profile of the Welsh population, potentially accounting for increases in demand that could be faced by Wales' public services.
- Barring a reform of the grant funding mechanism, the **Welsh Government should be allowed greater flexibility to manage its budget** to reflect these extraordinary circumstances. The annual limit on drawdowns from the Wales Reserve should be removed, allowing a possible £155 million of additional day-to-day spending for 2020-21, if needed.
- **Restrictions on the Welsh Government's ability to borrow should also be very significantly relaxed – or removed – for the duration of the coronavirus crisis**. This would allow the Welsh Government to meet the possible additional demands on Welsh public services not covered by the Barnett formula, as well as allowing greater flexibility to support Welsh households and businesses through the crisis.
- Wales' public finances and public services face an unprecedented situation. The fiscal framework should be urgently reformed to reflect this.

Coronavirus and the Welsh Government budget

8 April 2020

Introduction

The coronavirus pandemic is set to put a massive strain on the Welsh Government budget, with the huge measures already announced likely to be followed by further action in coming weeks and months. On 20 March 2020, Wales Fiscal Analysis published an initial briefing outlining the implications for the Welsh Budget from the UK government's budget announcements and initial fiscal response to Covid-19.[1]

This briefing provides an update on the Welsh Government's budgetary response to date and how these measures and further packages will be funded. The last section analyses how the crisis has highlighted the strengths and weaknesses of Wales' fiscal framework and suggests possible urgent reforms which may aid an effective budgetary response to the crisis.

Welsh Government budgetary response to date

In recognition of how much has changed since the Welsh Government published its Final Budget in February, the First Minister announced the intention to bring forward a supplementary budget (usually published in July of each year) to realign budgets with the new and urgent priorities.[2]

The budget measures announced so far have focussed on offering support for businesses through the non-domestic rates system and a support package for the economy and public services in Wales, amounting to £2.4 billion. These measures include:

- £1.3 billion support for businesses through lower non-domestic rates (discussed below)
- £500 million for an Economic Crisis Fund for businesses, charities and social enterprises (priority for those not targeted by previous measures); this consists of a £100 million Development Bank of Wales business loan scheme, and a £400 million emergency grant scheme.[3]
- £30 million for Local Government – including £7 million for free school meals provision and £10 million to support rough sleepers.[4]
- £69 million fund to support public transport.[5]
- £24 million fund to support the voluntary sector in Wales.[6]
- £15 million for a direct delivery food scheme.[6]

[1] https://www.cardiff.ac.uk/__data/assets/pdf_file/0004/1788628/WFA-Spring-Budget-2020.pdf
[2] https://record.assembly.wales/Plenary/6266#C285092
[3] https://gov.wales/new-500-million-economic-resilience-fund-launched-wales
[4] https://gov.wales/written-statement-coronavirus-and-local-government
[5] https://gov.wales/nhs-staff-get-free-travel-part-69m-hardship-fund-deal-public-transport
[6] https://gov.wales/multi-million-pound-boost-to-support-volunteers-and-wales-most-vulnerable

* £18 million for creative industries, culture and sport sectors.[7]

Further announcements and details about funding measures are expected. There are likely to be significant further resources required for the NHS to aid its response to the coronavirus. For example, up to 7,000 extra hospital beds are being created to accommodate an increase coronavirus cases.[8] £8 million has been allocated to convert the Principality Stadium into a field hospital with up to 2,000 beds. Local authorities will also be seeking clarity on any additional funding for social care and front-line services.

The Welsh Government will also need to consider how best to support household finances hit by the economic crisis. Whereas most levers in the form of tax and benefits are held by the UK government, there are options available for the Welsh Government to help households and individuals. The Welsh Government and local authorities provide a range of different schemes which complement the UK benefit system, provision and funding for which could be boosted in response to the current crisis (as has already been done in the case of free school meals).[9]

The Welsh Government also has powers over Council Tax, and there have been increasing calls to use this as a tool for alleviating some of the effects of the crisis, for example by funding council tax holidays.[10] The existing lever to help those struggling to pay Council Tax is the Council Tax Reduction Scheme (CTRS). With a large uptick in those applying for Universal Credit reported at the end of March, the crisis will likely lead to significantly greater demand for the scheme across local authorities. Funding for the Council Tax Reduction Scheme from the Welsh Government comes from a fixed grant to local authorities as part of their settlements, so local authority budgets bear the risk of additional demand. To avoid shortfalls in the local budgets, the Welsh Government will need to increase grant funding for CTRS and could explore enhancing eligibility for the scheme to provide further support for those affected by the economic crisis. The UK government announced a £500 million hardship fund for English local authorities, though the scheme in Wales is generally more generous than in England (where support has been localised).

Non-domestic rates measures

Business rates relief and grants to small businesses have formed a cornerstone of the UK Government's efforts to support businesses in England through the pandemic. The Welsh Government has announced that a similar package of grants and reliefs will be made available to businesses paying non-domestic rates in Wales.

The measures implemented by the Welsh Government include a one-year 100% relief for business properties operating in the retail, leisure and hospitality sectors with a rateable value of less than £500,000. Data from the Valuations Office Agency indicates that in the region of 50,000 business premises will benefit from this measure. These reliefs will be applied automatically to non-domestic rates bills issued by local authorities, and the Welsh Government will cover the cost of providing these reliefs.

In addition, grants of £10,000 are being made available to all businesses with a rateable value of less than £12,000 (the upper threshold to qualify for Small Business Rates Relief in Wales), and grants of £25,000 are being offered to businesses in the retail, leisure and hospitality sectors with a rateable value of

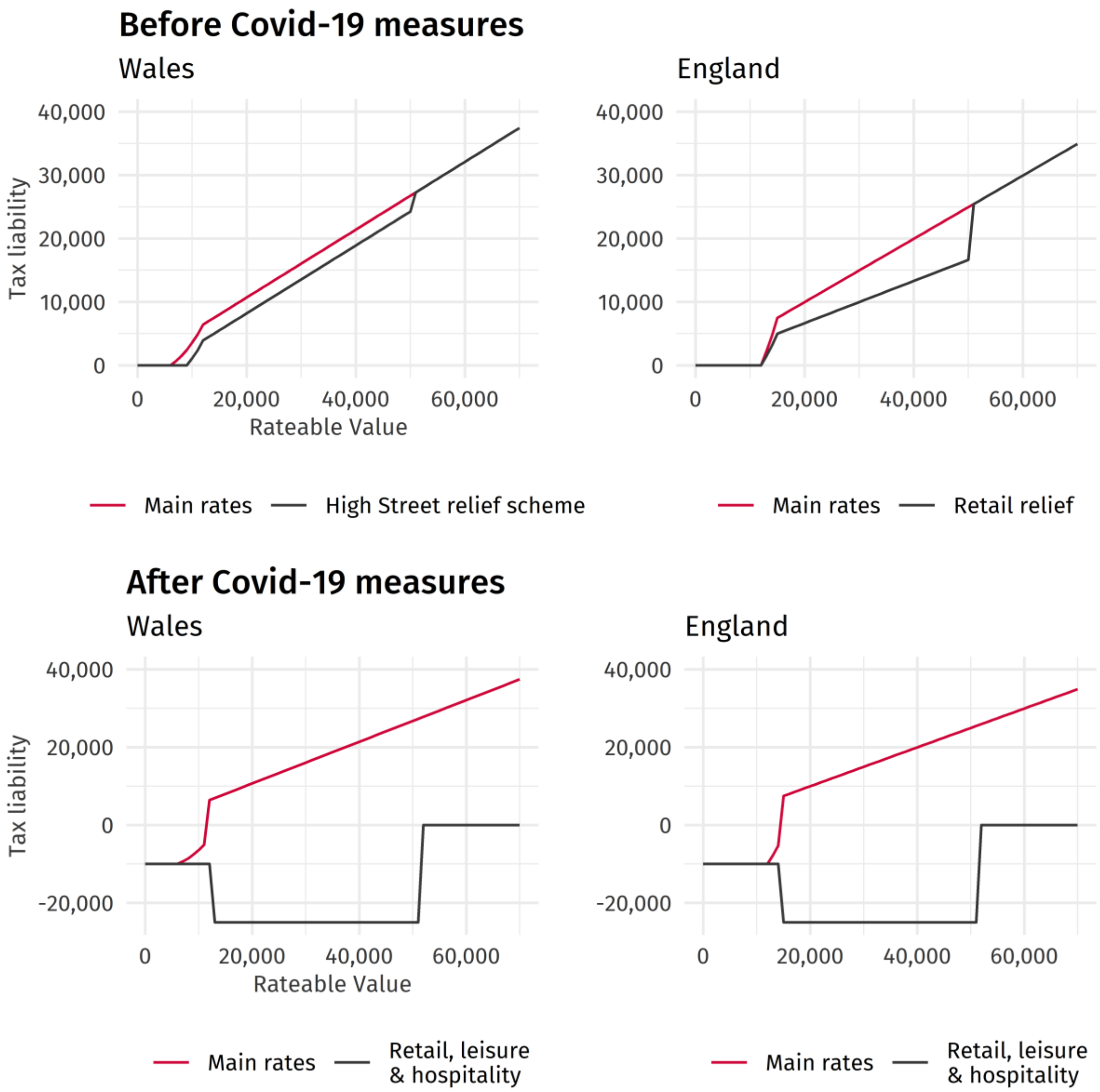
[7] https://gov.wales/18m-support-culture-creative-and-sport-sector-wales
[8] https://gov.wales/nhs-wales-rapidly-increases-capacity-cope-coronavirus
[9] For example, see the steps suggested here: https://www.bevanfoundation.org/commentary/six-things-that-the-welsh-government-could-do-to-help-low-income-families-through-covid-19/
[10] For example, Citizens Advice Cymru: https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/citizens-advice-cymru-wales-policy-research/covid-19-wales/ and https://www.itv.com/news/wales/2020-03-26/wales-coronavirus-council-tax-holiday/

between £12,001 and £51,000. Around 63,500 and 8,500 businesses are expected to be eligible for these two grants respectively. Eligible businesses will need to apply for this support through their local authority.

The mechanism for submitting and processing these grant applications appears to have been put in place with considerable speed, largely because of the clearly defined eligibility criteria and the fact that local authorities already possess data on businesses who might be eligible through the Valuation Office Agency. Assessing eligibility for other schemes, such as the UK Government's Self-employment Income Support Scheme is likely to be more difficult – those who qualify for this scheme are not expected to receive their first payment until June.

Figure 1

Non-domestic (business) rate tax schedules, before and after Covid-19 measures



Source: Authors' calculations. Excludes discretionary and transitional reliefs. 100% relief for retail, leisure and hospitality businesses does not extend to properties with a rateable value of more than £500,000 in Wales.

One unintended consequence of these measures is that the non-domestic rates schedule in Wales more closely mirrors the English business rates schedule compared to what was the case before the crisis

(**Figure 1**). But whereas the UK government has decided to extend the 100% relief for all properties in the retail, leisure and hospitality industries, the Welsh Government has set an upper threshold of £500,000 to qualify for this support. The Welsh Government claims that capping this relief will only affect around 200 properties across Wales but will release approximately £117 million to be put into the economic crisis fund.[11]

Funding the fiscal response

As outlined in our previous briefing, the funding for these measures mainly come from 'Barnett consequentials' triggered by policy announcements made in England. Budget 2020 and subsequent announcements amount to £1,757 million of additional revenue funding and £239 million of capital funding (see **Figure 2**). Assuming only the £100 million Development Bank of Wales loan fund is capital spending, the additional consequentials announced would be enough to fund the updated NDR relief and grants package and around half of the economy and public services package.

Figure 2

Fiscal response to date and additional funding available for the Welsh Government, £ million

	Revenue	Capital	Total
Initial NDR relief and grants	1400		1400
Exception for premises over £500,000	-117		-117
Updated NDR relief and grants package	**1283**		**1283**
Economic Crisis Fund	400	100	500
Local Government	30		30
Public Transport	69		69
Voluntary sector	24		24
Direct delivery food scheme	15		15
Creative industries, culture and sport sectors	18		18
Other (to be announced)	444		444
Economy and public services package	**1000**	**100**	**1100**
Total fiscal response to date	**2283**	**100**	**2383**

	Revenue	Capital	Total
Budget 2020 *consequentials*:	**122**	**239**	**364**
Budget 2020 measures:			
LA hardship fund	30		30
Business rates reliefs	65		65
Business support grants	130		130
Response fund:	**250**		**250**
Business package 17/03/2020	**1160**		**1160**
Total *consequentials*	**1757**	**239**	**1999**

Notes: Excludes small amount of additional Financial Transactions funding announced in Budget 2020. Economic Crisis Fund spending split between revenue and capital according to spilt between grant and loan schemes announced. Some of 'Other (to be announced)' measures assigned to revenue spending in this table may be capital spending.

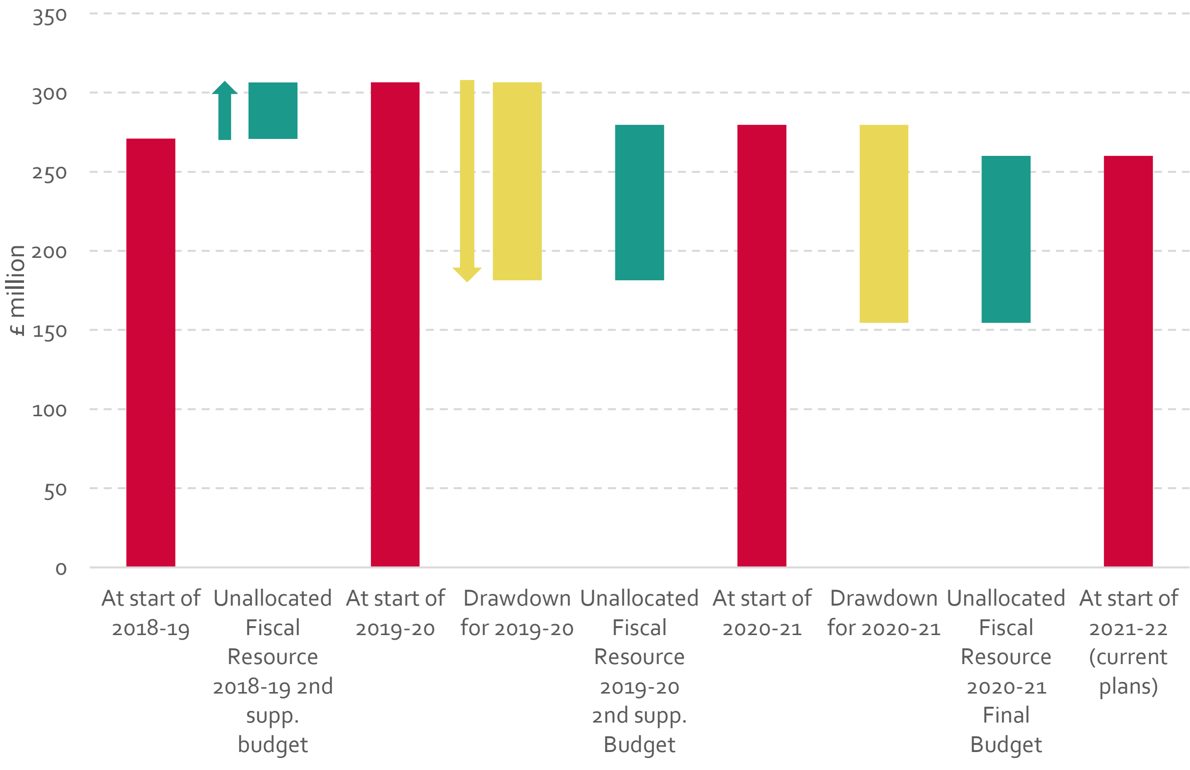
[11] https://businesswales.gov.wales/business-rates-relief

This means approximately £526 million of the revenue spending announced in response to the crisis is not being funded by *consequentials*.[12] The Welsh Government has only limited other options to fund its fiscal response.

Figure 3 shows an attempt to estimate movements of revenue funding into and out of the Wales Reserve from 2018-19 onwards based on published information and latest budget plans. The red bars show the available revenue funding at the start of each financial year. The Welsh Government's plans were already drawing down the maximum of £125 million a year in 2019-20 and 2020-21 (yellow bars). However, there was £98 million of unallocated revenue funding in the latest budget plans for 2019-20 and £105 million a year for 2020-21 (green bars). Barring departmental over-spending relative to supplementary budget plans, this unallocated funding returns to the Wales Reserve for the following financial year. This means the Welsh Government could have an additional £105 million to allocate for 2020-21, leaving £155 million in the Wales Reserve for the start of 2021-22. It should however be highlighted that this figure could change depending on outturn data for 2019-20 and 2020-21.

Figure 3

Projected movements in fiscal resource funding in the Wales Reserve, 2018-19 to 2021-22



Source: Welsh Government (2019) Second Supplementary Budget 2018-19; Welsh Government (2020) Second Supplementary Budget 2019-20; Welsh Government (2020) Final Budget 2020-21; and authors' calculations

The Welsh Government can borrow for current spending up to £200 million each year (within an overall £500 million cap), with repayments needing to be made within four years. However, this is only allowed if tax revenues are lower than forecast. However, current rules don't allow borrowing to cover the cost of new planned day-to-day spending such as responding to the coronavirus. The Welsh Government was

[12] Some spending categorised as revenue spending in figure 2 may in fact turn out to be capital spending. This would mean the 'unfunded' revenue response figure may be smaller.

already planning to borrow £125 million for capital spending purposes in 2020-21, close to its annual borrowing limit of £150 million.

This leaves the option of reallocating spending from other budget lines. The First Minster noted that funding will be drawn from all Main Expenditure Groups of the Welsh budget to fund new and urgent revenue priorities, and a parallel exercise in relation to capital expenditure will also take place. Funding has already been allocated from international trade missions which will no longer take place as well as some speed limit enforcement spending. It is understood that around a quarter of the £1.1 billion package for the economy and public services would be coming from European Union funded projects which can no longer take place.[13] However, the full breakdown of how the fiscal response is being funded – between reallocated budget lines, unallocated funding already in the budget, and reallocated EU funding – is not yet clear.

The extent to which the Welsh Government will be able to find significant further savings from other areas of the budget to fund its coronavirus response remains to be seen. For example, last year we noted the large part of the Welsh Budget which goes towards meeting the Welsh Government's and local authority pay bill (over £7.8 billion in 2017-18),[14] which will still need to be paid. Furthermore, although some local authority services are being scaled back, there will be other additional demand pressures for them to face (e.g. schools staying open for children of key workers during school holidays).

The fiscal framework in a time of crisis

The economic crisis will have a large impact on the Welsh Government's devolved taxes, as taxpayer incomes fall and property transactions reduce sharply. However, one of the best features of Wales' fiscal framework is that the Welsh Government will largely be insulated from this risk. This is because the Block Grant Adjustment (BGA) – the amount taken off the block grant to reflect tax devolution – will be linked to the fall in revenues in comparable UK government revenues.

This shielding of UK-wide economic shocks is best illustrated by analysis of historic data during the last financial crisis. Between 2007-08 and 2009-10, now-devolved tax revenues fell by more than £233 million in Wales. However, because equivalent UK government revenues in England and Northern Ireland also fell (reducing the BGA), the Welsh budget would have faced a cut of only £36 million. This time around, it may be the case that Welsh revenues hold up relatively better during the crisis, given that a higher share of Welsh workers are designated as key workers and a higher share of revenues come from public sector employment earnings, though the long-run relative economic effects are unknowable.

If the crisis underlines the strength of the BGA mechanism, it may also expose a weakness of the current system – namely how changes to the Welsh block grant are determined. The funding flowing to the Welsh Government from the UK government is determined by the Barnett formula, which allocates a population share of spending changes in England on programmes devolved to Wales. Since 2018, increments to the Welsh budget have been multiplied by a 'needs-based factor' of 105%. Earlier this week, the First Minister Mark Drakeford argued that in response to the crisis, "money should come to Wales based on our need not our population".

While the virus' relative impact on Wales over the course of the pandemic is of course currently unknowable, we do know how Wales' population profile corresponds with other parts of the UK. **Figure 4** presents some statistics for Wales and England which may suggest that a population share of spending

[13] https://www.bbc.co.uk/news/uk-wales-politics-52085642
[14] https://www.cardiff.ac.uk/__data/assets/pdf_file/0010/1517176/public_sector_june_final.pdf

in England may not be a fair reflection of the additional demands this crisis could place on Welsh public services. For instance, Wales has a significantly older population with much higher levels of ill-health and disabilities, which the 105% needs-based factor currently included in the Barnett formula is not fully accounting for. At the time of writing, the number of confirmed cases in Wales relative to population is also much higher than in England (though the number of deaths is currently lower).

Figure 4
Relevant statistics for Wales relative to England

Measure	Wales	England	Wales (England = 100)
Population			
Population over 65	20.8%	18.2%	114.2
Population over 75	9.3%	8.3%	112.6
Population over 85	2.6%	2.4%	107.7
Health			
DLA/PIP claimants per 1,000 of population	82.6	54.9	150.6
DLA/PIP claimants with respiratory conditions per 1,000 of population	3.8	2.1	180.7
Attendance Allowance claimants per 1,000 of population 65 and over	156.9	128.8	121.9
Business & employment			
Non-domestic properties with a rateable value of less than £15,000	79.4%	69.9%	113.7
Non-domestic properties in retail, leisure & hospitality sectors	42.9%	37.7%	113.6
Employees working in tourism industry	11.6%	11.1%	105.1
Covid-19			
Number of confirmed cases per 100,000	120.8	82.1	147.0
Number of deaths in a hospital setting per 100,000	6.8	10.1	66.9

Source: Authors' calculations. Population figures are based on ONS (2018) mid-year estimates. Number of DLA/PIP claimants is based on DWP data on cases with entitlement in May 2018. Data on non-domestic properties is sourced from the VOA stock of properties and SCAT tables. Data on employees working in the tourism industry is sourced from the Annual Population Survey and Business Register Employment Survey and obtained via StatsWales (2018). Number of Covid-19 cases and deaths are correct as of 07 April 2020 as reported at: https://www.arcgis.com/apps/opsdashboard/index.html#/f94c3c90da5b4e9f9a0b19484dd4bb14.

At the budget, the Chancellor committed that "whatever extra resources our NHS needs to cope with coronavirus – it will get". While that may be true for the NHS in England where funding will follow demand, the nature of the Barnett Formula means that this may not follow automatically for Wales.

Similarly, although the Welsh Government has largely implemented the same measures on non-domestic (business) rates as those announced in England, this does not necessarily mean that the cost of providing this support has been fully offset by Barnett consequentials. Wales' population share does not reflect differences in the composition and stock of rateable properties between the two countries.

For instance, Wales has a higher share of retail, leisure and hospitality properties (43%) compared to England (38%) – though this is likely to be offset by their lower average rateable values. Their lower rateable values meant that a relatively larger share of Welsh premises (75%) qualify for the £10,000 grant compared to England (70%). This is despite the fact that the grant is only made available to businesses with a rateable value of less than £12,000 in Wales, whereas businesses with a rateable value of between £12,000 and £15,000 are also eligible for this support in England.

This crisis is likely to underline the fact the Barnett formula is ill-suited to distribute funds to the devolved administrations, particularly where the aim is to target support at areas, individuals and businesses with the greatest need.

As argued by David Phillips of the Institute for Fiscal Studies, the fiscal response to the crisis from the devolved governments of the UK may be hampered by "limited reserves, constrained borrowing powers, and the funding flowing to them as a result of the Barnett formula may not reflect the challenges that they face".[15]

To reflect the possibility of an asymmetric impact of the coronavirus across the countries of the UK, the UK government could introduce temporary reforms to the Barnett formula. One option would be to follow the precedent set in the Welsh fiscal framework agreement of 2016 and introduce a coronavirus-related 'needs-based factor'. Increments coming to Wales from coronavirus measures could be multiplied by a factor which better captures the demographic profile of the Welsh population, thereby accounting for the potential increases in demand that could be faced by Wales' public services. This could be introduced when there is a clearer picture of the relative impact of the crisis in a few months' time.

Barring a reform of the grant funding mechanism, the Welsh Government should be allowed greater flexibility to manage its budget to reflect these extraordinary circumstances. For example, the annual limit on drawdowns from the Wales Reserve should be removed, allowing an additional £155 million of day-to-day spending for 2020-21, if needed.

Restrictions on the Welsh Government's ability to borrow should also be very significantly relaxed or removed entirely. While access to the current annual borrowing limit of £200 million a year would be a welcome addition to the Welsh Government's fiscal response, this annual cap should be temporarily increased, given the very low cost of borrowing. We note some international evidence of a moral hazard problem in substate government borrowing, where unlimited access to credit by governments that are not subject to a hard-budget constraint (a vow that a higher-tier government will not bail them out if they cannot afford debt repayments) is associated with fiscal indiscipline and significant regional budget deficits.[16] However, the scale of the current crisis should more than counterbalance these concerns, at least for the duration of the response by the public services to Covid-19. Greater access to borrowing would allow the Welsh Government to meet the possible additional demands on Welsh public services not covered by the Barnett formula. It would also allow the Welsh Government greater flexibility to support Welsh households and businesses through this crisis.

Wales' public finances and public services face an unprecedented situation. The fiscal framework should be urgently reformed to reflect this.

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[15] https://www.ifs.org.uk/publications/14766

[16] See for example Rodden, J. (2006). *Hamilton's Paradox: The Promise and Peril of Fiscal Federalism*. Cambridge: Cambridge University Press.

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