Dadansoddi Cyllid Cymru
Wales Fiscal Analysis

UK Budget 2021: the implications for Wales and the Welsh budget

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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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Introduction

The UK Budget 2021 delivered on 3 March was another landmark event in the UK government's fiscal response to Covid-19. It once again extended the huge levels of support for individuals and businesses in the face of ongoing public health restrictions. It also looked beyond the immediate crisis – increasing taxes and squeezing future growth in public spending in the hope of "fixing the public finances". However, it was a budget that kicked dealing with some of the legacies of Covid-19 – from the pressures on public services to the impact on inequalities – into the long grass.

The Chancellor's plans will have a big impact on the Welsh Government's budget. Allocations of additional funding through the Barnett formula and tax changes prompted immediate decisions from the Welsh Government on support for businesses and on devolved tax policy. For this year, the Welsh Government again has significant fiscal firepower at its disposal and will need to make large allocations at future supplementary budgets. However, the UK government's medium-term spending plans make for a more austere outlook for the Welsh budget and Welsh public services. As the last UK fiscal event before the forthcoming Welsh election, these spending plans should set the context for big debates over the Welsh budget and the use of devolved fiscal powers over the next Welsh parliamentary term.

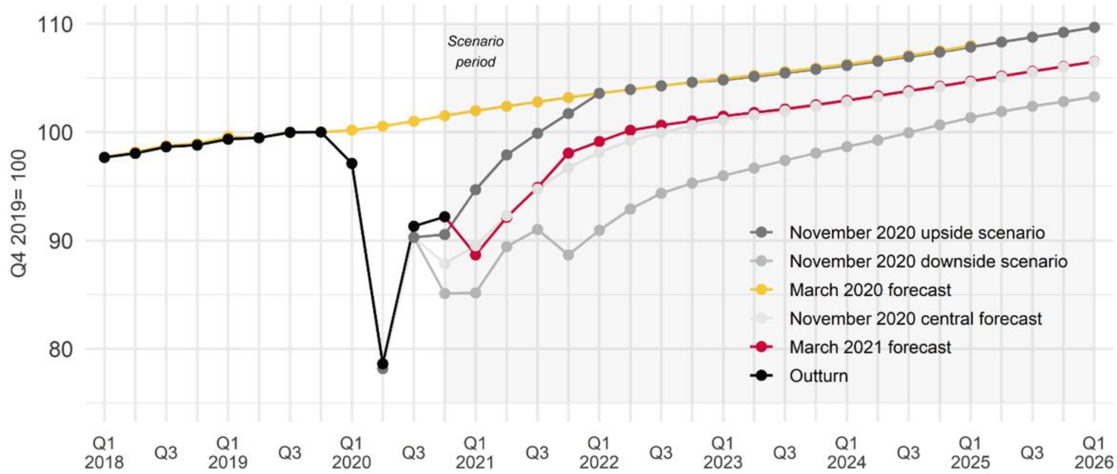
This briefing firstly looks at the economic and fiscal backdrop to the Budget, before analysing the large fiscal policy decisions taken. We then turn our attention to the impact on the Welsh budget for 2021-22 and the updated devolved tax forecasts. Lastly, we assess the magnitude of some of the direct UK government spending commitments in Wales made in the budget.

Economic and fiscal outlook

Alongside the Budget, the Office for Budget Responsibility (OBR) published its assessment of the economic outlook for the UK. **Figure 1** shows the path of GDP in the latest forecasts, compared to the March and November 2020 forecasts. With the extended restrictions imposed across the UK as a result of the second wave of Covid-19, the economy is set to shrink again in the first quarter of 2021. However, given the accelerated rollout of vaccines, the OBR is now forecasting a slightly faster recovery and expects the economy to reach pre-pandemic levels of output by the middle of 2022, ahead of the November 2020 central forecast. This is driven by an increase in consumption as the economy is reopened. Over the longer term, the OBR assumes the pandemic will lower output by 3% relative to pre-pandemic levels.

Figure 1

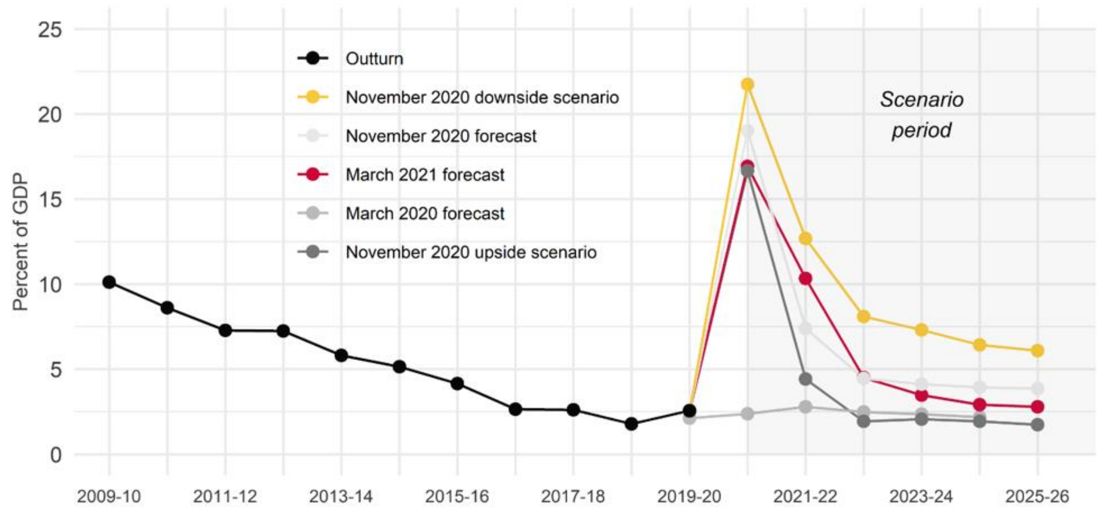
Real GDP scenarios for the UK: November 2020 scenarios versus March 2021 forecast



Source: Office for Budget Responsibility (2021) Economic and fiscal outlook; ONS; and authors' calculations

Figure 2

UK Public sector net borrowing



Source: Office for Budget Responsibility (2021) Economic and fiscal outlook; ONS; and authors' calculations

Public sector net borrowing is set to reach a record 16.9 % of GDP, or £355 billion, in 2020-21. Highlighting the great uncertainty surrounding these forecasts, this figure is £35 billion lower than the November forecast for 2020-21, due to better-than-expected tax receipts performance and lower than expected departmental spending. In contrast, the re-introduction of restrictions to contain the second wave and the extension of emergency support schemes mean borrowing next year will be higher than expected in November – reaching a total of £234 billion or 10% of GDP (**Figure 2**).

Under this new forecast, public sector net borrowing will return to pre-pandemic levels of under 3 per cent of GDP in 2025-26. The Chancellor neglected to set firm new fiscal rules, though stated the UK "in normal times should not be borrowing to pay for everyday public spending" (i.e. should only borrow to fund capital spending). Under the central scenario, this target would be met by 2025-26.

Across the UK, the unemployment rate is forecast to rise to a peak of 6.5% (2.2 million) at the end of 2021. A proportionate rise in Wales would mean unemployment increasing to roughly 87,000.[1] This is significantly below the projected peak under the November forecast (112,000), owing to the extension of government support in the Budget. The peak in unemployment is now forecast to occur after the government removes the furlough scheme in September.

Fiscal policy decisions

The first part of Chancellor Rishi Sunak's budget was aimed at protecting jobs and livelihoods while restrictions remain in place and prolonging several streams of support. This included a six-month extension to the furlough scheme and the uplift to Universal Credit. In England, alongside a new round of grants for affected businesses, business rates and stamp duty reliefs were also extended, with knock-on implications for the Welsh budget.

For the next two years, the government's tax policies reduced revenues, as part of overall fiscal stimulus. Most significantly, companies will be able to deduct 130% of plant and machinery investment from taxable profits in 2021-22 and 2022-23. The initial cost of this "Super Deduction" will be around £29 billion.

The Chancellor then turned his attention to "fixing the public finances", stressing the need for fiscal restraint once the pandemic has subsided. As shown in **Figure 3**, the budget contained a series of net tax rises from 2023-23 onwards, which made it the biggest tax rising budget since the Spring budget of 1993.[2] These measures included increasing the headline rate of corporation tax from 19% to 25% in 2023, partly reversing previous reductions over the last decade or so. On income tax, allowances and thresholds will be frozen beyond 2021-22. This policy will also have a major impact on the Welsh Government's devolved revenues in later years, as explored below.[3]

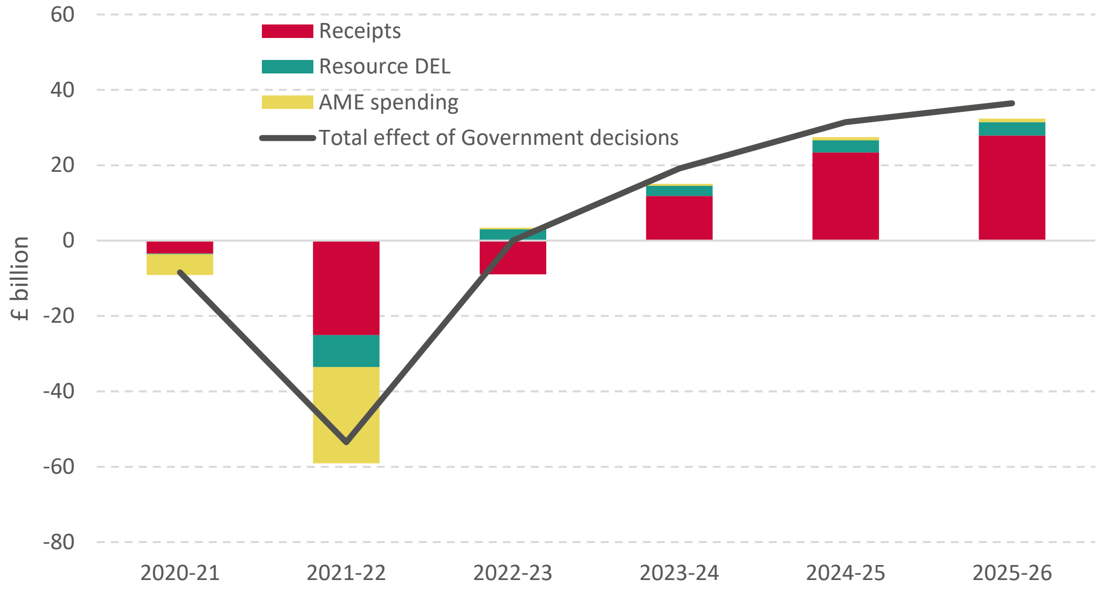
Significantly, the budget also contained cuts to departmental spending plans for years after 2021-22, by around £4 billion a year in cash terms. Treasury documents claimed the move was

[1] Unemployment rate for persons aged 16 and over.
[2] Institute for Fiscal Studies (2021) *'Public finances: yet more tax rises ahead?'* Available here https://www.ifs.org.uk/uploads/Public-finances-yet-more-tax-rises-ahead.pdf
[3] The effect on the Welsh budget will be more muted given Block Grant Adjustments (linked to revenues in England and Northern Ireland) will also increase.

made to reflect a change in the OBR's forecast for the GDP deflator (a measure of inflation) to maintain the same real-terms growth in public spending. However, the changes to this measure of inflation mostly reflect the impact of current lockdowns and are unlikely to reflect a reduction in the costs faced by public services. These planned cuts come on top of the decision to cut £12 billion a year from pre-pandemic spending plans made at the Spending Review in November.

Figure 3

Net effect of government policies on public sector net borrowing



Source: OBR (2021) Economic and fiscal outlook

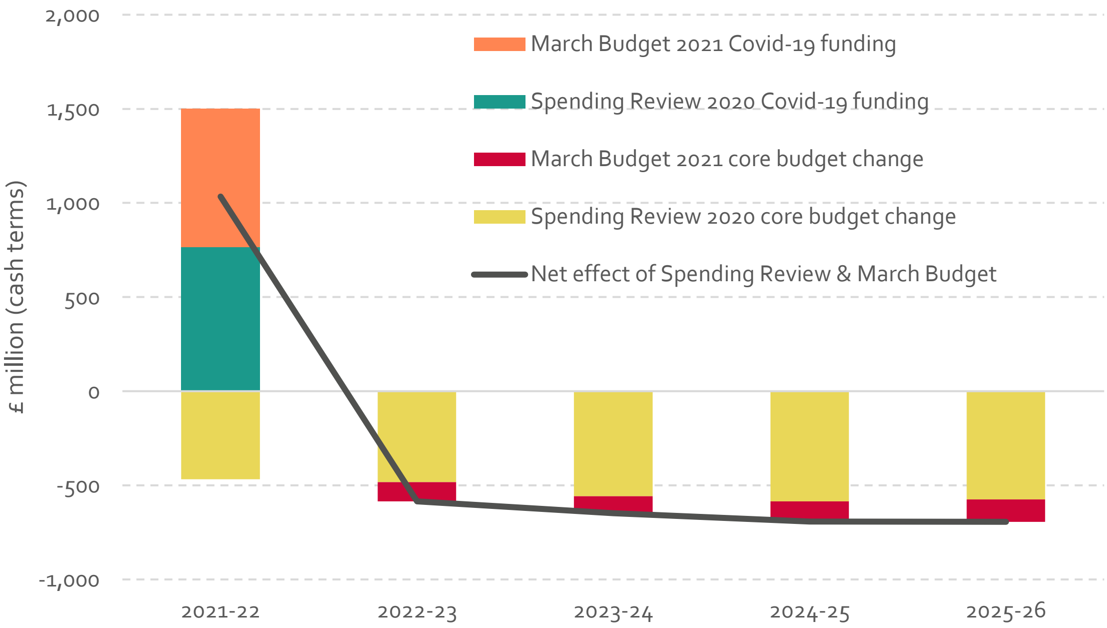
While huge amounts of funding have been allocated to public services in 2020-21 and 2021-22 to fund the Covid-19 response, the budget again contained no plan to address likely post-pandemic pressures in future years. The Chancellor's plans contain no Covid-19 related funding for years after 2021-22, assumes NHS and schools spending returns to pre-Covid multi-year plans, and implies cuts for other areas of the budget. The OBR described the potential legacy of the pandemic for spending on public services as one of the most significant risks to the medium-term fiscal outlook.

The decisions to cut back on pre-pandemic spending plans has had a large effect on the projected consequentials the Welsh Government can expect from 2021-22. Figure 4 shows our broad estimate of the *change* in consequentials deriving from UK government spending decisions at both the Spending Review in November and at the March Budget.

While no detailed spending plans have been set for UK departments beyond 2021-22, our projection assumes the reduction in planned spending is spread evenly across non-protected departmental budgets (outside of health, schools, defence, and foreign aid). We compare the projected Barnett consequentials under current plans against those forecast under plans laid out at the March 2020 budget. While the Welsh budget for day-to-day spending is set to grow over coming years - driven by the multi-year commitments to health and education made in England - projected consequentials have reduced significantly compared with pre-pandemic forecasts. **If delivered, these planned cuts would reduce the projected size of the Welsh budget by approximately £600 million a year in 2022-23 and 2023-24.**

Figure 4

Estimated *change* in consequentials for Welsh Government day-to-day spending budget from Spending Review 2020 and March Budget 2021 decisions, 2021-22 to 2025-26



Source: HM Treasury (2021) UK Budget 2021 documents; OBR (2021) Economic and Fiscal Outlook March 2021; and authors' calculations

These current spending plans – on which the projection of a current budget balance by 2025-26 are based – would mean a difficult outlook for the Welsh budget beyond 2021-22. Post-pandemic funding pressures are set to be severe – from tackling growing NHS waiting lists, remedying the impact on children's education, to the need to support the economic recovery. Funding these cost and demand pressures would involve a return to austerity for large parts of the Welsh budget under current budget plans.

Implications for the Welsh budget

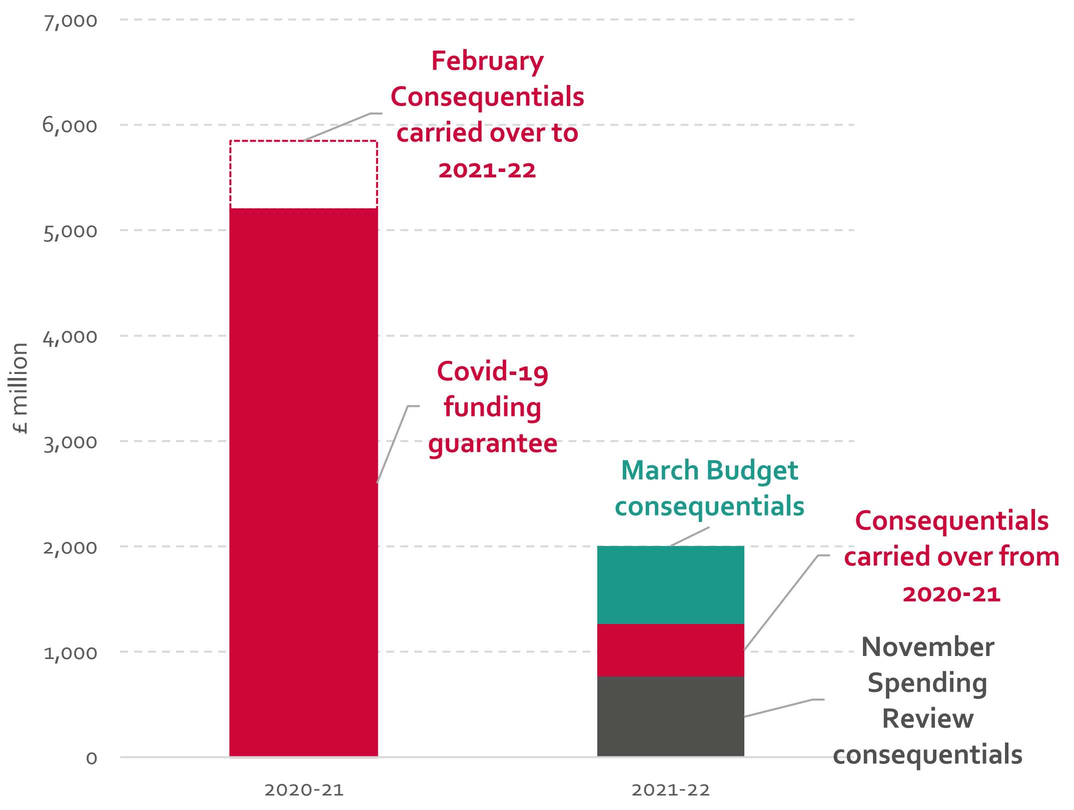
The UK budget had major implications for the Welsh Government's budget, a final version of which had been published a day before. The headline for Wales was the announcement of an additional **£735 million of revenue funding for the Welsh Government**. Based on budget documents, these consequentials were mainly triggered by the business rates relief extension in England and the new round of business grants.

The Budget also contained some additional allocations of Covid-19 support for public services in 2021-22, from the £21.3 billion reserve set aside at November's Spending Review. These allocations included £1.7 billion for the vaccine deployment programme and a further £400 million for the UK government. These allocations resulted in approximately £125 million of the £725 million of additional consequentials for the Welsh Government. Further allocations from the UK government's £18.8 billion Covid-19 reserve would result in additional in-year funding for the Welsh Government.

Meanwhile, the core day-to-day spending block grant for 2021-22 remained largely unchanged, and no additional capital consequentials were announced.

Figure 5

Welsh Government Covid-19 funding from UK government, 2020-21 and 2021-22



Source: HM Treasury (2021) UK Budget 2021 documents; Welsh Government (2021) Final Budget 2021-22; and authors' calculations

The consequentials follow the February announcement of an additional £650 million for the Welsh Government in 2020-21. The Welsh Government's 3rd Supplementary Budget for 2020-21 moved this funding from 2020-21 to 2021-22, following agreed Treasury flexibilities over this late funding. This means an additional £498 million of day-to-day spending is available for the Covid-19 response in 2021-22, with the rest of the funding switched from resource to capital funding.

As shown in **Figure 5**, in addition to the initial £766 million of Covid-19 funding announced at the Spending Review in November, **the Welsh Government has almost £2 billion of day-to-day spending to fund its Covid-19 fiscal response in 2021-22.**

Of this available Covid-19 funding, £77 million was allocated at the Draft Budget in December,[4] while a further £682 million was allocated at the Final Budget released on 2 March. These allocations included:

- £380 million for the NHS;
- £207 million for Local Authority Hardship Fund;
- An additional £50 million for contact tracing;
- £10.5 billion for the Discretionary Assistance Fund in 2021-22.

The additional Covid-19 funding made available for the NHS and local authorities is for the first six months of 2021-22. As in 2020-21, local authorities will submit claims retrospectively for income lost and additional expenditure incurred because of Covid-19. The Final Budget also included a capital stimulus package of £224.5 million – partly funded by consequentials moved from 2020-21 to 2021-22 - primarily aimed at housing schemes and schools.

As shown in **Figure 6**, between the Draft and Final Budgets, the Welsh Government has allocated £787 million of core budget day-to-day spending, alongside Covid-19 allocations of £759 million. This left £610 million of unallocated day-to-day spending in Final Budget plans. With additional consequentials from the UK Budget and changes to projected devolved revenues (discussed below), this means **the Welsh Government currently has approximately £1.3 billion to allocate at future supplementary budgets.**

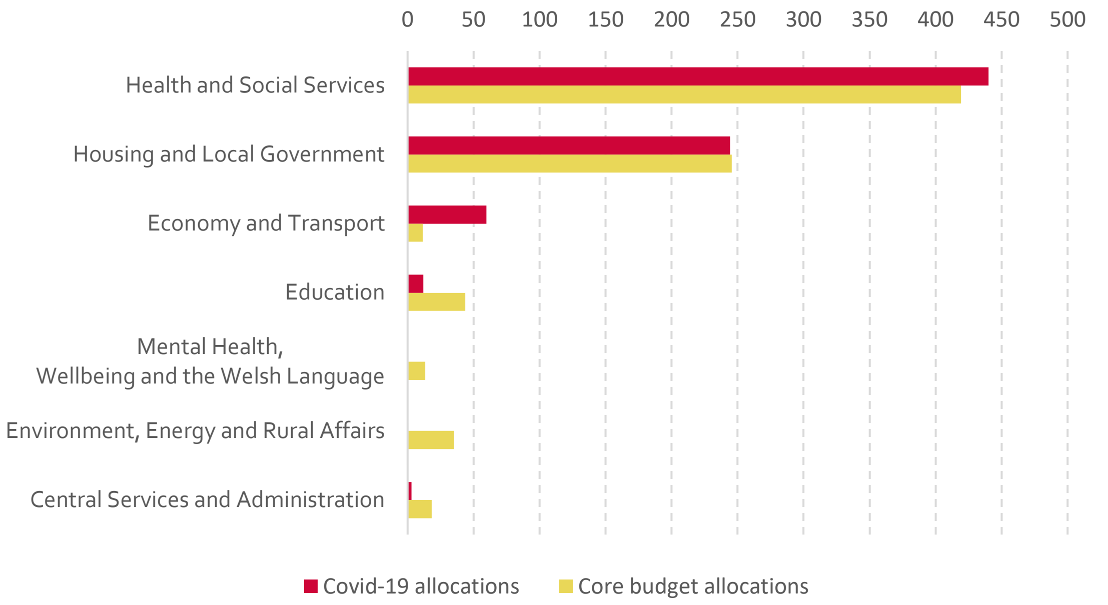
The confirmation of additional funding from the UK government prompted an immediate fiscal response by the Welsh Government. On 4 March, Finance Minister Rebecca Evans announced a tax relief package for retail, leisure, and hospitality businesses with a rateable value of up to £500,000, who will pay no non-domestic rates in 2021-22. Over 70,000 businesses are set to benefit from the scheme worth £380 million.

This differs to the scheme announced for England in several key respects. First, the UK only government offered 100% relief to retail, leisure, and hospitality premises for the first quarter of 2021–22, and 66% relief for the remaining three quarters. Second, the scheme in England will continue to be available for businesses with a rateable value of over £500,000 – although several large supermarkets and other retailers have repaid the rates relief, giving back an estimated £2bn to the UK Treasury.

[4] For a discussion of these allocations, see: https://www.cardiff.ac.uk/__data/assets/pdf_file/0007/2493862/draft_budget_analysis_final_1.pdf

Figure 6

Fiscal resource (day-to-day spending) allocations in Final Budget 2021-22, relative to (pre-Covid) Final Budget 2020-21 plans



Source: HM Treasury (2021) UK Budget 2021 documents; Welsh Government (2021) Final Budget 2021-22; and authors' calculations

A further package of business grant support from the Welsh Government is expected. The UK government package announced in the budget entailed non-essential retail businesses in England receiving one-off grants of up to £18,000, with businesses providing personal care (due to reopen at a later date) set to receive larger payments.

Devolved taxes

Alongside its Economic and Fiscal Outlook report, the OBR published an updated forecast for devolved taxes. These forecasts include the impact of UK government policies announced at the Budget and make use of the latest available outturn data, including real time Pay-As-You-Earn (PAYE) data published by HMRC.

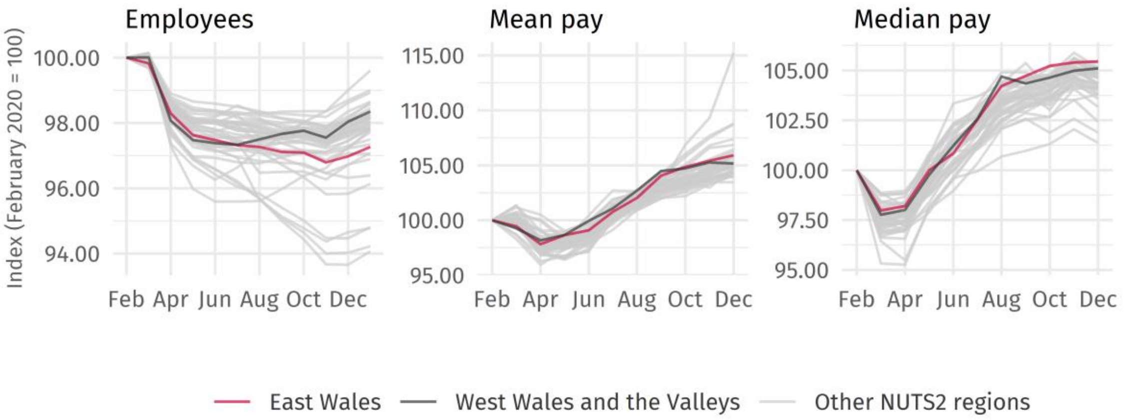
The forecast for UK income tax liabilities has been revised upwards since November 2020, primarily because of the impact of policies announced by the Chancellor. First, the decision to extend the Coronavirus Job Retention Scheme and the Self-Employed Income Support Scheme is expected to boost tax liabilities. Second, the decision to freeze the personal allowance and higher rate threshold in cash terms is expected to raise £2 billion across the UK in 2022-23, rising to £10 billion at the forecast horizon in 2025-26.[5]

These decisions boost the devolved tax take in Wales. However, the UK-wide increase in forecast tax revenue translates into larger Block Grant Adjustments (BGAs) – the deductions made to the block grant to account for the devolution of taxes to Wales. The impact of the changing forecasts for the Welsh budget will depend on the relative growth of devolved tax revenues relative to growth in the BGA.

As it turns out, there is some evidence to suggest Welsh earnings have held up better than other parts of the UK over the course of the pandemic. **Figure 7** shows real time data published by HMRC on the earnings and employment of payrolled workers for each of the 40 NUTS2 regions of the UK, indexed to February 2020. Since payrolled employees are responsible for paying the majority share of devolved income tax revenues, this offers a good preliminary indication of whether the Welsh tax take will suffer a relatively greater hit as a result of the pandemic.

Figure 7

Real time PAYE data for NUTS2 regions of the UK, Index (February 2020 = 100)



Source: WFA analysis of ONS (February 2021) Real times PAYE earnings and employment data.

In Wales, median and mean earnings are up around 5% on February 2020, above the UK average. Meanwhile the number of employees is around 2% lower, which is roughly in line with the UK average. According to the OBR, "earnings falls at the lower end of the pay distribution in Wales have been greater than the average falls seen at the UK level, whereas earnings have held up better at the higher end than they have on average across the UK".[6] Based on this data, the OBR assume that the portion of Income Tax that is devolved to Wales is expected to grow

[5] Office for Budget Responsibility (2021) *'Economic and fiscal outlook: March 2021'* Available here: https://obr.uk/download/march-2021-devolved-tax-and-spending-forecasts/ p.4
[6] https://obr.uk/download/march-2021-devolved-tax-and-spending-forecasts/ p.6

as a proportion of UK wide NS-ND (non-savings, non-dividend) revenues in the short term. Whilst the assumptions are uncertain, the forecasts assume that this is a temporary consequence of the pandemic and that the effect will unwind.

Also driving the Welsh share of UK NS-ND Income Tax upwards in the medium term is the asymmetric results of the UK government's decision to freeze the personal tax allowance. The OBR assume that since average incomes are lower in Wales, freezing the personal allowance will proportionally bring more people into the basic rate compared to the UK as a whole.[7]

Land Transaction Tax (LTT) revenues have also been revised upwards in each year of the forecast, driven by strong growth in property prices in the near term. The UK government opted to maintain the 0% rate for residential property transactions in England and Northern Ireland at £500,000 until the end of June. This threshold will fall to £250,000 in the second quarter of 2021-22 and will finally revert to its pre-pandemic level of £125,000 in October 2021.

Figure 8

Devolved tax forecasts, March 2021 (prior to the extension of the LTT holiday) and changes since December 2020

Source: OBR (March 2021) Devolved tax and spending forecasts; OBR (December 2020) Welsh Taxes Outlook. Does not include effects associated with the Welsh Government's extension of the temporary tax reduction period for LTT.

The Welsh Government announced that its temporary increase to the 0% band for Land Transaction Tax (£250,000) will be extended until the end of June, before reverting to its pre-pandemic level of £180,000.[8] This policy was not announced until after the OBR had published its devolved tax forecasts. Transactions data published by the Welsh Revenue Authority shows that in December 2020, 1,060 transactions benefitted from the increase to the threshold at a

[7] https://obr.uk/download/march-2021-devolved-tax-and-spending-forecasts/ p.10
[8] https://gov.wales/written-statement-land-transaction-tax-extension-temporary-tax-reduction-period

cost of roughly £1.4 million. Based on this figure, we can assume the cost of a further three-month extension is likely to be relatively modest.

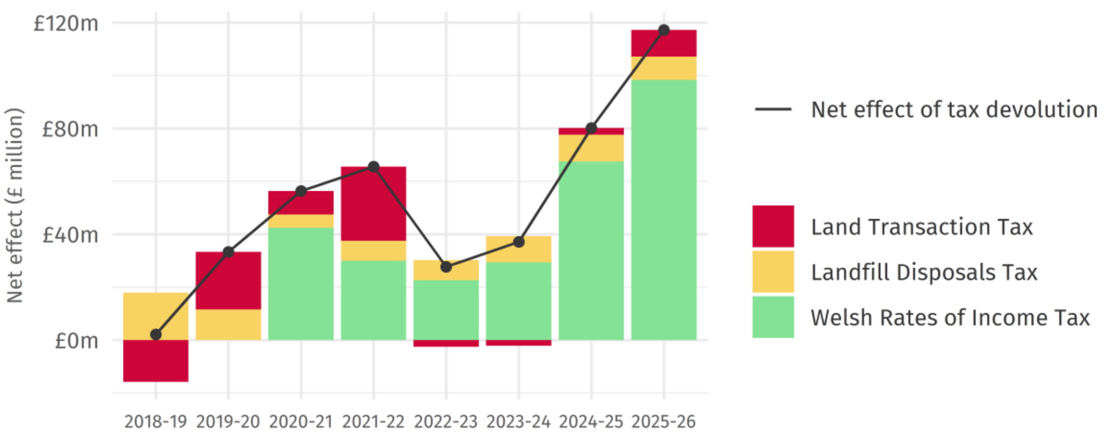
The forecast for Landfill Disposals Tax has also been revised upwards slightly in the near term, reflecting stronger than expected outturn data. **Figure 8** shows the latest devolved tax forecasts, and changes since the December 2020 forecasts, which accompanied the Welsh Government's draft budget for 2021-22.

Based on these figures, and the forecasts for equivalent revenues in England and Northern Ireland, we can estimate the budgetary impact of tax devolution on the Welsh budget in future years. The growth of devolved income tax revenues as a proportion of the UK NS-ND Income Tax take is the main driver of the positive budgetary effect shown in **Figure 9**. Devolved tax revenues are forecast to exceed the block grant adjustment by nearly £120 million in 2025-26. Though as always, these figures will almost certainly be revised in future forecasts.

In 2021-22, this represents a significant turnaround in the net effect of tax devolution from the December 2020 forecasts. At that point, tax devolution had a negative net effect of around £25 million in 2021-22, compared to the projected positive effect of £66 million in the latest forecasts. While figures for Land Transaction Tax and Landfill Disposals Tax are adjusted in-year to account for updated forecasts, Income Tax revenues and the accompanying BGA are locked in at the start of the financial year. Any difference between the forecast and the outturn will not be resolved until the reconciliation exercise – around 15 months after the end of the financial year.

Figure 9

Forecast budgetary impact of tax devolution on the Welsh Budget



Source: WFA analysis of OBR (March 2021) Devolved tax and spending forecasts. Does not include effects associated with the Welsh Government's extension of the temporary tax reduction period for LTT.

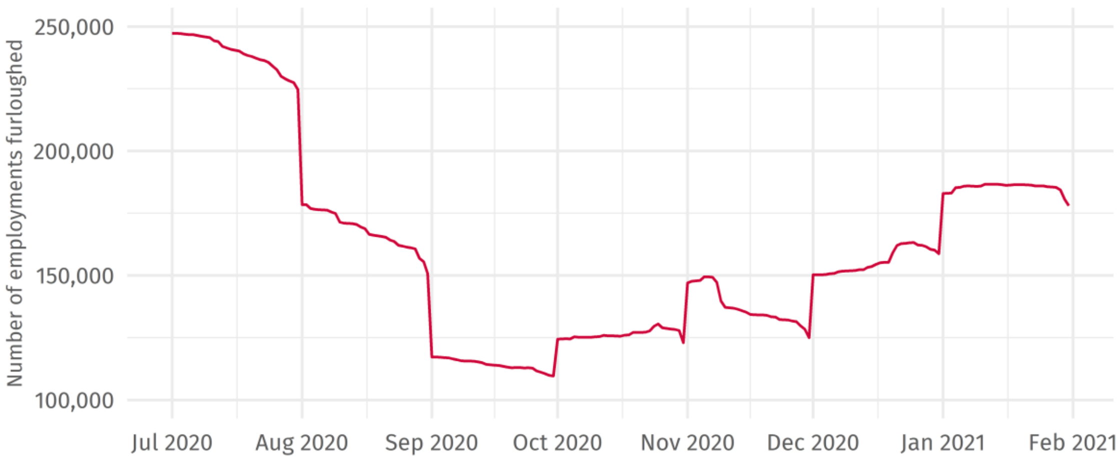
UK Government spending in Wales

One of the most anticipated announcements in the Chancellor's Budget speech was the decision to extend the Coronavirus Job Retention Scheme and the Self Employment Income Support Scheme until the end of September 2021. Employees who are furloughed will continue to be paid 80% of their wages throughout this period, while employers will be asked to contribute 10% towards the hours their staff do not work in July, increasing to 20% in August and September. At the end of January, 178,000 employments were furloughed in Wales, equivalent to 12% of the workforce. This is an increase of 70,000 compared to the end of September 2020 (**Figure 10**).

The Chancellor also announced a six-month extension to the £20/week uplift to Universal Credit. We estimate around 21% of Welsh households (290,000) will benefit from this policy, including three-quarters of single parent households.[9] Around 6% of households benefit from an increase in their disposable income of 5% or more as a result of this policy. But the (delayed) cliff-edge to this support remains in place. On current spending plans, the uplift will be reversed at the end of September, when the furlough and other income support schemes are also set to expire.

Figure 10

Employments furloughed in Wales, July 2020 – January 2021



Source: HRMC (2021) HMRC Covid-19 Statistics

The Chancellor devoted a third and final part of his speech to 'building our future economy'. On this note, the Budget provided additional information on several funds, which will now be run

[9] The results presented here are based on UKMOD version A2.0+. UKMOD is maintained, developed, and managed by the Institute for Social and Economic Research (ISER) at the University of Essex. The process of extending and updating UKMOD is financially supported by the Nuffield Foundation, based on the annual update of the UK component of EUROMOD funded by the European Union Programme for Employment and Social Innovation "EaSI" (2014-2020). The results and their interpretation are the authors' responsibility.

by the UK government across the UK. In Scotland, Wales and Northern Ireland, the UK government intends to use the new financial assistance powers included in the UK Internal Market Act. These include the Levelling Up Fund, the Community Renewal Fund (a precursor to the forthcoming Shared Prosperity Fund), and the Community Ownership Fund. Based on proposed spending in 2021-22, a Welsh-population share of these funds would amount to roughly £47 million. Actual distribution of funds from the Levelling Up Fund and Community Renewal Fund will be based on bids led by local authorities, with each area assessed in terms priority for funding. 17 Welsh Local Authorities are in Category 1 (highest priority) for the Levelling Up Fund, while 14 of the 100 priority places for the Community Renewal Fund are in Wales.

A further £58 million was allocated to three regional growth deals in Wales over five years, with £11.6 million allocated in 2021-22. The Chancellor also announced match-funding worth £34.8 million over four years (~£12.3 million in 2021–22) for a Hydrogen Hub in Holyhead and a Global Centre for Rail Excellence in Neath Port Talbot and Powys.

Taking a population share of the three UK-wide funds and adding the funding for City Deals and the two match-funding projects, the Budget implies additional UK government investment in Wales of approximately £70 million in 2021-22. This amounts to less than 0.1% of Wales' pre-pandemic GDP.

The Chancellor also announced a new UK-wide investment bank with the intention of boosting private sector investment in UK infrastructure. However, the levels of annual lending forecast fall significantly short of its predecessor, the European Investment Bank. When fully operational, the UK Investment Bank is expected to lend around 0.08% of UK GDP annually. This compares to the 0.3% of UK GDP lent at the height of the European Investment Bank's operations.[10]

Lastly, one of the main announcements of the budget was the creation of eight new 'freeports' in England. These 'regional hubs for trade, innovation and commerce' will benefit from simplified customs procedures, concentrated government support and temporary tax breaks. The Chancellor said the UK government would work with the devolved governments to establish free ports in Wales, Scotland, and Northern Ireland. The cost of these proposals was not contained in the budget, as they came too late to be incorporated into the OBR's forecasts. It is reported the Welsh Government is being offered a Barnett-based share of the seed funding for ports in England, of around £8 million. The Welsh Government's competency over planning and devolved taxes means they will have a significant say over whether a freeport is established in Wales or not. The Welsh Government will need to balance the potential boost to economic activity in Wales with the risk of merely displacing economic activity from elsewhere in Wales at significant cost to the taxpayer.

[10] https://obr.uk/download/economic-and-fiscal-outlook-march-2021/ p.159

Conclusion

The welcome extension of economic support in the 2021 UK budget will provide vital support to maintain incomes and avoid job losses for the next six months. If the much lower projected unemployment levels are realised, then this would be a testament to the success of these support measures. However, away from immediate pandemic support for the economy, promises of 'levelling up' across the UK may well fall short given current projected funding levels over coming years.

The budget decisions mean the Welsh Government now has substantial fiscal firepower in 2021-22 to respond to the pandemic and will need to make significant additional allocations on top of Final Budget plans. However, the better news on forecast devolved taxes is outweighed by the tight outlook for the Welsh budget after 2021-22. The proposed cuts to pre-pandemic spending plans look implausible in the face of likely significant pressures on public services. On this front, it was significant that the Chancellor reiterated the manifesto commitment of not raising the main rates of income tax, VAT or National Insurance, the obvious way for revenues to be increased.

This Budget should therefore set the context for debates ahead of the Welsh election in May over the devolved tax and spend choices facing the next Welsh Government.

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