

The medium-term fiscal outlook for local government in Wales

BRIEFING NOTE

OCTOBER 2023

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, Solace Wales, and the Wales Council for Voluntary Action. 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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Fiscal outlook for local government services in Wales

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Over recent months, there have been increasing concerns raised about the financial sustainability of Welsh local authorities. Research by the BBC found that 20 Welsh councils expect a combined shortfall of £395 million over the next two years.¹ The Welsh Local Government Association estimate a budget gap could open up of between £330 million to £480 million next year, with “serious impact on local service delivery”. The Senedd’s Local Government and Housing Committee recently warned that immediate and long-term extra funding is needed to stop leisure centres and libraries from closing.²

Meanwhile, the Welsh Government has described its budgetary position as “the most difficult financial situation since the dawn of devolution”.³ Cabinet ministers were asked over the summer to mitigate budgetary pressures in 2023-24 and in preparation for the 2024-25 budget round.⁴

While core local government funding was spared from in-year cuts this year,⁵ tight public spending plans over coming years paint a worrying picture for the medium-term. This short briefing analyses the fiscal outlook for day-to-day spending by local authorities in Wales.

Summary

- We estimate that spending pressures have outstripped the growth in local government revenues over the last two years, despite significant nominal terms increases in funding from the Welsh Government. A key driver has been substantial pay increases for local government staff and teachers, despite many workers still seeing real terms pay cuts. In response, local authorities have mitigated pressures by drawing down significantly from their reserves (built up during the previous two years) and Council Tax increases averaging 5.8% in 2023-24.
- The local government settlement is set to increase by 3.1% next year. Even with Council Tax increases of 5% and with inflation and pay increases falling, we estimate a funding gap of £354 million will open up in 2024-25 - i.e. a shortfall in the funding required to meet spending pressures and maintain existing service provision (relative to our 2021-22 baseline). Consequentials from the Spring Budget 2023 and

¹ <https://www.bbc.co.uk/news/uk-wales-politics-66580660>

² <https://senedd.wales/media/3fdmwwiv/cr-ld15967-e.pdf>

³ <https://www.bbc.co.uk/news/uk-wales-politics-66580660>

⁴ <https://www.gov.wales/written-statement-update-about-budget-2023-24>

⁵ <https://www.gov.wales/update-on-2023-2024-financial-position-summary-of-main-changes>

better-than-forecast devolved tax revenues means some funding may be available for the Welsh Government to support local authorities in 2024-25.

- Based on current, indicative UK government spending plans, the Welsh Government's resource budget is set to increase by just 0.8% per year on average between 2024-25 and 2027-28 (in real terms). Beyond increasing health, schools, and childcare spending, we estimate the Welsh Government will need to find cuts of £318 million in cash terms by 2027-28 in all other spending areas.
- Under our assumptions, total local government funding from the Welsh Government is set to fall slightly in nominal terms (by an average of -0.2% per year) over the years 2025-26 to 2027-28. That would mean a 4.3% reduction in real terms over the three years.
- With Council Tax increases of 5%, we estimate gross revenue expenditure would grow by an average of 1.1% per year over the three years to 2027-28 (in nominal terms). Given the outlook for grant funding, local authority budgets are likely to become more dependent on Council Tax revenues. Including the planned increase in grant funding next year, we estimate over four-fifths of the increase in local government resource revenues by 2027-28 will derive from increasing Council Tax revenues.
- Further use of reserves, higher than 5% Council Tax increases, and/or further funding from the Welsh Government could mitigate the projected funding gap in 2024-25. However, under our central scenario for funding over future years, local authority finances appear to be on an unsustainable path, with the funding gap growing in each year of the projection. Relative to our base year of 2021-22, the funding gap could grow to £744 million by 2027-28.
- While the economic and fiscal context could radically change, our projections of spending pressures and funding suggest there could be significant reductions in local services over coming years. With the current UK government and opposition Labour party refusing to commit to additional spending on public services, the Welsh Government and local authorities must now weigh up the difficult choices that may lie ahead.

Local government funding in 2023-24 and 2024-25

Back in December 2021 - when the Welsh Government first set out its indicative plans for local government funding to 2024-25 - the outlook was in stark contrast to the previous decade of austerity budgets. In nominal terms, increases in core local authority revenues were among the most substantial since devolution, with Aggregate External Finance increasing by 9.4% in 2022-23 and 7.9% in 2023-24. However, as with all areas of public spending, higher-than-forecast inflation has significantly reduced the real terms value of these settlements, with local budgets facing huge unforeseen cost pressures. Including specific grants, total Welsh Government resource funding for local government only increased by 3.6% in real terms this year (or by 2.1% using the CPI measure of inflation).

A big driver of additional pressures has been the increases in pay for local government staff and teachers, despite much of the workforce seeing real terms pay cuts. Local government staff pay scales increased by £1,920 in 2022-23 and 2023-24, which we estimate meant average increases of 7.2% per year. The Welsh Government also announced teacher pay deals of 6.5% for the 2022-23 academic year and 5% in 2023-24. As explored in the final section of this briefing, we estimate that spending pressures have outstripped local government revenues during the past two years.

After setting lower Council Tax increases of 2.2% in 2022-23, local authorities increased levels by an average of 5.8% in 2023-24, a trend that is likely to continue. Budget data suggests local authorities are also using appropriations from their reserves, worth £137 million and £193 million in 2022-23 and 2023-24 respectively, which were built up during the previous two years.

For 2024-25, the core local government revenue settlement is currently set to increase by 3.1%. Even with inflation levels rapidly falling and assuming Council Tax increases of 5%, funding is unlikely to keep pace with spending pressures. There may be some scope for further funding from the Welsh Government in 2024-25. For example, consequential from the Spring Budget 2023 amounted to £139 million in 2024-25, mainly from the childcare announcements in England. The latest forecasts for devolved taxes and block grant adjustments also suggests £88 million more for the Welsh Government to spend than is currently budgeted for, while outturn data for income tax revenues in 2021-22 could result in a positive reconciliation of £38 million in 2024-25. These factors will be confirmed at the UK government's Autumn Statement.

However, with significant pressures across all areas of the Welsh budget, local authorities are again likely to draw down reserves to meet funding pressures in 2024-25. This briefing focuses on the current fiscal outlook for the years beyond 2024-25, looking at medium-term sustainability.

Beyond 2024-25 – the medium-term outlook

UK government current spending plans

Beyond the current Spending Review period, there are no published, detailed plans for UK government departmental spending, so the size of the Welsh block grant beyond 2024-25 is unknown. This section outlines the UK fiscal outlook and the implications of the UK government’s indicative spending plans for the years 2025-26 to 2027-28.

Over recent years, slower growth and higher interest rates have negatively affected the public finances. In the aftermath of the “mini budget” of September 2022, the current Chancellor, Jeremy Hunt, announced a package of fiscal consolidation measures at the Autumn Statement 2022. Indicative departmental spending plans were reigned back from previous plans. However, most of the spending cuts were pencilled in for only the last three years of the five-year forecast period, and beyond the date of the next UK General Election. Despite a relatively optimistic forecast from the Office for Budget Responsibility and plans to increase taxes to nearly 38% of GDP by 2027-28, the government’s fiscal rules are barely met on current plans. The very small fiscal “headroom” against these targets could be wiped out by tiny changes in forecasts. Alternatively, the recent upward revisions to UK GDP could provide a fiscal boost for the Chancellor ahead of the Autumn Statement.⁶

Departmental spending is set to grow by just 1% a year in real terms from 2024-25 to 2027-28. We make several assumptions on the distribution of this spending to project the size of the Welsh block grant. We assume that:

- NHS spending increases in line with the historical average increase (of 3.6%) and in line with the implications of the NHS workforce plan;⁷
- Schools spending is held flat in real terms;
- Childcare spending grows in line with the policy announcements at the Spring Budget 2023 (growing by 12.2% per year in real terms);
- UK defence spending grows to 2.5% of GDP by 2030;
- Overseas aid spending is maintained at 0.5% of GDP.

These assumptions have big implications for other “non-protected” spending areas which would likely see real terms cuts – we assume these spending areas grow uniformly over the forecast period. From these assumed spending plans, we model the additional funding the Welsh Government would receive through the Barnett formula.

⁶ <https://www.ft.com/content/50386cc2-003b-4af1-946b-cf3243da810f>

⁷ See: Warner and Zaranko (2023) Implications of the NHS workforce plan, Institute for Fiscal Studies. Available from : <https://ifs.org.uk/publications/implications-nhs-workforce-plan#:~:text=The%20plan%20aims%20to%20increase,%25%20and%203.4%25%20per%20year.>

Alternative scenario

These projections are of course subject to massive uncertainty. The fiscal forecasts are likely to significantly change before firm spending plans are set. Spending will also be influenced by the priorities of the government formed after the next UK General Election. The tight spending plans have arguably been set to “flatter” the medium-term public finances – the feasibility of implementing cuts to many areas of spending after 2024-25 is questionable, given the state of many public services. As a result, it would be sensible to consider other plausible paths for UK government public spending.

We therefore project an alternative scenario where spending grows faster after 2024-25. Specifically, we assume that departmental spending grows by 2% in real terms per year - similar to plans outlined at the March 2022 budget, before the fiscal consolidation measures of the Autumn Statement 2022. This would mean that the UK government’s resource DEL would be £4.8 billion higher in 2025-26, £9.4 billion higher in 2026-27, and £14.2 billion higher in 2027-28 (in nominal terms). We maintain our previous assumptions for spending commitments on the NHS, schools, childcare, defence, and overseas aid. The modelled increase in spending therefore affects spending in “unprotected areas” which would grow over the three-year period.

Welsh Government budget outlook and options

Combining the projections for the Welsh resource block grant set out above with the latest forecasts for devolved taxes, we can outline the budget outlook for the Welsh Government’s day-to-day spending beyond 2024-25. The outlook by source of funding under current spending plans is set out in **Figure A1** in the annex of this briefing. The block grant (before the Block Grant Adjustment) is set to increase by 2.0% in 2025-26, 2.2% in 2026-27 and 2.8% in 2027-28 (in cash terms).

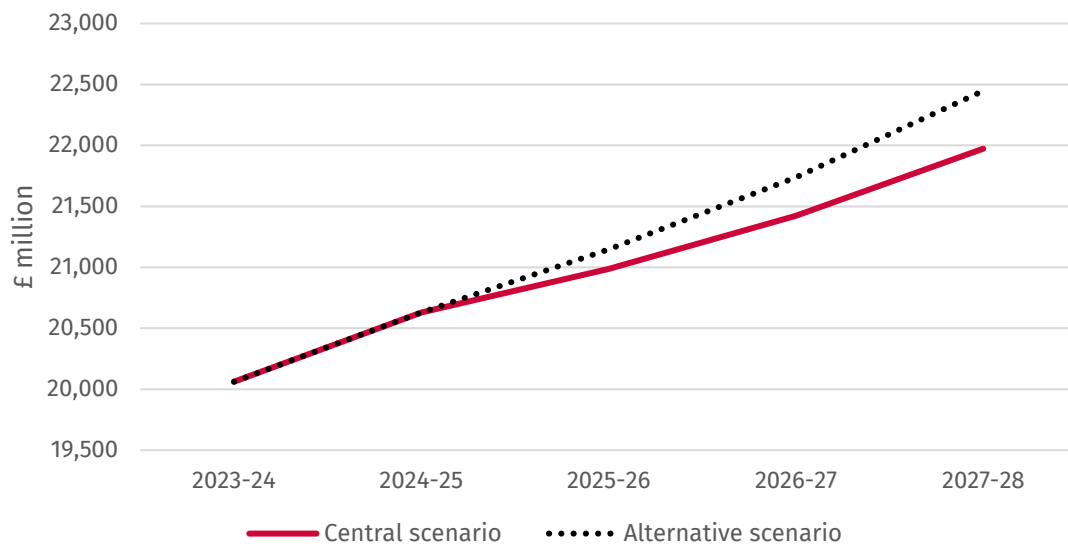
We estimate the overall positive net effect of tax devolution on the Welsh Budget will average £292 million per year between 2025-26 and 2027-28 under current forecasts. After subtracting the Block Grant Adjustment (linked to comparable UK government revenues in England) and adding in devolved financing, **the Welsh Government’s resource budget is set to increase by 1.7% in 2025-26, 2.1% in 2026-27 and 2.6% in 2027-28 (in cash terms). In real terms, these increases average 0.8% over the projection period.**⁸

⁸ Projected reconciliations to outturn data for income tax revenues over recent years (to address forecast errors) increase the Welsh budget significantly in 2024-25, and lesser amounts in later years. This lowers the increase in the overall Welsh resource budget compared to the projected increase in the block grant (albeit from a higher level).

Figure 1 also shows the projected resource budget under the ‘alternative scenario’ outlined above. Relative to the central scenario, this would increase the block grant by around £160 million in 2025-26, £314 million in 2026-27, and £474 million in 2027-28. The real terms increase in the overall resource budget would average 1.5% over the projection period.

Figure 1

Projected Welsh Government resource budget (nominal terms), 2023-24 to 2027-28

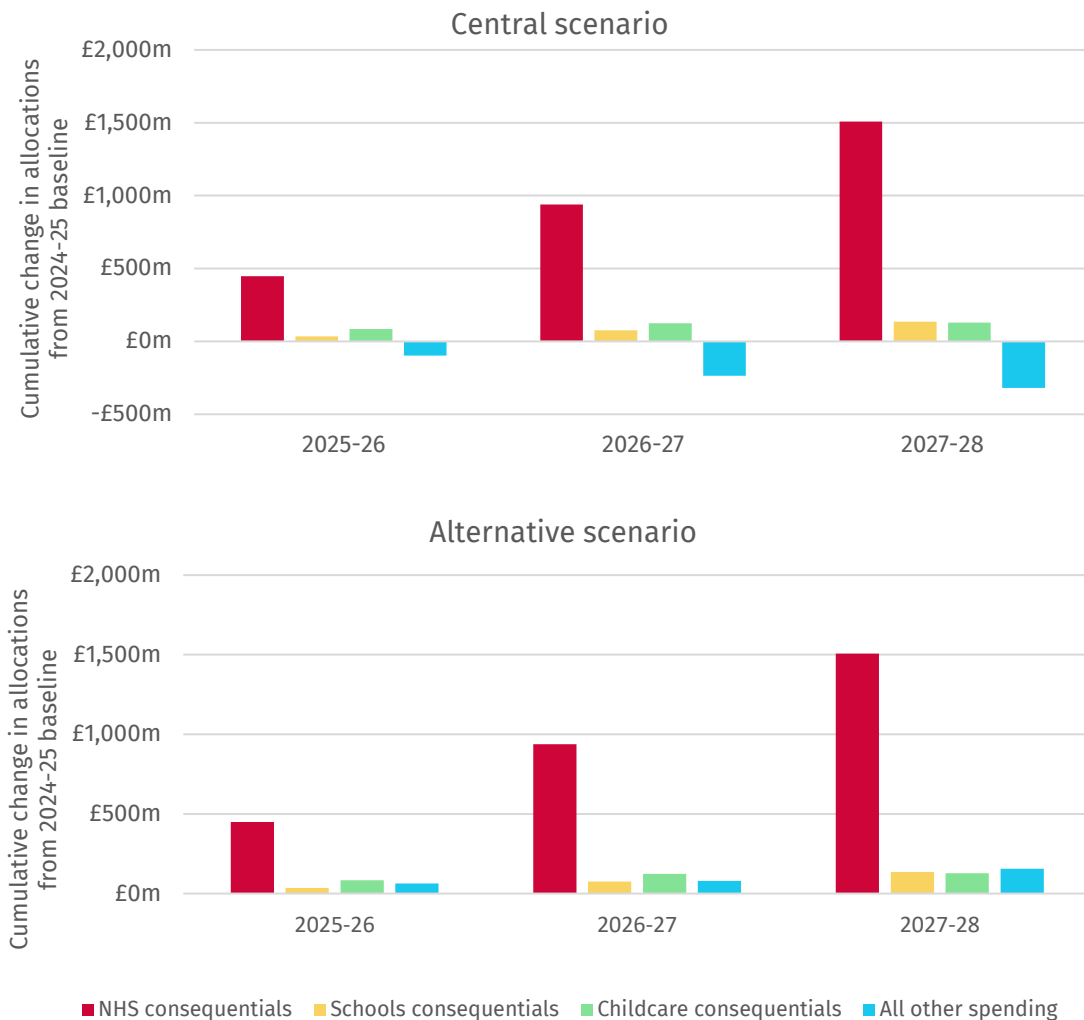


Source: Wales Fiscal Analysis calculations based on HM Treasury (2023) Block Grant Transparency July 2023; HM Treasury (2023) Spring Budget 2023. ● Notes: See main text for assumptions made in projections. Projections are for Welsh Government resource DEL (including Non-Domestic Rates revenues).

To explore what this outlook means for public services, we make two assumptions. Firstly, we assume the Welsh Government doesn’t change devolved tax policies. Secondly, that the Welsh Government broadly follows the UK government’s spending patterns: ‘passing on’ consequential to the NHS and schools and increasing childcare spending in line with additional consequential from UK announcements. **Figure 2** shows the indicative additional allocations (relative to 2024-25 budget allocations) these assumptions would imply. Under our central scenario, **allocations to the NHS would increase by £1.5 billion from 2024-25 to 2027-28 in cash terms (equivalent to 3.7% increases in real terms)**, with smaller increases in schools spending. The additional childcare consequential would total £256 million in 2027-28 (up £128 million from 2024-25). **This would mean the Welsh Government would need to find £363 million of cuts in all other areas of spending by 2027-28 (in nominal terms)**. Under our alternative scenario, the Welsh Government would be able to marginally increase spending in these areas in cash terms by 2027-28.

Figure 2

Indicative additional allocations from 2024-25 baseline (nominal terms)



Source: Wales Fiscal Analysis calculations. ● Notes: See main body of text for assumptions made. Projections are for Welsh Government resource DEL allocations (including redistributed Non Domestic Rates revenues).

In terms of overall funding to Welsh local authorities, we assume schools spending consequential are passed on to local budgets and the Welsh Government grows all other local government funding in line with “non-protected” spending areas.⁹ We assume that Aggregate External Finance (which includes the Revenue Support Grant and re-distributed Non-Domestic Rates revenues) and specific grant funding grow at the same rate from 2024-25 onwards to calculate overall grant funding to local authorities.

⁹ We take schools spending as education specific grants and a share of Aggregate External Finance.

Figure 3

Projected Welsh Government grant funding to local authorities, 2023-24 to 2027-28 (£ million)

	Projection period				
	2023-24	2024-25	2025-26	2026-27	2027-28
Central scenario					
Aggregate External Finance (Revenue Support Grant and NDR revenues)	5,520	5,688	5,674	5,647	5,659
Increase (£m)		168	-15	-27	12
Nominal terms increase		3.1%	-0.3%	-0.5%	0.2%
Real terms increase		1.4%	-1.2%	-1.7%	-1.5%
Specific Grant funding	1,301	1,258	1,255	1,249	1,251
Total Welsh Government grant funding	6,821	6,946	6,928	6,895	6,910
Increase (£m)		126	-18	-33	15
Nominal terms increase		1.8%	-0.3%	-0.5%	0.2%
Real terms increase		0.2%	-1.2%	-1.7%	-1.5%
Alternative scenario					
Aggregate External Finance (Revenue Support Grant and NDR revenues)	5,520	5,688	5,745	5,786	5,869
Increase (£m)		168	56	41	83
Nominal terms increase		3.1%	1.0%	0.7%	1.4%
Real terms increase		1.4%	0.0%	-0.5%	-0.3%
Specific Grant funding	1,301	1,258	1,270	1,279	1,298
Total Welsh Government grant funding	6,821	6,946	7,015	7,065	7,167
Increase (£m)		125	69	50	102
Nominal terms increase		1.8%	1.0%	0.7%	1.4%
Real terms increase		0.2%	0.0%	-0.5%	-0.3%

Source: Wales Fiscal Analysis calculations. ● Notes: Increases refer to year-on-year changes. Real terms changes calculated using GDP deflator forecasts from Office for Budget Responsibility (2023). Specific grants for 2023-24 and 2024-25 based on Final Local Government Settlement for 2023-24, which may understate total where grants are TBC. 2023-24 figure excludes NDR reliefs for hospitality industry (included in AEF).

As outlined in **Figure 3**, under our central scenario, total local government funding is set to fall slightly in nominal terms (by an average of -0.2% per year) over the years 2025-26 to 2027-28. Using forecast GDP deflator measure of inflation, that would mean a total fall of 4.3% in real terms over the three years.

Under our alternative scenario, projected total funding would grow by an average of 1% per year from 2024-25 to 2027-28. However, after accounting for inflation, funding would still fall by -0.7% in the three years to 2027-28.

Outlook for local government budgets

In either of the funding scenarios outlined above, local authority budgets face a difficult medium-term outlook. It is likely that budgets will become more dependent on Council Tax over coming years. For simplicity, we assume Council Tax increases of 5% a year in Wales over the forecast period – in line with the revised referendum limits for Council Tax increases in England for 2023-24 and 2024-25.

The core local finance settlement is set to increase by 3.1% next year. Accounting for a fall in specific grants, total grant funding is set to increase by 1.8% - but this increase could be higher once all specific grants are confirmed. With Council Tax increases averaging 5%, total resource funding would increase by 2.6% in nominal terms in 2024-25, or £214 million. With inflation forecast to fall to 1.6% in 2024-25, this would mean a real terms increase in resource revenues of 0.9%.

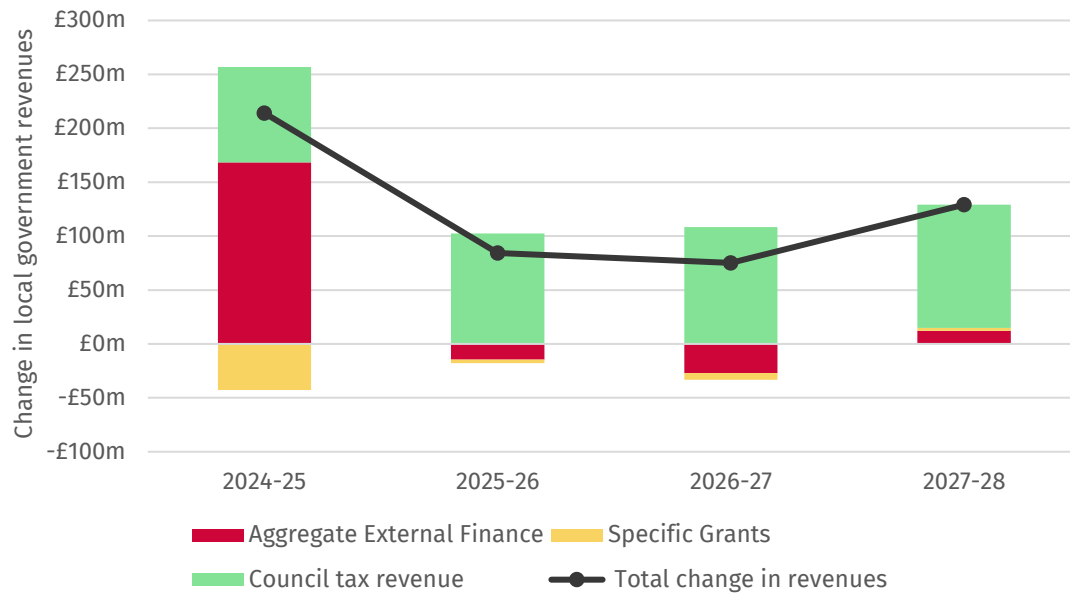
However, as explored earlier, budgets for the current year are set to be boosted by appropriations from local authority reserves of £193 million. If local authorities do not further draw-down their reserves in 2024-25, then the overall change in gross revenue expenditure would amount to just 0.3% in nominal terms.

Beyond 2024-25, under our assumptions, increases in local authority budgets will be solely driven by council tax increases (as shown in **Figure 4**). Including the increase in funding next year, we estimate that **over four-fifths of the increase in local government resource revenues to 2027-28 will come from council tax revenue increases.**

Gross revenue expenditure would grow by an average of 1.1% per year in the years 2025-26 to 2027-28 (in nominal terms). After accounting for forecast inflation, this would amount to an average fall of -0.2% in spending per year. Under our alternative scenario, gross revenue expenditure would increase by an average of 2.0% per year in nominal terms from 2024-25 to 2027-28, or 0.7% in real terms.

Figure 4

Changes in local government resource funding, central scenario (year-on-year)



Source: Wales Fiscal Analysis calculations. ● Notes: Some specific grants in 2024-25 have yet to be confirmed.

To put these funding projections in context, we model the total spending pressures that local authorities could face, making assumptions on demand drivers (such as population or pupil number projections) and cost drivers (such as pay deals). Our base year for our projections is the most recent 2021-22 spending outturn data (excluding pandemic-related spending). For a full methodology and discussion of our projections of spending pressures, see the annex of the Welsh Budget Outlook 2022 report.¹⁰ The major difference relative to our previous projections in December 2022 is updated assumptions on pay to reflect pay offers to local government staff and teachers in 2022-23 and 2023-24.

By comparing the projected increase in spending pressures with our projections of funding, we estimate the “funding gap” facing local authority budgets, i.e. the shortfall in funding required to meet pressures and maintain existing service provision. Our projections suggest a substantial funding gap has opened since 2021-22 – as shown in **Figure 5**. As explored earlier, local authorities have significantly mitigated this shortfall by budgeting to draw down on reserves in 2022-23 and 2023-24.

In 2024-25, we estimate that spending pressures will grow by a further 3.8%, while projected funding increases by 0.3% (without further appropriations from local authority reserves).

This would increase the projected funding gap to £354 million. Our assumption for pay

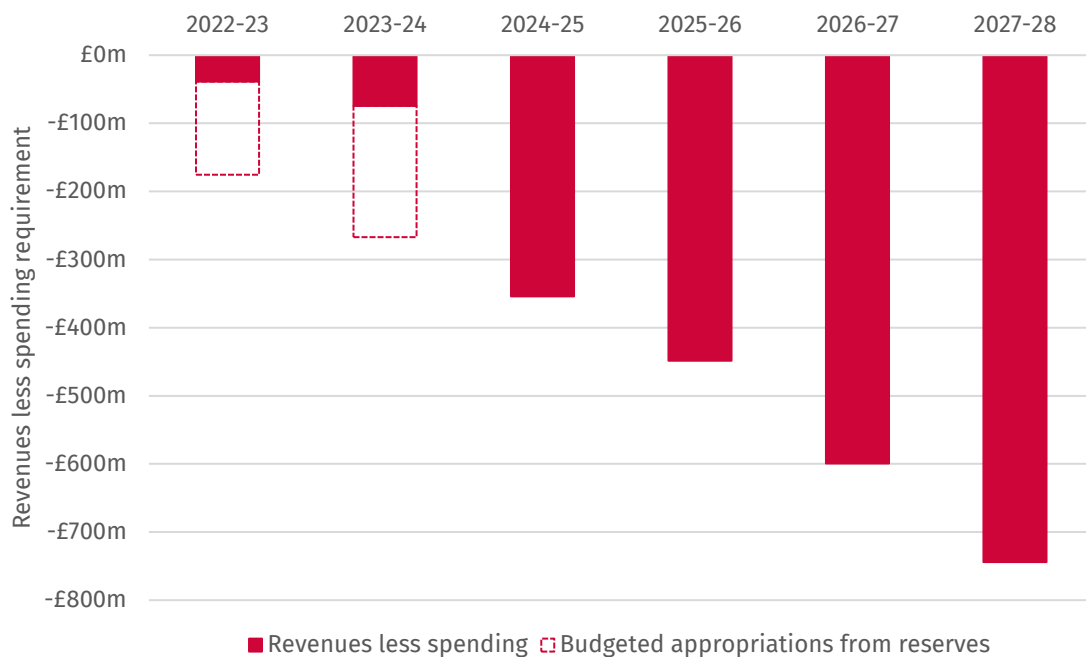
¹⁰ https://www.cardiff.ac.uk/data/assets/pdf_file/0007/2688199/wbo_2022_full_report_final.pdf

increases in 2023-24 is taken from the forecast for economy-wide average earnings growth from the Office for Budget Responsibility. They currently forecast earnings growth of 1.7%, with CPI inflation set to fall to 0.6%. However, the funding gap would be considerably larger if the growth in local government pay remains elevated. **Pay increases averaging 3.7% instead would result in a projected funding gap of £443 million in 2023-24.**

Further use of reserves, higher than 5% council tax increases, and/or further funding from the Welsh Government could reduce this projected funding gap in 2024-25. However, as shown in **Figure 5**, under our central scenario for funding over future years, local authority finances appear to be on an unsustainable path, with the funding gap growing in each year of the projection. The funding gap in 2027-28 could grow to £744 million (relative to 2021-22), although there are very substantial uncertainties around the projections. Under our alternative scenario for funding presented above, the additional funding in later years of the projections would mean the funding gap levelling out at approximately £418 million.

Figure 5

Local authorities' projected 'funding gap' relative to 2021-22 baseline



Source: Wales Fiscal Analysis calculations. ● Notes: See main text for assumptions made in these projections.

Conclusion

The projections outlined in the briefing suggest a difficult medium-term outlook for Welsh local authority budgets. Inflation and pay rises are set to fall over coming years, but spending pressures are still likely to outstrip projected increases in funding. This could result in cuts to local services. In the context of the deep cuts in spending since 2010, the feasibility of achieving these further cuts to services remains questionable. Any increases in local authority budgets are likely to come from higher levels of Council Tax, a highly regressive source of additional tax revenue. This makes the case for Council Tax reform even more urgent and should again encourage policy makers to revisit the question of whether to instead use the more progressive lever of raising revenues, namely devolved income tax increases.

Of course, as has been the case over recent years, the economic and fiscal context could radically change. The recent revisions in UK GDP shows the inherent uncertainty in fiscal plans and forecasts. Following a UK General Election next year, a different government could set an alternative path for public spending. However, with the current UK government and opposition Labour party refusing to commit to additional spending on public services, the Welsh Government and local authorities must now weigh up the difficult choices that may lie ahead.

Annex

Figure A1

Welsh Government resource DEL, by source of funding (central scenario)

Year:	Projection period				
	2023-24	2024-25	2025-26	2026-27	2027-28
Block Grant - before BGA	18,916	19,174	19,557	19,997	20,548
<i>Annual change</i>		1.4%	2.0%	2.2%	2.8%
<i>of which: non-Barnett funding</i>	320	342	342	342	342
<i>of which: IFRS16 changes</i>	-100	-117			
Block Grant Adjustment (inc. reconciliations)	-2,928	-3,327	-3,315	-3,415	-3,515
Block Grant - after BGA	15,988	15,847	16,242	16,583	17,033
Drawdown from the Wales Reserve	66	30			
Non-Domestic Rates	906	1,121	1,150	1,150	1,158
WRIT revenues	2,766	2,982	3,081	3,202	3,344
Reconciliation (projected)		338	164	91	0
Land Transaction Tax	300	283	327	379	425
Landfill Disposals Tax	41	39	37	36	36
Principal repayment of borrowing	-4	-11	-14	-18	-22
Total devolved funding	4,073	4,783	4,746	4,840	4,940
Total resource funding	20,062	20,630	20,988	21,423	21,973
<i>Nominal terms annual changes</i>		2.8%	1.7%	2.1%	2.6%
Total resource funding (2023-24 prices)	20,062	20,306	20,453	20,629	20,805
<i>Real-term annual changes</i>		1.2%	0.7%	0.9%	0.9%

Source: Authors' calculations – see main text for assumptions made • Notes: Block Grant Adjustments include projected income tax reconciliations in years 2024-25 to 2025-26. No assumptions on drawdown from Wales Reserve after 2024-25.

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