Prifysgol Caerdydd
Cardiff University

Dadansoddi Cyllid Cymru
Wales Fiscal Analysis

Welsh Budget Outlook 2021

GUTO IFAN & CIAN SIÔN

DECEMBER 2021

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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Wales Fiscal Analysis
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Executive Summary

The outlook for the Welsh budget has been transformed over recent months, with a substantial amount of additional funding available for day-to-day spending on public services next year than previously expected. However, many areas of the budget face major cost and demand pressures, during a challenging economic period.

Against this backdrop we present the second annual Welsh Budget Outlook report, setting out the outlook for devolved and local spending, analysing spending pressures, examining the budgetary impact of devolved and local taxes, and exploring policy options over coming years.

Economic and fiscal outlook

- The Office for Budget Responsibility (OBR) recently revised down its judgement on the extent to which the pandemic has done lasting damage to the economy from 3 per cent to 2 per cent. Unemployment is now expected to peak at 5.2% in the near term – down from the 6.5% peak forecast in March 2021.
- Since September 2019, Wales has consistently recorded a lower unemployment rate than the UK average and has seen a faster recovery in employee numbers compared to the UK average over the past 21 months. On the face of it, a furlough "cliff-edge" has been avoided.
- The OBR forecasts that CPI inflation is set to peak at 4.4% in the second quarter of 2022, before slowing to 2.3% in 2023-24. Importantly, they also note that rises in fuel and energy prices since their forecasts were made are "consistent with inflation peaking at close to 5% next year".
- The outlook for household finances remains challenging. The squeeze on household incomes is likely to be felt particularly acutely due to the combination of price increases, planned tax rises, as well as the reversal of the £20 a week uplift to Universal Credit.

UK Budget and Spending Review 2021

- The improved economic outlook, as well as departmental underspending, significantly lowered forecast UK public sector borrowing. At the Budget, the Chancellor confirmed tax rises, driven by the Health and Social Care Levy, as well as higher departmental spending. The Chancellor now plans to spend £9 billion more on public services in 2024-25 than under pre-pandemic spending plans.

- Meeting the newly-set fiscal targets and increasing departmental spending as planned is predicated on increasing the tax-to-GDP ratio to 36% in 2026-27, up from 33% in 2019-20 – its highest level since the 1950s and above the average for developed economies.

Update on the 2021–22 budget

- In contrast to 2020-21, the UK government has not set a Covid Funding Guarantee for the Welsh Government budget in 2021-22, meaning uncertainty remains over the financial position for this year. Covid-19 funding for day-to-day spending in 2021-22 stood at £2.6 billion in May 2021 and a further £314 million was confirmed at the Spending Review.
- The Welsh Government has so far allocated almost £1.5 billion of Covid-19 funding in its budget. Our analysis of Welsh Government announcements suggests a further £945 million of additional revenue funding has been committed. This implies the Welsh Government has a further £505 million of uncommitted Covid-19 revenue funding for future announcements later in the financial year.

Outlook for day-to-day spending to 2024–25

- The outlook for day-to-day spending in the Welsh budget has been transformed over recent months, with funding for 2022-23 being £1.6 billion higher than expected based on March 2021 spending plans. Relative to the 2021-22 baseline, core spending (excluding Covid-19) will grow by £2.0 billion next year, and by £2.9 billion by 2024-25.
- As an illustrative spending scenario, we assume the Welsh Government "passes-on" consequentials deriving from NHS spending in England to the NHS in Wales. Increases to the NHS budget would take up over half of the increase to the Welsh budget in 2024-25 and would be 11% higher in real terms than in 2021-22.
- In contrast to much of the last decade, passing on consequentials to the NHS will still allow large increases in funding for all other areas of spending. However, spending outside of the NHS will still remain around 5% below pre-austerity levels in 2024-25, and 10% below on a per-person basis.

Outlook for capital spending to 2024–25

- The Welsh Government's core capital block grant will increase in nominal terms in 2022-23, driven by increases in Financial Transactions funding which reduces in subsequent years. After increases in real terms since 2016-17, the capital block grant will fall in real terms during this Spending Review period.

- Recovering from Covid-19 will likely require significant additional capital investment in the NHS, while the multi-year capital settlement will allow the Welsh Government to set out investments to tackle climate change. However, our analysis suggests that increasing capital spending in both these areas over coming years will mean difficult choices for all other areas of capital spending.

Local government and taxation

- In our scenario, local authority spending will need to grow by 3.9% a year in nominal terms over the next three years to meet baseline funding pressures in 2024-25, with some continuing pandemic-related costs and losses projected over the next two years. Another source of pressure will be the need to support pupils for lost learning time during the pandemic, which could mean an additional £66 million per year for Welsh schools.
- Under our indicative spending scenario, Welsh Government funding for local government is projected to grow by 4% a year in nominal terms over the next three years, with the increase in funding front-loaded in 2022-23. In later years, councils may have to rely more heavily on council tax increases to meet projected spending needs. The Welsh Government could opt to allocate additional funding above our indicative spending scenario to limit the need for council tax increases.
- Policies on business rates in England at the Budget triggered approximately £160 million of consequential funding for the Welsh Government budget in 2022-23. Important decisions will need to be made on whether to extend non-domestic rates reliefs for businesses and on setting the multiplier in 2022-23.
- Funding set aside for adult social care reform in England has triggered roughly £150 million a year of consequential funding for the Welsh Government in 2024-25. The cost of introducing free personal care services for those in receipt of domiciliary and residential care is estimated to be £192 million a year.

Funding and spending pressures

- Making several assumptions about the funding pressures facing the NHS in Wales, we estimate Covid-19 related pressures could average £530 million a year over the next three years, on top of underlying pressures. Although there are huge uncertainties around these estimates, we find that health-related consequentials from NHS spending in England will be broadly sufficient to cover the projected funding pressures over the next three years.
- The Co-operation Agreement between the Welsh Government and Plaid Cymru contains significant additional spending commitments. These include free school meals for all primary school pupils, expansion of early years childcare to all two-year-olds, and the ambition for a National Care Service free at the point of need. Under our

assumptions on the funding pressures facing different areas of the Welsh budget, we project there will be substantial funding available to fund the policy proposals included in the Co-operation Agreement.

1 Economic and fiscal outlook

The Chancellor presented his recent Autumn Budget against an improved economic backdrop. The Office for Budget Responsibility (OBR) revised down its judgement on the extent to which the pandemic has done lasting damage to the path of economic output from 3 per cent to 2 per cent.[1] Unemployment is now expected to peak at 5.2% in the near-term – down from the 6.5% peak forecast in March 2021. Government borrowing has also been revised down relative to the March 2021 forecast owing to stronger tax receipts, reflecting the upward revision to nominal GDP.

Rather than banking these improvements to the fiscal forecast, the Chancellor took advantage of the increased 'headroom' against his fiscal targets to further increase departmental spending. When combined with the tax rises announced in March and September 2021, the overall spending envelope has increased significantly compared to the indicative plans set out at the beginning of the fiscal year.

The budgetary position of the Welsh Government – which is still determined, by and large, by UK spending decisions – has drastically improved. Core day-to-day spending (excluding Covid-19 spending) is set to grow by 8.6% in real terms next year and will be 9% above 2010-11 levels. For the first time since 2017, the Welsh Government will also benefit from a multi-year funding settlement, which should aid long-term planning and implementation of the policies included in the Co-operation Agreement.[2]

But despite the improved budgetary position, the outlook for household finances remains challenging. A combination of inflationary pressures and cuts to working-age benefits is set to squeeze households' purchasing power over the coming months. Moreover, many service areas face major cost and demand pressures. In this respect, the newly sequenced Omicron variant is a timely reminder that the pandemic and related pressures are unlikely to disappear completely anytime soon.

It is against this backdrop that we present the second annual *Welsh Budget Outlook* report, setting out the outlook for devolved and local spending, analysing spending pressures, examining the budgetary impact of devolved and local taxes, and exploring policy options for government over the coming years.

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[1] Office for Budget Responsibility, *Economic and fiscal outlook – October 2021* (London: Office for Budget Responsibility, 2021). https://obr.uk/efo/economic-and-fiscal-outlook-october-2021/

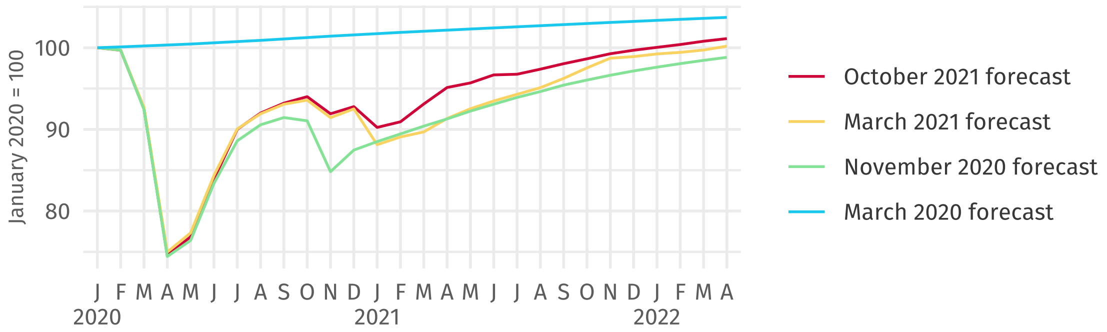
[2] Welsh Government, *The Co-operation Agreement*, 22 November 2021 (Cardiff: Welsh Government, 2021). https://gov.wales/co-operation-agreement-2021

1.1. UK economic outlook

One of the most significant factors behind the improvement to the economic outlook compared to the March 2021 forecast is the Office for Budget Responsibility's revised assumption about the pandemic's long-run impact on economic output. The Winter 2020–21 lockdown had a smaller than anticipated impact on the economy, while the success of the vaccine rollout and the subsequent easing of public health restrictions led to a stronger than expected rebound in demand over the Summer. As shown in **Figure 1.1**, after successive upward revisions, real GDP is now forecast to recover its pre-pandemic (January 2020) level in December 2021. Nevertheless, it remains two per cent below its pre-pandemic path at the forecast horizon.

Real GDP is forecast to grow by 6.5% in 2021, 6.0% in 2022, before returning to more historically normal rates of growth in future years. Growth in real GDP is forecast to average 1.7% a year between from 2023 to 2026 – in line with pre-pandemic trends, but considerably below than the pre-financial crisis average.

Figure 1.1
Monthly real UK GDP forecasts, Office for Budget Responsibility



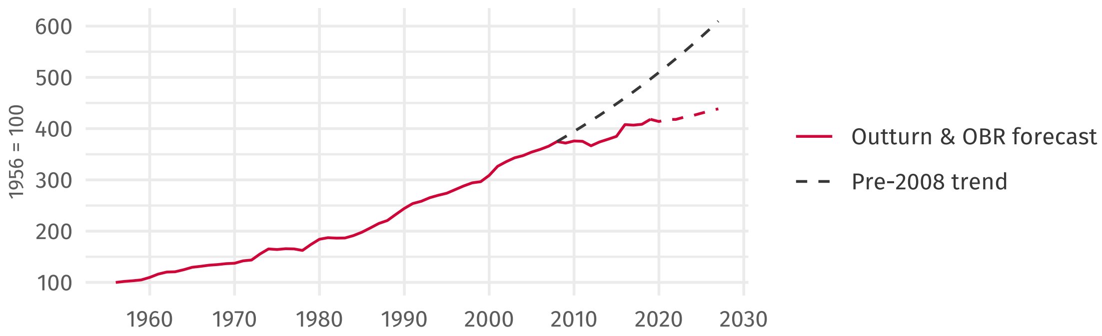
Source: OBR (2021) Economic & fiscal outlook.

Despite the improved picture for economic output, the outlook for household finances remains challenging. Real disposable household income – which measures how much households have available to spend or save after adjusting for the impact of inflation – is projected to fall between the second and fourth quarters of 2021. And between 2021 and 2027, real household income is forecast to grow by less than 1% each year on average, well below the long-run average of 2.6%. In fact, had the pre-financial crisis annual growth rate of 2.6% been sustained, real household incomes would be 28% higher in 2027 than what's implied by current projections (**Figure 1.2**).

The weak outlook for household incomes reflects a similarly weak outlook for average earnings. However, the earnings prospect for the lowest earners is set to improve. The proportion of the workforce in low paid jobs (defined as those paid less than two-thirds of median hourly earnings) is expected to fall over the coming years, with recent and planned increases to the National Living Wage outpacing growth in median earnings.

Figure 1.2

Growth in real household disposable income, UK



Source: WFA analysis of ONS (2021) RDHI per head; OBR (2021) Economic & fiscal outlook – October 2021.

In the near-term, the squeeze on household incomes is likely to be felt particularly acutely due to the combination of price increases, planned tax rises (including the new Health & Social Care Levy and frozen personal allowances), as well as the decision to reverse the £20 a week uplift to Universal Credit which has left the standard unemployment allowance at its least generous since the Second World War.[3]

According to the most recent OBR forecast, CPI inflation is set to peak at 4.4% in the second quarter of 2022, averaging 3.7% in 2022–23, before slowing to 2.3% in 2023–24. Importantly, this does not account for the rises in fuel and energy prices that have occurred since the forecast was closed in September. The OBR further comment that recent developments are “consistent with inflation peaking at close to 5% next year”, and that it could reach a level not seen in the UK for three decades.[4]

As illustrated in **Figure 1.3**, the recent increases to the consumer price index have been driven by the outsized contribution of certain goods and services to the headline inflation rate. In October 2021, consumer gas prices were up 28% on a year ago, and second-hand care cost were up by 23%. Other notable items whose prices have increased by more than the headline CPIH inflation rate of 3.8% include fuel (22%), electricity (19%), and restaurants and cafes (5%). These inflationary pressures have been driven, in part, by global supply chain bottlenecks triggered by a strong rebound in consumer demand over the Summer.

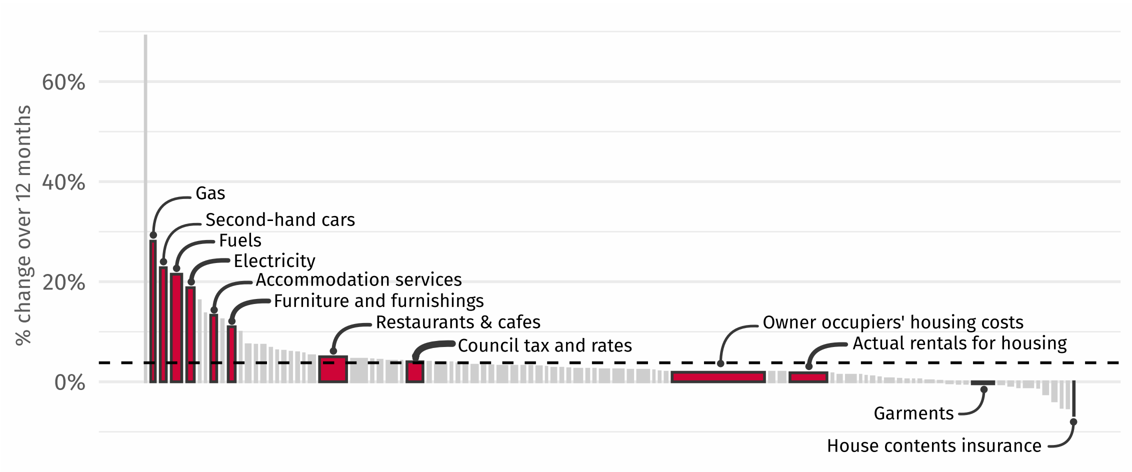
[3] Cian Siôn, “When ends don’t meet: tax rises and benefit cuts (Part 1)”, *Thinking Wales [Blog]*, 15 October 2021. https://blogs.cardiff.ac.uk/thinking-wales/when_ends_dont_meet_part1/

[4] Office for Budget Responsibility, *Economic and fiscal outlook*, 7.

One of the areas where price increases have been most visible has been in the energy sector. Although the price cap will continue to shield consumers from the volatility of wholesale costs (which are borne by suppliers – and therefore are not directly reflected by the CPI and CPIH indices), the recent increase to the price cap and supplier insolvencies mean that energy bills are likely to be a key source of pressure on household finances over the coming months.[5] This effect will be compounded as fixed term deals expire and households are moved onto more expensive tariffs.

Figure 1.3

CPIH inflation by item, % change on a year earlier (October 2021)



Source: ONS (2021) Consumer price inflation, UK: October 2021. • Notes: The width of the bars denotes the weight of the respective item in the consumer basket.

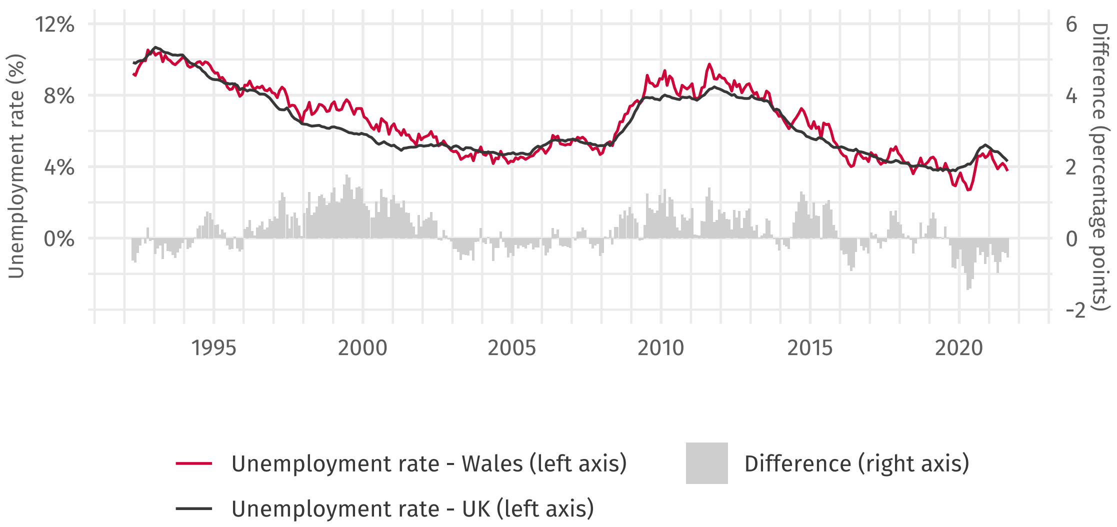
1.2. Welsh labour market

The labour market has also proven to be more resilient than previously assumed. UK headline unemployment is now projected to peak at 5.25%, 1.25 percentage points below what had been forecast in March.

Figure 1.4 shows the headline unemployment rate for Wales and the UK since 1992. The Wales series is noisier due to the smaller sample size in the Labour Force Survey, from which these indicators are derived. Nevertheless, the general trends remain instructive. At the turn of the millennium, Wales consistently reported an unemployment rate approximately one percentage points higher than the UK average. This gap narrowed, and even reversed, during the mid-2000s before resurfacing in the aftermath of the 2008 global financial crisis.

[5] Cian Siôn, "When ends don't meet: a cost-of-living crisis (Part 2)", *Thinking Wales [Blog]*, 22 October 2021. https://blogs.cardiff.ac.uk/thinking-wales/when-ends-dont-meet-part2/

Figure 1.4
Unemployment rates, Wales and UK



Source: ONS (2021) Labour market in the regions of the UK – November 2021

However, since September 2019, Wales has consistently recorded a lower unemployment rate than the UK average. The economic inactivity rate rose briefly during the first months of the pandemic, although it has since returned to pre-pandemic levels. This corroborates evidence from HMRC's Real Time PAYE information data, which shows that Wales has seen a faster recovery in employee numbers compared to the UK average over the past 21 months.[6]

One of the main reasons why unemployment has not reached levels seen during the 2010s has been the employment support schemes introduced by the UK government – the largest of which was the Coronavirus Job Retention (furlough) scheme. As this scheme was wound down at the end of September, fewer than 40,000 employments were still fully or partially furloughed in Wales, down from 247,000 at the beginning of July 2020 (**Figure 1.5**). On the face of it, a furlough "cliff-edge" has been avoided. The vast majority of the 474,000 Welsh workers who have been furloughed at some point since April 2020 had already left the scheme when it was wound down earlier this year.

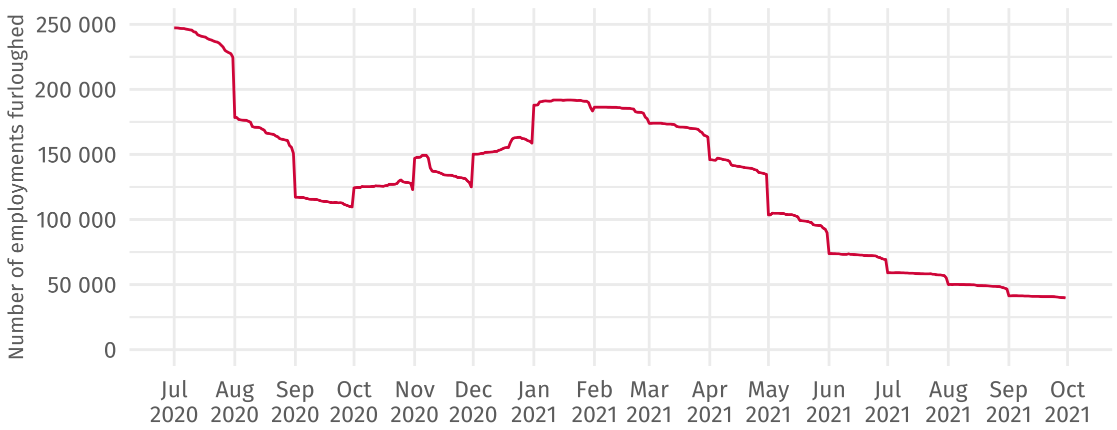
The picture varies between sectors, however. Even as the scheme was being wound down, take-up remained relatively high (11%) among those working in the arts, entertainment, and recreation sector (equivalent to 2,000 employments in Wales). And although take-up in the accommodation and food services sector had fallen from its 55% high in January 2021 to 7%

[6] Cian Siôn, "When ends don't meet: towards a "high-wage" economy? (Part 3)", *Thinking Wales [Blog]*, 26 October 2021. https://blogs.cardiff.ac.uk/thinking-wales/when-ends-dont-meet-part3/

by the end of September, this still equated to 5,000 employments furloughed as the scheme was brought to a close.

Figure 1.5

Number of employments furloughed in Wales, July 2020 – September 2021



Source: HMRC (2021) Coronavirus Job Retention Scheme statistics – November 2021. • Notes: Figures for September 2021 are provisional.

1.3. UK Budget and Spending Review 2021

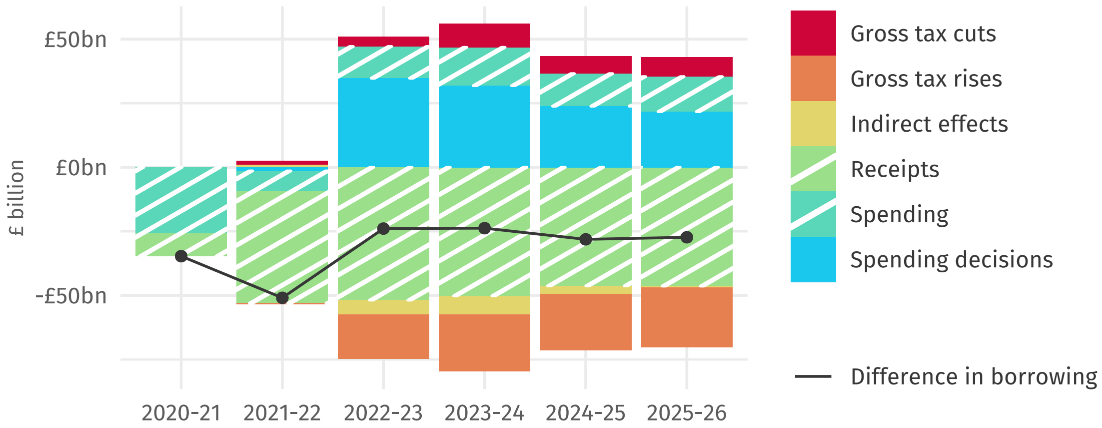
The improved economic outlook, as well as departmental underspending, significantly lowered UK public sector borrowing compared to forecasts. **Figure 1.6** shows the factors that contributed to borrowing being £35 billion lower than forecast in 2020-21, £51 billion in 2021-22, and an average of £25 billion per year lower across the Spending Review period. The main driver over the forecast period was the improvement in forecast receipts (hashed, green bars).

The major fiscal policy decisions announced at the Budget included tax rises, driven by the Health and Social Care Levy, and higher departmental spending. Planned departmental spending has been transformed since the March 2021 budget. Rather than cutting back on March 2020 spending plans, the Chancellor now plans to spend £9 billion more on public services in 2024-25 than under pre-pandemic spending plans. The Chancellor also announced new fiscal targets, with a new mandate for fiscal policy that debt as a share of GDP should fall between the second and third year of the forecast horizon. He also announced three further supplementary targets: a current budget balance by the third year of the forecast horizon; that public sector net investment should average less than 3% of GDP; and welfare spending should remain within the cap.

The forecasts suggest the Chancellor is on course to meet his fiscal targets, with some fiscal headroom over the forecast period. Meeting the targets and increasing departmental spending as planned is predicated on increasing the tax-to-GDP ratio to 36% in 2026-27, up from 33% in 20219-20. This is a result of the three major tax increases announced this year, namely: corporation tax rate increases; income tax threshold freezes; and the Health and Social Care Levy. These increases would increase the tax-to-GDP ratio in the UK to its highest level since the 1950s and to above the average for developed countries.

Figure 1.6

Changes in UK public sector net borrowing since March 2021 forecast



Source: OBR (2021) Economic & fiscal outlook – October 2021. • Notes: The hashed bars are indicative of underlying forecast changes.

This is a key part of the context for the outlook for the Welsh Government's budget and own tax policies over coming years. There are reasons to doubt whether this planned increase in taxes will take place, not least that the Chancellor himself claimed to want to see taxes "going down not up" before the end of the Parliament. There are however several factors that are pushing the UK government towards the higher taxes introduced this year. Firstly, the population will age significantly over coming years, increasing demands on public services. In Wales, for example, the population aged 75 and over is set to increase by over a quarter in this decade. Secondly, for healthcare spending in particular, there are significant non-demographic demand and cost pressures, compounded by relatively modest growth since 2010 and the Covid-19 pandemic. Thirdly, public opinion since 2017 has consistently shown appetite for higher taxes for higher spending, in contrast to the early part of the last decade. Lastly, the slow economic growth experienced since the financial crisis is set to continue, meaning lower revenues to fund spending on public services. These factors would make it difficult for recent tax increases to be reversed over the medium term. If tax cuts were to be prioritised by the UK government, some of the additional pressures on public services in Wales may need to be borne by devolved and local taxes.

2 Welsh budget outlook

The UK government's Autumn Budget and Spending Review 2021 set the Welsh Government's block grant funding for the next three years. The outlook based on UK government spending plans from March 2021 painted a bleak picture ahead of the Senedd election in May.[7] The increased departmental spending by the UK government has transformed the outlook for the Welsh budget.

This section explores the fiscal outlook to 2024-25 before the Welsh Government publishes its Draft Budget later this month. The first section provides a brief update on the 2021-22 budget, analysing the allocations made up to the 1st Supplementary Budget and subsequent funding announcements by the Welsh and UK governments. The second section assesses the outlook for day-to-day spending after the UK government's Spending Review 2021 and provides some illustrative spending scenarios for the Welsh budget. Lastly, we analyse the outlook for capital spending and some of the choices and trade-offs the Welsh Government faces as it plans investments over the next three years.

2.1. Update on the 2021–22 budget

The Welsh Government's budget position in 2021-22 has continued to evolve throughout the year. However, in contrast to the 2020-21 budget, the UK government has not set a Covid Guarantee for the Welsh Government budget, meaning uncertainty remains over the financial position for this year.

At the time of the UK government's main estimates in May 2021, Covid-19 funding for day-to-day spending in 2021-22 stood at £2.6 billion - £497 million of which was funding carried forward by the Welsh Government from 2020-21. Subsequent announcements by the UK government in England increased Covid-19 consequentials - for example, additional funding for the NHS in England and the UK government's Household Support Fund. At the Spending Review, the Chancellor confirmed an extra £314 million of revenue funding for 2021-22.

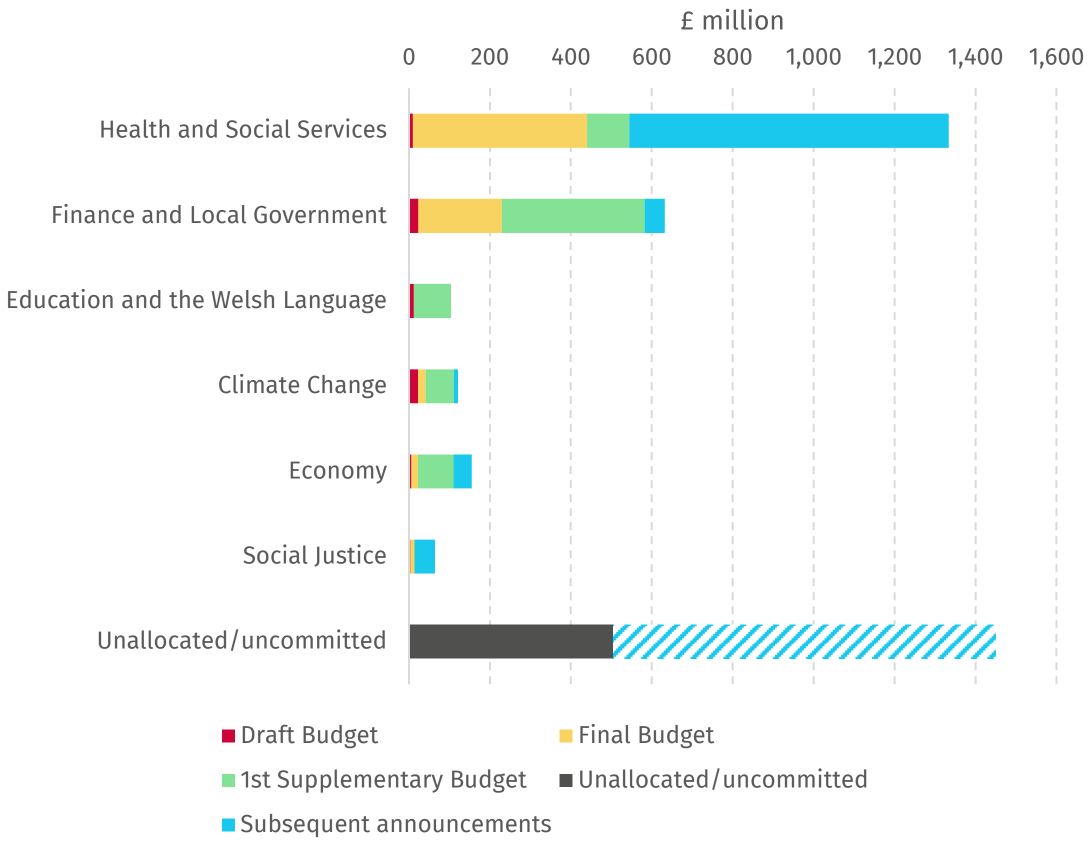
Figure 2.1 provides an update on the allocations and commitments made by the Welsh Government for day-to-day spending on its Covid-19 response in 2021-22. At the 1st Supplementary Budget for 2021-22, the Welsh Government had allocated £1.47 billion, including support for the NHS and local governments for the first six months of the financial

[7] See Guto Ifan and Cian Siôn, *Welsh Election 2021: Fiscal Outlook and Challenges for the Next Welsh Government* (Cardiff: Wales Fiscal Analysis, 2021). https://www.cardiff.ac.uk/__data/assets/pdf_file/0009/2514834/election_outlook_2021_FINAL_19042021.pdf

year and a NDR reliefs package costing £352 million. This left £1.1 billion of day-to-day spending unallocated in the budget. Combined with subsequent funding confirmed by the UK government, this means the Welsh Government will have £1.45 billion to allocate at its 2nd Supplementary Budget.

Figure 2.1

Covid-19 allocations (resource spending) in Welsh Government budgets and estimated uncommitted funding



Source: Welsh Government budget documents and announcements, and authors' calculations • Notes: The hashed bar shows estimated funding commitments made but not yet allocated in the budget.

As shown by the blue bars in Figure 2.1, the Welsh Government has made significant funding commitments which will be reflected in its supplementary budget. Some of the major funding announcements include:

- **£10 million** grant scheme to help people to pay rent during the pandemic (30 June 2021)[8]

[8] https://gov.wales/new-10-million-grant-scheme-help-people-struggling-pay-their-rent-during-pandemic

- **£25 million** a year recurrent funding for urgent and emergency care (22 July 2021)[9]
- £551 million extra Covid-19 funding for health and social services - **£411 million** for ongoing costs; **£100 million** for recovery plans; £40 million capital funding for equipment and adapting hospitals and other buildings (19 August 2021)[10]
- **£48 million** Covid-19 recovery fund to support social care in Wales (14 September 2021)[11]
- **£5.1 million** for childcare and play-work services (24 September 2021)[12]
- **£20 million** revenue funding to support access to play, sporting, creative and expressive, and cultural activities and experiences for children and young people (6 October)[13]
- **£50 million** to extend the Local Government Hardship Fund to March 2022 (Decision Report 13 October 2021)
- **£170 million** a year recurrent funding for planned care services (4 November 2021)[14]
- **£51 million** for the Winter Fuel Support Scheme and Household Living Costs (16 November 2021)[15]
- **£45 million** for business support and expansion of Personal Learning Accounts (23 November 2021)[16]
- **£7 million** of further support for unpaid carers (25 November 2021)[17]

These announcements suggest approximately **£945 million** of additional revenue funding on top of budget allocations already made for 2021-22. This would imply the Welsh Government has a further **£505 million of uncommitted Covid-19 revenue funding** for future announcements later in the financial year. However, this should be seen only as a very rough estimate of available funding, since this list of funding announcements may not be exhaustive, and some announcements may not be additional to allocations made in the budget.

The need for further support for public services, businesses, and individuals in 2021-22 remains uncertain and will depend on how the pandemic evolves over coming months. A worsening of cases and hospitalisations may require additional support for health and social care services, particularly with the ramping up of the vaccine boosters. Rail services may also require further support if passenger numbers and fare revenues remain low. If the situation requires some re-introduction of public health restrictions on businesses, appropriate levels of support for businesses will need to be made available – which will need to be funded from

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[9] https://gov.wales/plan-deliver-urgent-and-emergency-health-care-right-place-first-time-wales
[10] https://gov.wales/ps551m-extra-covid-funding-health-and-social-services
[11] https://gov.wales/ps48m-covid-recovery-fund-support-social-care-wales
[12] https://gov.wales/written-statement-funding-support-childcare-and-play-services
[13] https://gov.wales/36-million-support-families-and-children-recover-pandemic
[14] https://gov.wales/health-minister-pledges-170m-extra-year-transformation-how-planned-care-services-are-delivered
[15] https://gov.wales/written-statement-welsh-government-support-winter-fuel-support-scheme-and-household-living-costs
[16] https://gov.wales/45-million-package-train-staff-and-help-welsh-smes-grow
[17] https://gov.wales/new-package-support-unpaid-carers

unallocated funding if additional support is not forthcoming from the UK government. Further allocations to support individuals may also be required, for example through increased self-isolation payments.

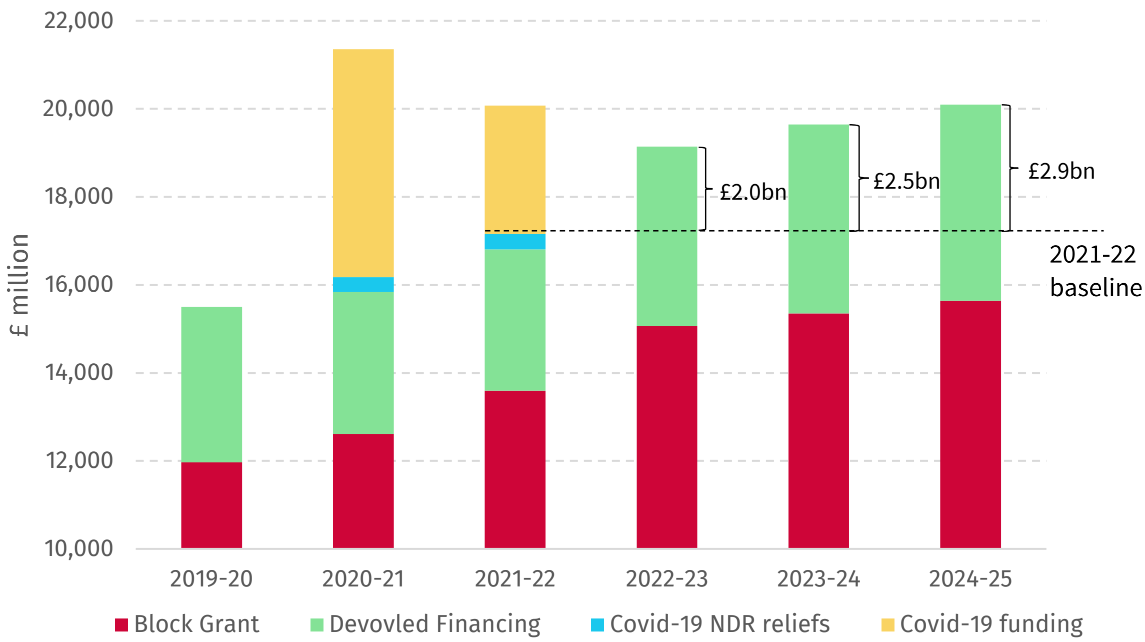
There will likely again be late revisions in funding from the UK government at the time of its Supplementary Estimates in February 2022. It remains to be seen whether the UK government will allow some ad-hoc budget flexibilities again as it did last year. If not, the Welsh Government only has very limited scope to carry funding forward into future years through the Wales Reserve.

2.2. Outlook for day-to-day spending to 2024-25

The outlook for day-to-day spending in the Welsh budget has been transformed over recent months. As a result of decisions outlined in section 1.3, we estimate that core day-to-day funding for the Welsh Government budget next year will be £1.6 billion higher in 2022-23 and £1.1 billion higher in 2024-25 than expected based on March 2021 plans.

Figure 2.2

Welsh Government funding for day-to-day spending, 2019-20 to 2024-25 (resource DEL and devolved financing, nominal terms)



Source: HM Treasury (2021) Block Grant Transparency June 2021; HM Treasury (2021) Autumn Budget and Spending Review 2021; Office for Budget Responsibility (2021) October 2021 Devolved Taxes and Spending Forecast; Welsh Government (2021) 1st Supplementary Budget 2021-22; and authors' calculations

Figure 2.2 shows funding for Welsh Government day-to-day spending from 2019-20 to 2024-25, from block grant funding from the UK government and from devolved financing sources. Relative to the 2021-22 baseline, core spending (excluding Covid-19) will grow by £2.0 billion next year, and by £2.9 billion by 2024-25. Given Covid-19 funding will come to an end after 2021-22, total day-to-day spending will fall next year. Any pandemic-related spending pressures will need to be met from within the core budget.

Figure 2.3

Sources of finance for Welsh Government day-to-day spending, 2021-22 to 2024-25 (resource DEL, nominal terms)

	2021-22	2022-23	2023-24	2024-25
Block Grant (RDEL)	13,593	15,065	15,350	15,639
Covid-19 funding	2,914	0	0	0
Devolved financing	3,213	4,082	4,292	4,455
Non-Domestic Rates	*661*	*1,112*	*1,155*	*1,180*
Welsh Rate of Income Tax (as budgeted)	*2,064*	*2,478*	*2,629*	*2,748*
Land Transaction Tax	*324*	*337*	*353*	*373*
Landfill Disposals Tax	*42*	*33*	*33*	*33*
Principal repayment of borrowing[1]	*-2*	*-4*	*-4*	*-4*
Drawdown from the Wales Reserve	*125*	*125*	*125*	*125*
Total amount to be allocated	**19,720**	**19,147**	**19,642**	**20,094**
Excluding Covid-19 funding & accounting for Covid-19 NDR reliefs in 2021-22	**17,158**	**19,147**	**19,642**	**20,094**
2021-22 prices	*17,158*	*18,642*	*18,714*	*18,790*
Real-terms annual change		*8.6%*	*0.4%*	*0.4%*

Source: HM Treasury (2021) Block Grant Transparency June 2021; HM Treasury (2021) Autumn Budget and Spending Review 2021; Office for Budget Responsibility (2021) October 2021 Devolved Taxes and Spending Forecast; Welsh Government (2021) 1st Supplementary Budget 2021-22; and authors' calculations ● Notes: (1) Repayments estimated based on information in Draft Budget 2021-22 document.

Figure 2.3 provides a further breakdown of Welsh Government financing by source. Devolved financing is set to grow strongly next year, partly driven by the Covid-19 NDR reliefs worth £352 million that were provided in 2021-22 and which have not yet been extended (see section 3). There is also a recovery of revenue from the Welsh Rates of Income Tax in 2022-23 relative to the budgeted data for 2021-22 (which is fixed at the beginning of the year and not updated to reflect the latest forecasts). We project that all the devolved taxes will have a positive effect on the Welsh budget over coming years i.e. forecast revenues are growing faster than the corresponding forecasts for block grant adjustments.[18] We also expect

[18] Guto Ifan and Cian Siôn, *UK Government Budget and Spending Review 2021: Implications for Wales* (Cardiff: Wales Fiscal Analysis, 2021). https://www.cardiff.ac.uk/__data/assets/pdf_file/0010/2580715/spending_review_2021_briefing_formatted.pdf

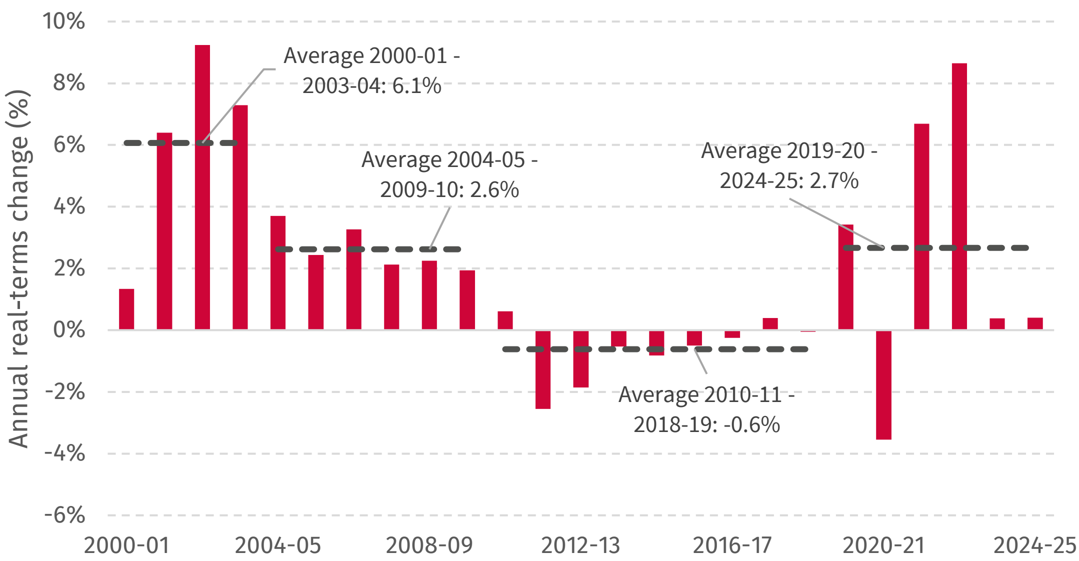
positive reconciliations for income tax forecast errors for 2020-21 and 2021-22 to be applied in 2023-24 and 2024-25, but have not included these in our projections, given they will not be confirmed until outturn data becomes available.

We also assume the Welsh Government draws down £125 million from the Wales Reserve each year (in our spending scenarios later in the chapter, we also make an allowance for unallocated funding going into the reserve each year).

After removing Covid-19 funding and accounting for the Covid-19 NDR reliefs provided in 2021-22, the core budget will increase by 8.6% in real terms next year. For the last two years of the Spending Review period, real-terms growth in funding amounts to 0.4% a year.

Figure 2.4

Annual change in Welsh Government core day-to-day spending, 2000-01 to 2024-25 (real terms)



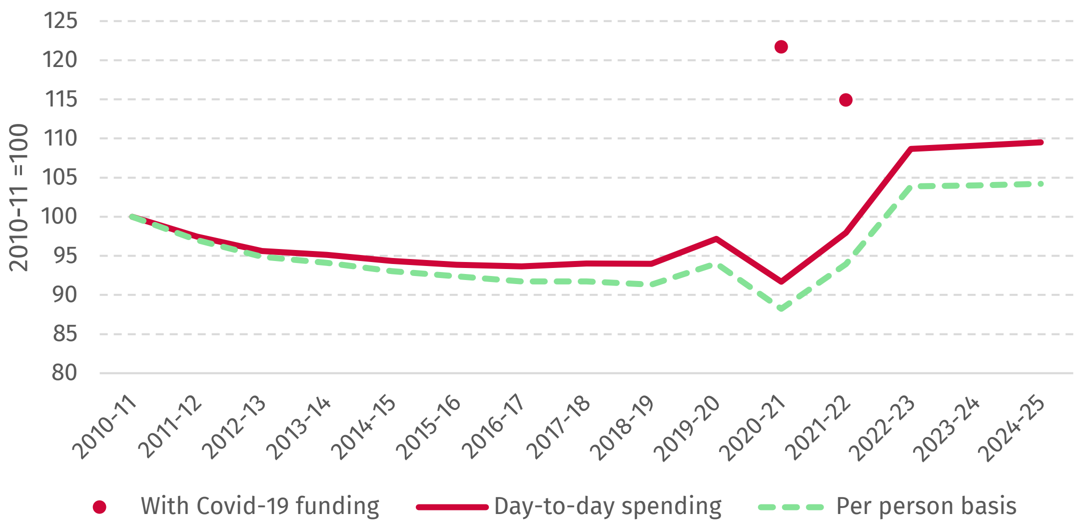
Source: HM Treasury (2021 and previous) Public Expenditure Statistical Analyses; HM Treasury (2021) Block Grant Transparency June 2021; HM Treasury (2021) Autumn Budget and Spending Review 2021; Office for Budget Responsibility (2021) October 2021 Devolved Taxes and Spending Forecasts ● Notes: Series adjusted for the devolution of Council Tax benefit in 2013-14 and the inclusion of farm support payments in Welsh Government RDEL since 2020-21. Covid-19 spending in 2020-21 and 2021-22 excluded.

Figure 2.4 puts these increases in funding in an historic perspective, showing annual changes in Welsh Government resource funding from the beginning of devolution in 1999-00. 2022-23 is set to see the second largest one-year increase in 'core' spending, followed by very small real terms growth in spending for the following two years. Smoothing over the pandemic-related fluctuations in the measure of inflation (GDP deflator) over the past two years, the average increase in core day-to-day spending from 2018-19 to 2024-25 is set to be 2.7% in real terms. These increases are in sharp contrast to the trend over the previous decade since 2009-10. Recent and prospective funding increases are similar to those seen between 2004-05 to 2009-10, but lower than the increases seen during the first years of devolution.

Overall, the Welsh Government's budget for day-to-day spending will be approximately 9% higher in 2022-23 in real terms compared to 2010-11, on a broadly like-for-like basis. After accounting for population growth, spending will be 4% higher than pre-austerity levels in 2022-23 and will remain flat in real terms thereafter.

Figure 2.5

Trends in Welsh Government day-to-day spending, 2010-11 to 2024-25 (2010-11=100, real terms)



Source: HM Treasury (2021 and previous) Public Expenditure Statistical Analyses; HM Treasury (2021) Block Grant Transparency June 2021; HM Treasury (2021) Autumn Budget and Spending Review 2021; Office for Budget Responsibility (2021) October 2021 Devolved Taxes and Spending Forecasts • Notes: Series adjusted for the devolution of Council Tax benefit in 2013-14 and the inclusion of farm support payments in Welsh Government RDEL since 2020-21

2.3. Illustrative allocations for day-to-day spending

As will be explored in sections 3 and 4, there are very large spending pressures facing the Welsh budget over coming years. However, the spending trade-offs facing Welsh ministers are arguably less acute than in previous tough budget rounds. After the improvement in the fiscal outlook over recent months, the Welsh Government will need to make large funding allocations. For the first time in over a decade, there are opportunities to grow all areas of spending and expand some public services. Decisions taken later this month will determine the shape of the Welsh budget over coming years.

To illustrate some of the choices facing the Welsh Government as it sets its Draft Budget, in this section we make several assumptions about budget allocations for years 2022-23 to 2024-25. The total amounts of funding to be allocated is determined by the block grant and devolved financing outlined in the previous section. We also assume the Welsh Government leaves £76 million of revenue funding as unallocated in the budget, matching our assumed unallocated core funding in the 2021-22 budget, which would be paid into the Wales Reserve each year.[19] We also assume that resource funding for sponsored bodies is maintained in real terms.[20]

We then model budget allocations if the Welsh Government broadly follows UK government decisions on spending in England. Specifically, we assume:

- The Welsh Government passes on consequentials from NHS England spending to the NHS in Wales, while consequentials from other Department of Health and Social Care funding is also allocated towards health costs (not including the portion we assume is for adult social care reform in England).
- The Welsh Government allocates consequentials from funding for adult social care reform in England (£5.3 billion) towards social care reform in Wales.[21]
- Consequentials from schools spending in England are passed on to local governments in Wales.
- The Welsh Government uses estimated funding from recent changes to Business Rates in England to implement similar policies in Wales.
- The remaining funding in the budget is allocated proportionally to all other service areas.

These illustrative spending allocations are set out in **Figure 2.6** and **Figure 2.7** below.

In this illustrative scenario, increases to the NHS budget would take up over half of the increase to the Welsh budget in 2024-25 (red bars in **Figure 2.7**). Core NHS funding allocations (excluding Covid-19 funding) in 2024-25 would be 11% higher in real terms than in 2021-22. Core funding for local government would also increase by around 5.1% in real terms by 2024-25, driven by increasing consequentials from schools spending in England. In addition, there would also be around £150 million available to implement social care reforms by 2024-25.

[19] In reality, the Welsh Government is likely to leave much more funding as unallocated in its budget plans for coming years to allocate at Final and Supplementary budgets, given the uncertainty relating to the pandemic.
[20] This includes funding for the Senedd Commission, Public Services Ombudsman for Wales, Wales Audit Office, and the Electoral Commission.
[21] We assume the portion not allocated directly to local government is split evenly from 2022-23 to 2024-25.

Figure 2.6

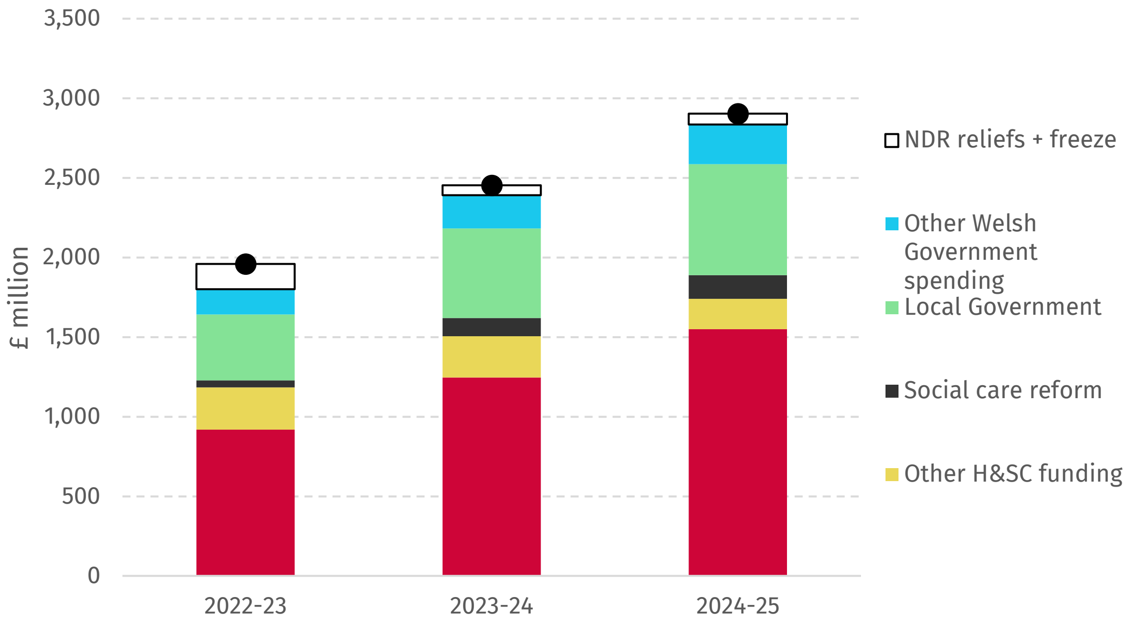
Illustrative Welsh Government spending allocations, 2021-22 to 2024-25

	2021-22	2022-23	2023-24	2024-25
NHS	8,156	9,075	9,402	9,706
Other H&SC funding	0	265	259	189
Social care reform	0	45	115	150
Local Government	5,644	6,053	6,198	6,331
of which: Schools	*2,215*	*2,450*	*2,538*	*2,626*
of which: Other local government	*3,430*	*3,618*	*3,675*	*3,720*
Other Welsh Government spending	3,236	3,400	3,454	3,496
NDR reliefs + freeze	0	158	61	67

Source: Authors' calculations based on Welsh Government (2021) 1st Supplementary Budget for 2021-22 and projections from Figure 2.4. • Notes: Schools portion of local government funding based on SSA share and specific grant funding.

Figure 2.7

Illustrative increases to budget allocations relative to 2021-22 core budget allocations



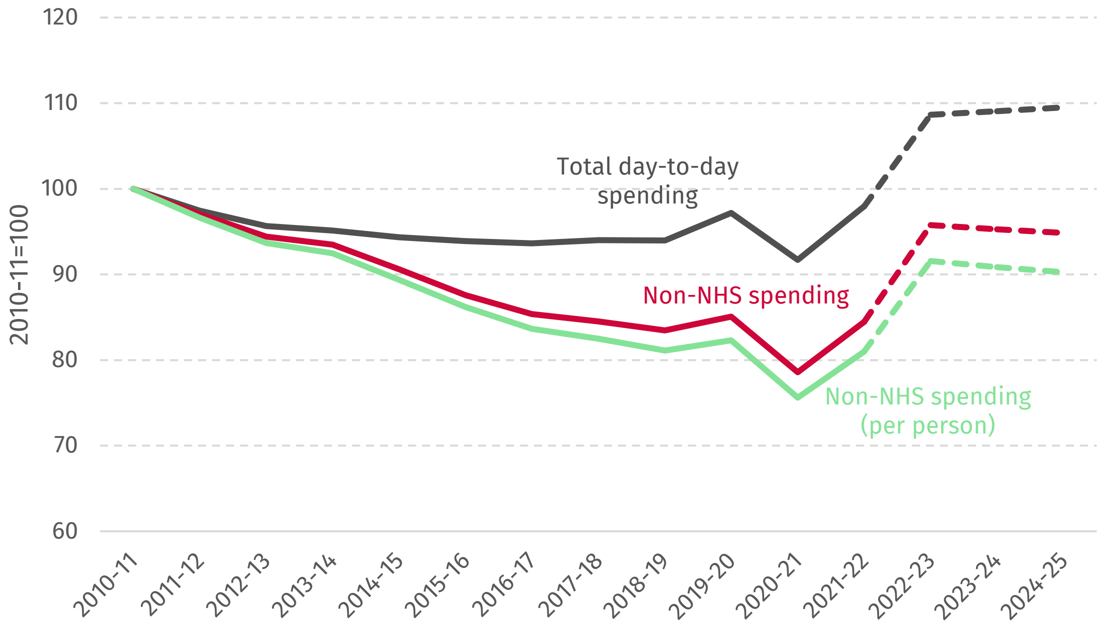
Source: Authors' calculations based on Welsh Government (2021) 1st Supplementary Budget for 2021-22 and projections from Figure 2.4.

In contrast to much of the last decade, passing on consequentials from additional NHS spending in England will still allow increases in funding for all other areas of spending. Funding for other Welsh Government services could increase by 2.7% in real terms in 2022-23 but would fall in real terms in following years.

Under this indicative spending scenario, total spending outside of the NHS would increase substantially in real terms for the first time in over a decade, reversing some of the cuts seen after 2010-11. However, as shown in **Figure 2.8**, spending outside of the NHS will remain around 5% below pre-austerity levels in 2024-25. On a per person basis this portion of the Welsh budget would be 10% below pre-austerity levels by 2024-25.

Figure 2.8

Trends in non-NHS day-to-day spending allocations under illustrative spending scenario, 2010-11 to 2024-25 (real terms)



Source: See Figures 2.5 and 2.6. Authors' calculations based on Welsh Government (2021 and previous) budget documents. Last supplementary budget allocations for each year used. Population data from Statswales (2021) and ONS (2021) 2018-based population projections.

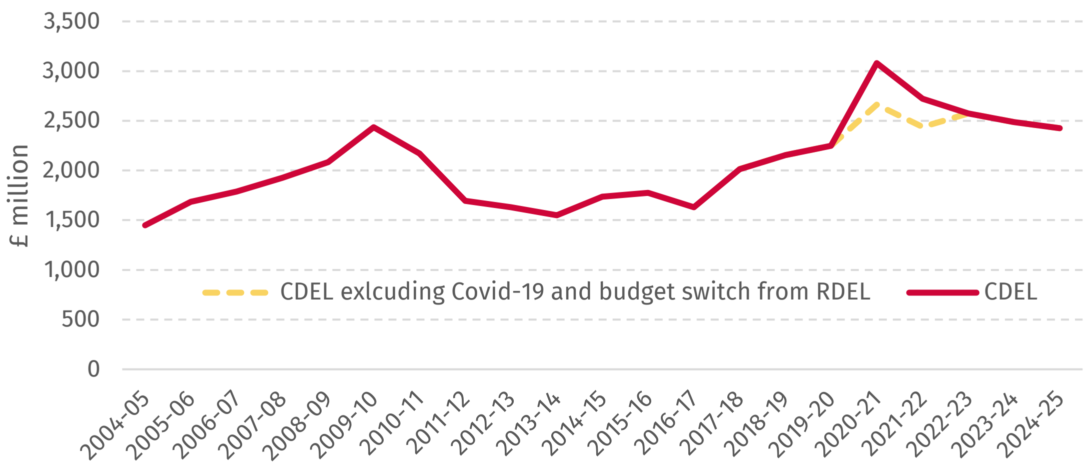
2.3. Outlook for capital spending to 2024-25

At the Spending Review, the Chancellor confirmed an additional £111 million for Welsh Government capital spending in 2021-22. This means there will be £293 million of capital funding to be allocated at the 2nd Supplementary Budget for 2021-22.

In contrast to the budget for day-to-day spending, there were no big increases announced for capital spending after this year. The Welsh Government's core capital block grant will increase in nominal terms in 2022-23, driven by increases in Financial Transactions funding which reduces in subsequent years. However, spending will fall next year after accounting for Covid-19 funding in 2021-22. **Figure 2.9** shows the total Welsh Government capital block grant in real terms since 2004-05, with the dotted yellow line showing the trend excluding Covid-19 funding and a one-off budget switch from day-to-day spending in 2020-21. After increases since 2016-17, the capital block grant will fall in real terms over the Spending Review period. However, capital spending will be sustained at a higher level than the previous decade, at a similar level to 2009-10. As a share of the Welsh economy, Welsh Government capital spending will average 2.9% of projected GDP between 2022-23 and 2024-25, slightly higher than the long-run average of 2.6% from 2004-05 to 2021-22.[22]

Figure 2.9

Welsh Government Capital DEL, 2004-05 to 2024-25 (2021-22 prices)



Source: HM Treasury (2021 and previous) Public Expenditure Statistical Analyses; HM Treasury (2021) Block Grant Transparency June 2021; HM Treasury (2021) Autumn Budget and Spending Review 2021; Welsh Government (2021) 3rd Supplementary Budget 2020-21.

As shown in **Figure 2.10**, we also assume that the Welsh Government borrows up to the annual limit of £150 million in each year of the Spending Review period. Some funding will also be available to be drawn-down from the Wales Reserve – at the end of the 2019-20 financial year, it held capital reserves of £40 million and financial transactions funding worth £67 million. We don't include this funding given uncertainties around amounts paid into the reserve in 2020-21 and 2021-22.

[22] This projection assumes Welsh GDP grows in line with the UK average from 2019.

Figure 2.11 shows the capital funding allocations made in the 2021-22 budget, by Main Expenditure Group. The Climate Change portfolio makes up by far the largest share (over half) of capital spending, with over £1.5 billion allocated in 2021-22. Almost half of this total is made up of transport-related spending, with £274 million allocated for Transport for Wales, £204 million for sustainable travel, and £106 million for Motorway and Trunk Road spending. Housing-related expenditure makes up the next largest component, the largest allocation of which is the £300 million for Social Housing Grants.

Figure 2.10

Projected Welsh Government capital budget, 2021-22 to 2024-25 (nominal terms)

	2021-22	2022-23	2023-24	2024-25
CDEL	2,325			
Financial Transactions	113			
Total CDEL excluding Covid-19 funding	**2,438**	**2643**	**2610**	**2594**
Covid-19 - CDEL	137	0	0	0
Covid-19 - Financial Transactions	35	0	0	0
Additional CDEL funding (Spending Review 2021)	111			
Borrowing	150	150	150	150
Total to be allocated	**2,871**	**2,793**	**2,760**	**2,744**
Unallocated - CDEL	225			
Unallocated - Financial Transactions	68			
Total allocated	**2,578**	**2,793**	**2,760**	**2,744**

Source: Authors' calculations based on HM Treasury (2021) Autumn Budget and Spending Review 2021; Welsh Government (2021) 1st Supplementary Budget 2021-22

Given the increasing salience of climate change, the multi-year capital settlement will allow the Welsh Government to set out the investments it will make in this area over the next three years and beyond. As part of the Co-operation Agreement, the Welsh Government will be examining potential pathways to net zero by 2035. It is likely that several spending areas in the Climate Change budget will need to be ramped up over coming years. The Office for Budget Responsibility assume that UK net zero public spending will amount to £344 billion (in 2019 prices) before 2050.[23] On a Welsh level, that could amount to £17 billion, which spread over three decades, may equate to £0.5 billion per year. Not all the spending areas assumed are currently under devolved competence, but a substantial amount will be. Brown et al. (2021) estimate that the cost of decarbonising of Wales' housing will require around

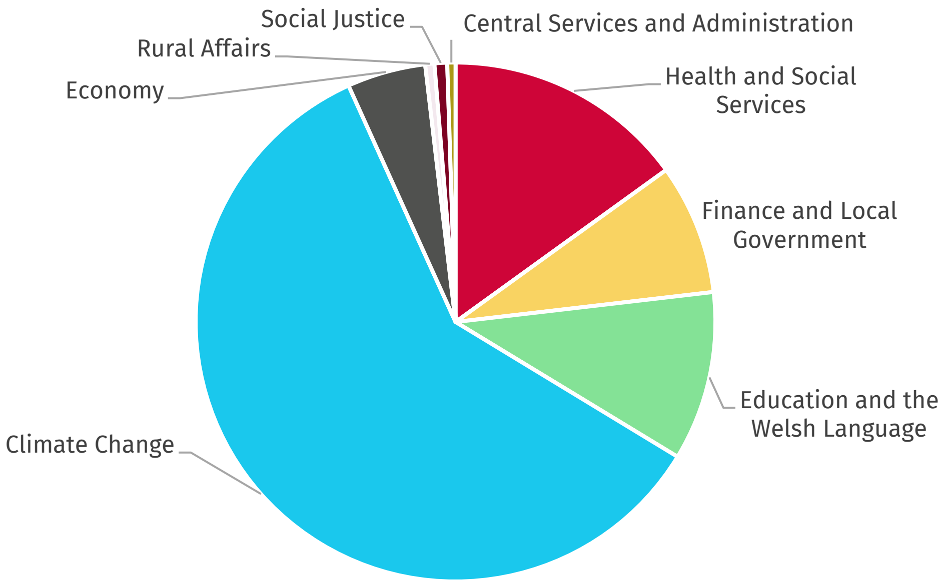
[23] Office for Budget Responsibility, *Fiscal Risks Report* (London: Office for Budget Responsibility, 2021) https://obr.uk/docs/dlm_uploads/Fiscal_risks_report_July_2021.pdf

£5.3 billion of government investment over ten years, of which it assumes the Welsh Government's share being £1.7 billion.[24]

The next largest area of capital spending is the Health and Social Services budget, with £374 million allocated for the NHS capital budget in 2021-22. Capital budget allocations to the NHS have increased significantly since 2015-16 but remain well below the levels seen in 2009-10 in real terms.[25] Across the UK, capital investment in health is low by international standards.[26] In 2017-18, the reported total maintenance backlog in the Welsh NHS stood at £561 million.[27] Furthermore, recovering from Covid-19 will likely require significant additional capital investment in infrastructure, facilities, and equipment, over and above pre-pandemic plans. It is likely therefore that the Welsh Government will allocate more of its capital budget to the NHS over coming years.

Figure 2.11

Capital spending allocations by Main Expenditure Group, 2021-22



Source: Welsh Government (2021) 1st Supplementary Budget 2021-22

[24] Donal Brown, Christian Jaccarini, Chaitanya Kumar, Cathy Madge, and Eurgain Powell, *Financing Wales' Housing Decarbonisation* (London: New Economics Foundation, 2021). https://neweconomics.org/uploads/files/Financing-Wales-Housing-Decarbonisation.pdf

[25] Guto Ifan, *The NHS and the Welsh Budget: Outlook and challenges for the next Welsh Government* (Cardiff: Wales Fiscal Analysis, 2021). https://www.cardiff.ac.uk/__data/assets/pdf_file/0017/2512610/election_outlook_2021_health_08_04.pdf

[26] Health Foundation, *Failing to capitalise: Capital spending in the NHS*. (London: Health Foundation, 2019). https://www.health.org.uk/publications/reports/failing-to-capitalise

[27] https://www.bbc.co.uk/news/uk-wales-49661434

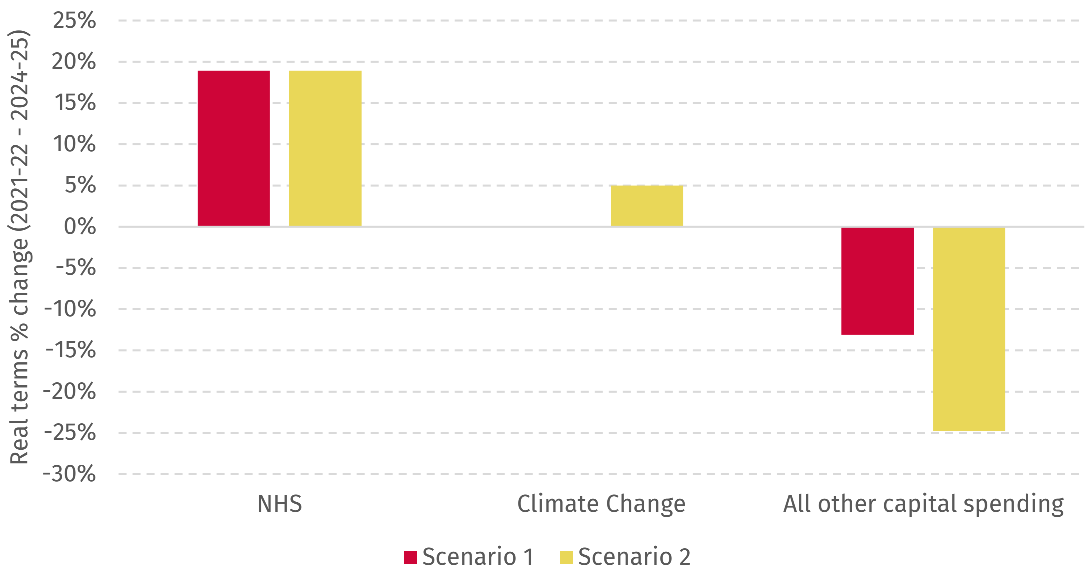
To illustrate some of the choices facing the Welsh Government as it sets its capital budget later this month, we provide the following two illustrative scenarios, making assumptions about health and climate change related spending:

- **Scenario 1**: Capital funding for Health and Social Services grows broadly in line with consequentials resulting from increased capital spending by the Department for Health and Social Care in England (£105 million a year more in nominal terms in 2024-25). The Climate Change budget is maintained in real terms (£77 million more allocated in 2024-25 in nominal terms).
- **Scenario 2**: Capital funding for Health and Social Services as in Scenario 1. The Climate Change budget is increased by 5% in real terms from 2021-22 to 2024-25 (£189 million more allocated in 2024-25 in nominal terms)

As shown in **Figure 2.12**, both these options would require significant trade-offs for all other areas of capital spending. Increasing annual NHS capital spending and climate change spending over coming years would mean cutting back on all other capital spending areas. The scope for reigning back on other capital spending in this way may be limited. These illustrative scenarios imply that despite recent increases in capital spending, the capital spending plans of the UK government may not be sufficient to meet the demands of coming years – a situation exacerbated by the Welsh Government's limited capital borrowing powers.

Figure 2.12

Real terms change in annual capital spending allocations, 2021-22 to 2024-25



Source: Authors' calculations based on projections in Figure 2.10

3 Local government outlook

The pandemic has presented local authorities with a series of unique challenges. Not only has it required increased spending on existing service areas, but councils have also been tasked with new and varied responsibilities, including the administration of grant payments to eligible businesses, responding to excess deaths, expanding homelessness support, and contact tracing. These new responsibilities and the sudden depletion of regular income streams in March 2020 necessitated a rapid change to the way councils were funded. In response, the Welsh Government channelled additional funding through the Single Emergency Hardship Fund, which fully compensated councils for most pandemic-related pressures. In contrast to other parts of the UK, where councils were provided additional funding based on *ex-ante* estimates of spending needs, Welsh local authorities retrospectively submitted returns to the Welsh Government and were compensated for actual expenses and income losses incurred.[28]

In 2020–21, £400 million was paid from this fund with respect to additional expenditure claims, and a further £190 million was paid to compensate councils for non-tax income losses (**Figure 3.1**). These funding streams were supplemented with hypothecated grants and un-ringfenced funding to compensate for losses in council tax collection and increased eligibility for the council tax reduction scheme. Originally only intended to cover costs and losses during the first half of 2021–22, the Hardship Fund has since been extended to support some pandemic-related costs and losses until March 2022.[29]

Even in the absence of new restrictions, some pandemic-related pressures are likely to continue into the next financial year, including reduced income from sales, fees and charges, and additional costs for the adult social care sector. The Accelerated Learning Programme and similar initiatives will also need to be extended to fully meet the estimated spending requirement on “catch-up” learning. Nevertheless, underlying demand for council services – particularly social care – will be the main driver of local government pressures in future years.

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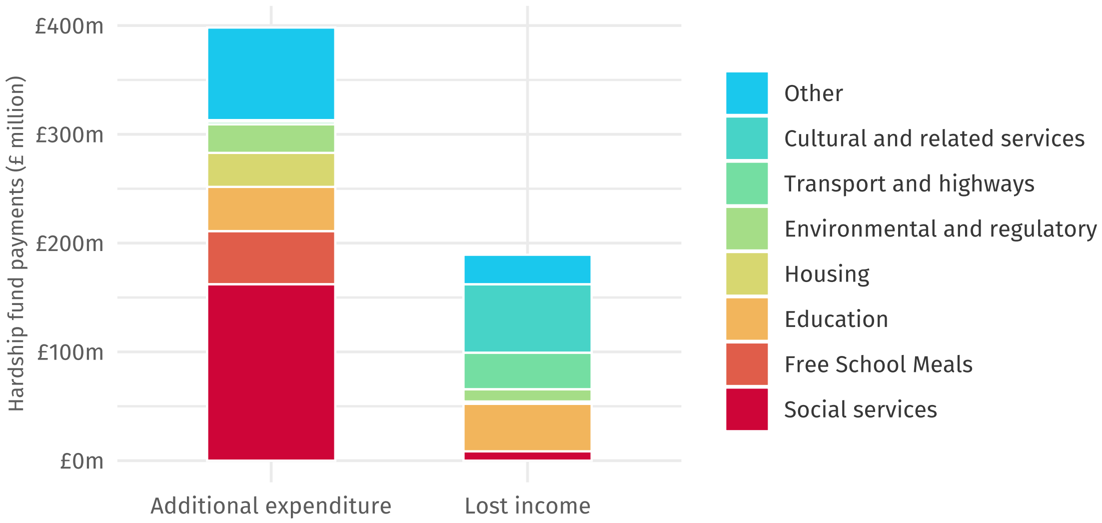
[28] Kate Ogden, David Phillips, and Cian Siôn, “What’s happened and what’s next for councils,” in *The IFS Green Budget: October 2021*, eds. Carl Emmerson, Paul Johnson, and Ben Zaranko (London: Institute for Fiscal Studies, 2021), 295–344. https://ifs.org.uk/publications/15688

[29] On 13 October 2021, the Minister for Finance and Local Government announced a further allocation of £50 million on top of the £206 million originally set aside for the Local Government Hardship Fund in 2021–22. Separate in-year allocations have been made to support the social care sector (£26m), provide homelessness support (£10m), fund tenancy hardship grants (£8m), self-isolation payments (£4m), as well as the recently announced Winter Fuel Support Payments scheme (£38m).

Due to the improved funding outlook for the Welsh budget, our indicative spending scenario similarly implies a substantial real-terms uplift to the local government settlement in 2022–23. However, due to the front-loaded nature of the UK government's spending envelope, future increases are likely to be more modest (Figure 3.2). From 2023–24, the Welsh Government must either commit a larger proportion of budget increases to local government, or alternatively, councils may have to rely more heavily on council tax increases to meet projected spending needs (albeit to a lesser extent than in recent years). Important decisions will need to be made ahead of the 2022–23 Draft Budget as well, including whether, and to what extent the relief on non-domestic rates for retail, leisure, and hospitality business premises is continued.

Figure 3.1

Payments made to local authorities from the Single Emergency Hardship Fund, 2020–21



Source: Welsh Government (2021) FOI request. ● Notes: Other payments include £40m for central services, £25m for digital transformation, £25m to compensate for savings not achieved, and smaller allocations for planning and development, self-isolation payments, and statutory sick pay enhancements. These figures were correct as of 10 August 2021, when a small number of claims were still on hold.

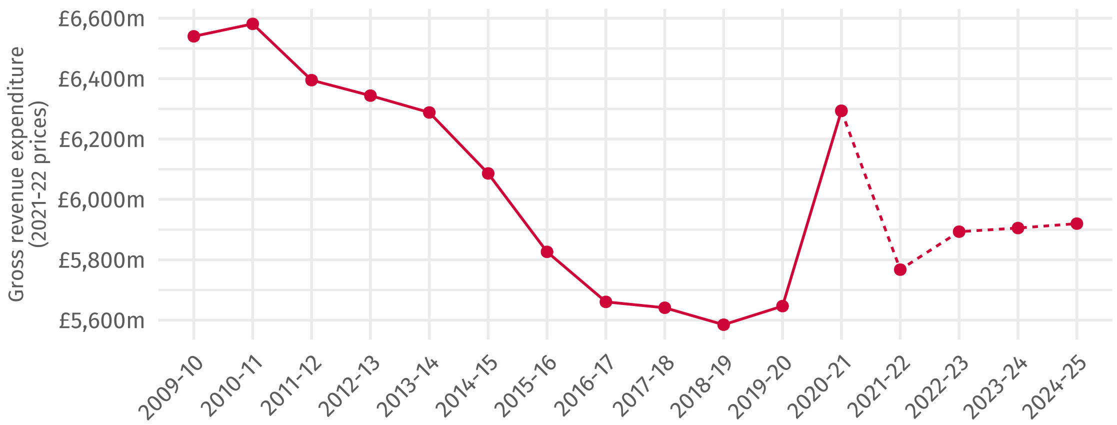
The Welsh Government has also committed to major reforms of local government financing and services over this Senedd term – including bringing forward proposals to reform the adult social care sector and make council tax "fairer".[30] These are both welcome commitments. Of course, there are important considerations in their implementation. If the cost of reforming the social care sector exceeds the amount of additional funding allocated to local authorities, this could lead to a funding shortfall for other local government services. There is precedent for this – when free personal care was rolled out in Scotland in 2002, the

[30] Welsh Government, *The Co-operation Agreement*.

cost was initially underestimated in the planning group report.[31] Similarly, reforming council tax will require the Welsh Government to strike a balance between the more practical option of modifying the existing band structure and more ambitious proposals to replace the tax altogether. In any case, it will be important to consider the distributional impact of any proposed changes on households and local authorities.

Figure 3.2

Welsh Government funding to local authorities, and projections to 2024–25 (2021–22 prices)



Source: WFA analysis; StatsWales (2021) Financing of local authority gross revenue expenditure. • Notes: Chart shows the combined value of the Revenue Support Grant (RSG), specific grants (excluding Housing Benefit grants), and re-distributed non-domestic rates. The Council Tax Reduction Scheme has been removed from the RSG in years prior to 2013–14 to ensure consistency with its treatment in subsequent years. The figure for 2021–22 represents the amount allocated at the Final Local Government Settlement, plus subsequent funding announcements – although the outturn may be higher. See Annex A for forecast methodology. Funding is adjusted for inflation using the GDP deflator series. A fall in public sector output during 2020–21 temporarily raised the GDP deflator, which suppresses the real terms increase in funding between 2019–20 and 2020–21.

3.1. Outlook for local government finance

Building on our previous modelling work, this section contains updated projections of local authority spending pressures to 2026–27.[32] Our projections have been rebased using the most recent 2020–21 outturn data (less pandemic-related spending), incorporate revised assumptions about future demand for social services and the persistence of pandemic-related costs and income losses, and include refinements to the way increases to the national living wage and employee costs are modelled. While some of the differences

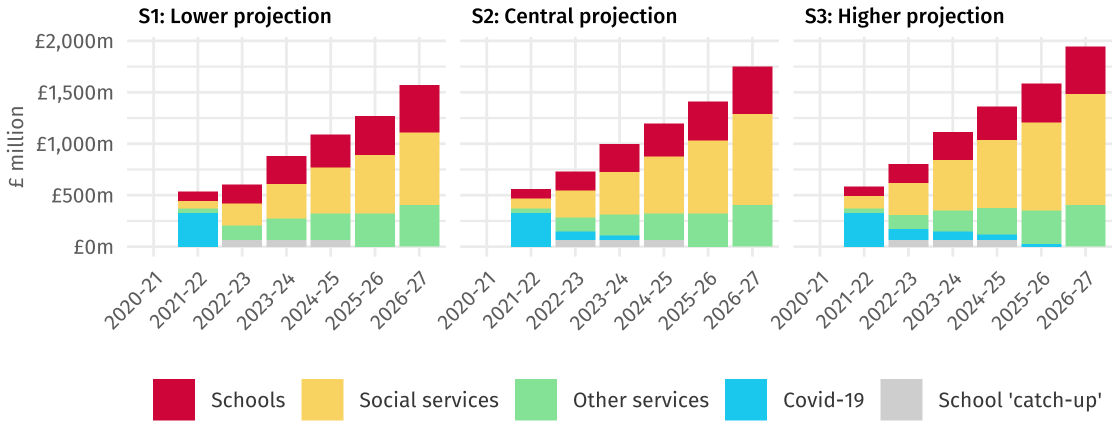
[31] Cian Siôn and Michael Trickey, *The cost of free personal care: Lessons from Scotland* (Cardiff: Wales Fiscal Analysis, 2021). https://www.cardiff.ac.uk/wales-governance-centre/publications/finance

[32] Cian Siôn and Guto Ifan, *Local Government & the Welsh Budget: Outlook and challenges for the next Welsh Government* (Cardiff: Wales Fiscal Analysis: 2021). https://www.cardiff.ac.uk/__data/assets/pdf_file/0009/2513619/lgf_outlook_2021_7.pdf

compared to our April 2021 report stem from changes in assumptions and methodology, these new projections also incorporate the most recent data on the economic outlook and reflect policy decisions that have been announced since then.

Figure 3.3

Components of local authority spending pressures from 2020–21



		£ million						
Scenario	**Pressures**	**2020–21**	**2021–22**	**2022–23**	**2023–24**	**2024–25**	**2025–26**	**2026–27**
S1: Lower	Schools	0	92	184	270	323	382	457
	Social services	0	77	214	339	444	565	708
	Other services	0	41	138	205	257	322	402
	Covid-19	0	327	0	0	0	0	0
	School 'catch-up'			66	66	66	0	0
	Total	**0**	**525**	**602**	**880**	**1,089**	**1,269**	**1,567**
S2: Central	Schools	0	92	184	270	323	382	457
	Social services	0	99	262	415	551	707	888
	Other services	0	41	138	205	257	322	402
	Covid-19	0	327	78	39	0	0	0
	School 'catch-up'			66	66	66	0	0
	Total	**0**	**547**	**728**	**995**	**1,196**	**1,411**	**1,748**
S3: Higher	Schools	0	92	184	270	323	382	457
	Social services	0	122	311	494	662	857	1,083
	Other services	0	41	138	205	257	322	402
	Covid-19	0	327	104	78	52	26	0
	School 'catch-up'			66	66	66	0	0
	Total	**0**	**570**	**803**	**1,113**	**1,360**	**1,587**	**1,942**

Source: See Annex A for full methodology ● Notes: Table and chart show additional funding required to meet councils' spending requirements relative to the 2020–21 (non-Covid) baseline. Lower cost scenario reflects slower growth in demand for adult and children's social services, and less persistent Covid-19 costs and income losses. Higher cost scenario reflects faster growth in demand for adult and children's social services, and more persistent Covid-19 costs and income losses. School 'catch-up' line shows estimated spending needs from 2022–23 onwards.

In October 2021, the OBR revised up its forecast for CPI growth and the GDP deflator.[33] Our model assumes that these near-term inflationary pressures result in faster growth in local authority input costs, particularly at the start of the forecast period. The OBR also applied an upward revision to its forecast for average earnings growth in the near-term, though growth is expected to slow at the forecast horizon. We assume that pay for local authority staff tracks growth in average earnings, adjusted to account for the planned increase in teacher's starting salaries to £30,000 by 2023–24.[34]

The planned 6.6% increase to the National Living Wage (NLW) from April 2022 is also set to increase staff costs – particularly for social care providers. We estimate the direct cost of the pay uplift for care workers subject to the NLW to be £10 million next year and that this will be reflected in larger payments to commissioned care providers.[35] The new Health and Social Care Levy is also set to increase employee national insurance costs – we estimate that the local authority pay bill will be £27 million higher next year as a result.

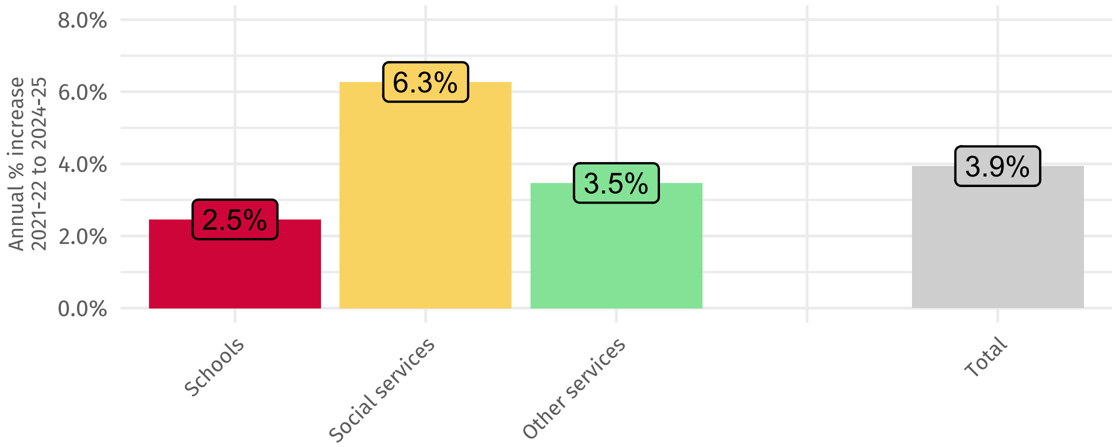
In total, councils' projected spending requirements are £1,196 million higher in 2024–25 compared to the 2020–21 (non-Covid) baseline, and £1,748 million higher by 2026–27. If demand for social care services grows at a slower pace and Covid-19 costs and income losses are less persistent, the projected increases are £1,089 million and £1,567 million respectively. If growth in demand for social services exceeds that assumed in the central scenario and post-pandemic pressures are long-lasting, the spending requirements could be £1,360 million higher in 2024–25 and £1,942 million higher by 2026–27.[36]

Taking the central scenario as the most likely outcome, this implies that local authority spending will need to grow by 3.9% a year in nominal terms over the next three years to meet baseline pressures in 2024-25 (**Figure 3.4**). Due to the tapering of pandemic-related costs and losses over the forecast period, the projected increase in councils' spending requirement is largest next year. A projected fall in pupil population explains the slower growth in schools' spending requirement, although any cost savings will depend on the extent to which decreased demand feeds through into lower inputs, such as the size of the schools' workforce.[37]

[33] Office for Budget Responsibility, *Economic and fiscal outlook*.
[34] Starting salaries for teachers were originally set to increase to £30,000 by September 2022, as per the UK government's commitment in England. However, the indirect effect of the public sector pay freeze in 2021–22 has delayed this objective. We assume that this target will now be reached by 2023–24, and that the Welsh Government will follow suit.
[35] We have not incorporated any assumption about the indirect cost of maintaining pay differentials in our estimate.
[36] Demand for children and families' social services is assumed to grow by 4.3% in our central scenario (in line with the 3-year average increase in the number of children in local authority care). This figure is replaced with 2.3% and 6.3% in our lower and higher scenarios respectively. Demand for adult social care is assumed to grow by 2.0% in our central scenario (1.5% / 2.5% in our lower / higher scenarios). See Annex A for further detail.
[37] Ogden, Phillips, and Siôn, "What's happened and what's next for councils," 319–321.

Figure 3.4

Projected average annual increase in councils' baseline (non-covid) spending requirements, 2021-22 to 2024-25



Source: WFA analysis. See Annex A for full methodology. • Notes: Chart shows the annual increase in spending required over three years to meet spending pressures in 2024-25 according to the central scenario. Excludes the spending requirements on Covid-19 and "catch-up" learning initiatives.

Another potential source of pressure for councils on top of their baseline spending requirement will be the need to provide continued support for pupils to compensate for lost learning time in classrooms during the pandemic. There is strong evidence in the academic literature on the link between school spending and learner outcome, and that these effects may be compounded for learners from more disadvantaged backgrounds.[38] Given the considerable amount of school-time lost in 2020–21, the current school-age cohort may also be at a disadvantage compared to their older (and younger) counterparts.

So far, the Welsh Government has committed £400 per pupil to facilitate "catch-up" learning initiatives in 2020–21 and 2021–22. This is higher than other parts of the UK but considerably less than some countries in an international context, including the United States (£1,830 per pupil) and the Netherlands (£2,090 per pupil).[39] Indeed, the Education Policy Institute estimated that an additional £3.2 billion would be required for English schools over the next three years, on top of previous announcements, to recover two months' lost learning by

[38] Luke Sibieta, *Review of School Spending in Wales: Building in evidence, fairness, transparency and clear expectations* (Cardiff: Welsh Government, 2020). https://gov.wales/sites/default/files/publications/2020-10/review-of-school-spending-in-wales.pdf

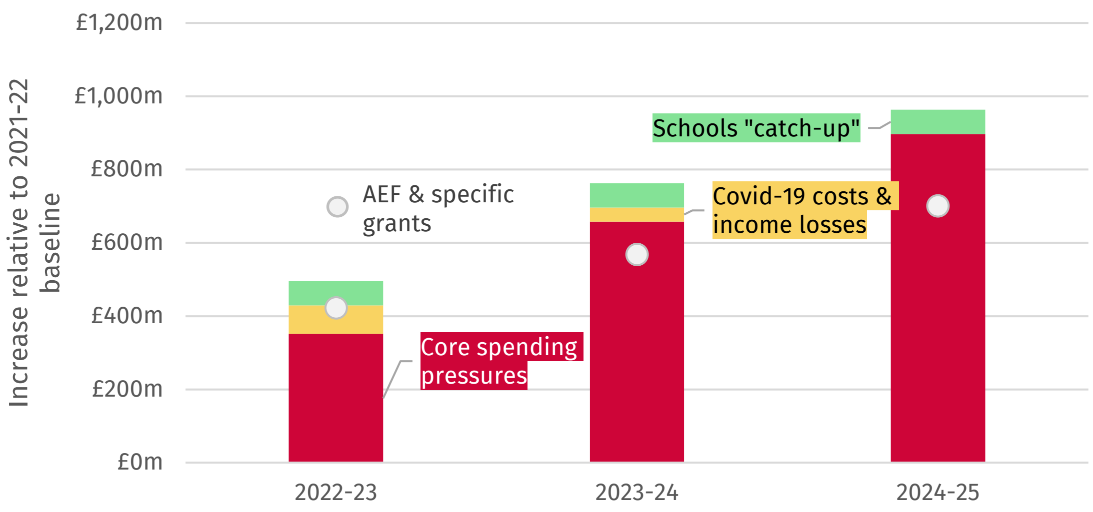
[39] Jon Andrews, Tim Archer, Whitney Crenna-Jennings, Natalie Perera, and Luke Sibieta, *Education recovery and resilience in England: Phase two report* (London: Education Policy Institute, 2021). https://epi.org.uk/publications-and-research/education-recovery-and-resilience-in-england-phase-two-report-october-2021/

extending school hours.[40] Taking a population of this estimate implies than an additional £66 million might be required for Welsh schools over the next three years on top of the baseline growth in spending requirements.

Under the indicative spending scenario outlined in the previous chapter, Welsh Government funding for local government is projected to grow by 4.0% a year in nominal terms over the next three years (7.4% in 2022–23, 2.4% in 2023–24 and 2.1% in 2024–25).[41] This increase in funding in front-loaded, reflecting UK government spending plans. As a result, local authorities are set to face limited real terms growth in their funding settlement 2023–24 and 2024–25 under our indicative scenario.

Figure 3.5

Projected increase in local authority spending pressures and Welsh Government funding relative to 2021-22 baseline



Source: WFA analysis. See Annex A for full methodology. • Notes: The grey circles represent the projected increase in the Revenue Support Grant, redistributed non-domestic rates and specific grants to local authorities (excluding increases resulting from growth in council tax levels and the tax base).

As shown in **Figure 3.5**, the growth in the local government settlement and specific grants alone is sufficient to cover additional baseline and pandemic-related pressures in 2022–23, although it falls short of the amount required to fund a comprehensive "catch-up" learning programme. From 2023–24 onwards, the projected increases to the settlement alone are insufficient to meet spending pressures. In the absence of a more generous settlement than

[40] Whitney Crenna-Jennings, Natalie Perera, and Luke Sibieta, *Education recovery and resilience in England: Phase one report* (London: Education Policy Institute, 2021). https://epi.org.uk/publications-and-research/education-recovery-and-resilience-in-england/

[41] Welsh Government funding for local government includes the Revenue Support Grant, redistributed non-domestic rates and specific grants (excluding housing benefit grants).

the one implied by our indicative spending plans, local authorities will need to rely on council tax increases to meet their spending requirements in future years.

3.2 Council Tax

So far, we have only evaluated the funding outlook in the context of the projected growth in the local government settlement. However, local authorities can also levy increases to council tax levels to fund additional spending. In 2022–23, each additional percentage point increase in council tax levels implies an extra £15 million for local authorities (net of the council tax reduction scheme). Even in the absence of changes to council tax levels, revenues from council tax tend to grow over time due to the growth in the size of the property tax base. We use the latest figures from the Office for Budget Responsibility which imply that the council tax base in Wales grows by 0.6% a year over the forecast period.

Figure 3.6

Local authority "funding gap" implied by our indicative spending plans under various assumptions about council tax increases.

		Council funding less spending requirement (£ million)		
Scenario	**Assumed increase in council tax levels**	**2022–23**	**2023–24**	**2024–25**
With school "catch-up" spending	0% each year	−66	−178	−237
	1% each year	−50	−148	−191
	2% each year	−35	−117	−143
	3% each year	−20	−85	−95
	4% each year	−5	−54	−46
Without school "catch-up" spending	0% each year	0	−112	−171
	1% each year	16	−82	−125
	2% each year	31	−51	−77
	3% each year	46	−19	−29
	4% each year	61	12	20

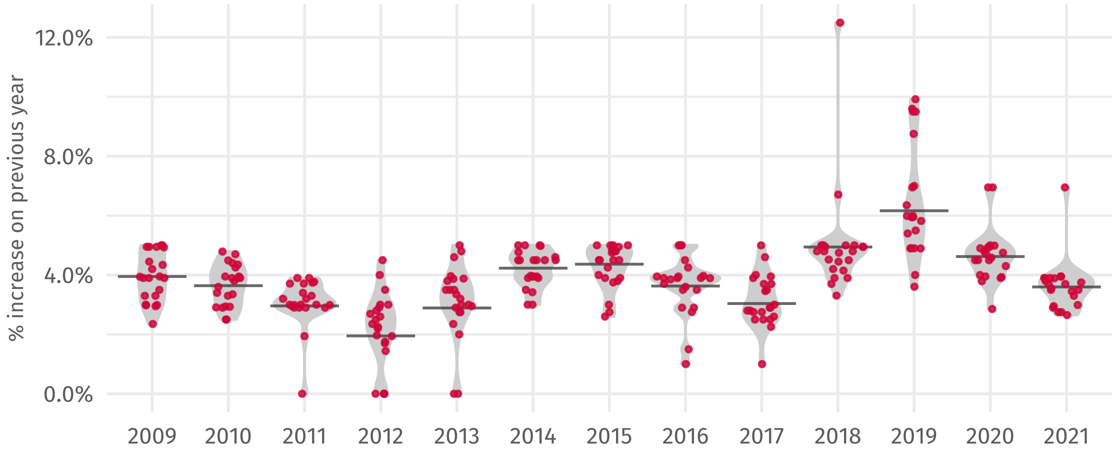
Source: WFA analysis. See Annex A for full methodology. ● Notes: Council funding less spending requirement represents the difference between the projected (baseline and Covid-19) spending pressures entailed by our central scenario (using 2021–22 as a base year) and the projected growth in the revenue support grant, redistributed non-domestic rates, specific grants (excluding housing benefit grants), and council tax revenue (net of the council tax reduction scheme).

Figure 3.6 shows the difference between projected revenues and spending needs under our indicative spending scenario and using varying assumptions about council tax increases. Whilst it would be difficult to fully fund an "catch-up" learning programme from councils' budgets, all other local government pressures could be met over the next three years with council tax increases of roughly 3.6% a year. This would leave local authorities with some headroom for additional spending in 2022–23, but funding would broadly match spending pressures in the following two years.

Of course, the Welsh Government could opt to allocate additional funding to local authorities (above the amount implied by our indicative scenario). As we discuss in the next chapter, this could help limit future increases in council tax levels. Even in the absence of additional funding, local authorities may be able to propose smaller increases to council than those seen in recent years. Between 2018–19 and 2020–21, council tax increases averaged 5.3% a year across Wales. Future increases may be more in line with those seen during the first half of the 2010s, when the local government settlement was partially protected from the full effects of austerity policies (**Figure 3.7**).

Figure 3.7

Annual increases in council tax levels, 2009 to 2021

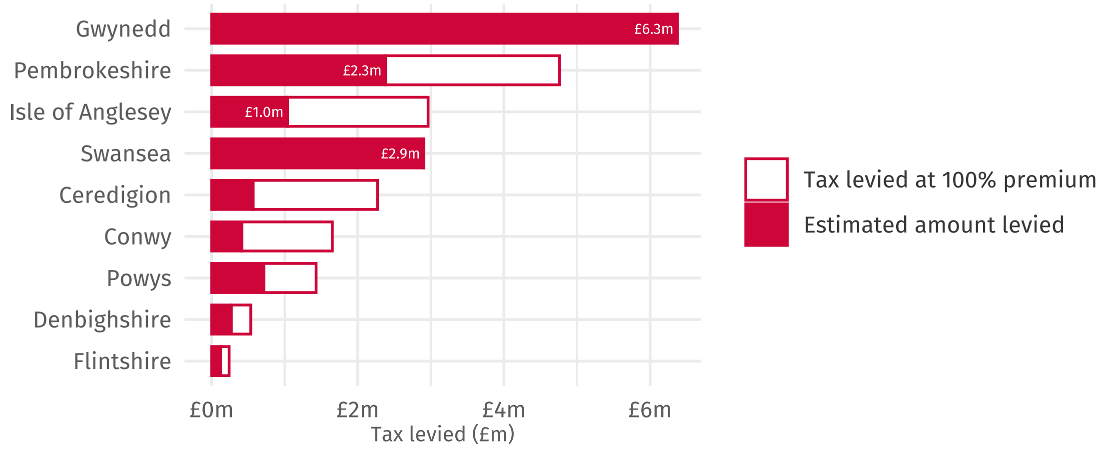


Source: StatsWales (2021) Council tax by billing authority. • Notes: Grey lines denote the average increase in council tax levels across Wales.

Since 2017, local authorities have been able to apply a premium (or discount) of up to 100% of Council Tax bills for second homes and long-term empty homes. In 2021–22, nine local authorities opted to levy a premium on second homes: Conwy and Ceredigion apply a premium of 25%, the Isle of Anglesey applies a premium of 35%, Denbighshire, Flintshire, Powys, and Pembrokeshire each apply a premium of 50%, while Gwynedd and Swansea apply a 100% premium (**Figure 3.8**). Although the total revenue raised remains relatively small (£15 million in 2021–22), it has become an increasingly important source of revenue for some local authorities. Local authorities will set the levels of premiums and discounts for 2022–23 as part of their normal budget setting process in the new year.

Figure 3.8

Estimated revenue raised from council tax premiums on second homes, 2021–22



Source: WFA analysis of StatsWales (2021) Council tax dwellings, by CT1 row description. • Notes: Chart does not show revenues from the premium on long-term empty properties.

The recent Co-operation Agreement between the Welsh Government and Plaid Cymru reiterated both parties' commitments to making council tax 'fairer'.[42] The problems with council tax are well-document.[43] It is a regressive tax – both with respect to income and property value.[44] Moreover, the regressive effects of the tax have been amplified by the fact that increases in Council Tax bills have outpaced growth in earnings in every single year since between 2009 and 2019. During the last Senedd term, the Welsh Government commissioned several studies into potential options for reform. The options included a simple revaluation exercise, adjusting the existing band structure to make the system more proportional with respect to property values, or replacing council tax with a tax based on land value or income.[45] When deciding how to progress, the Welsh Government will need to strike a balance between the more practical option of reforming the existing band structure and more ambitious proposals to replace the tax altogether.

As with any major piece of tax reform, reforming or replacing council tax would create winners as well as losers. This might explain why previous governments have been disinclined to undertake frequent revaluation exercise (let alone reforms). However, many more low- and middle-income households would benefit rather than lose out from making council tax more proportional and transitional arrangements could be put in place to protect

[42] Welsh Government, *The Co-operation Agreement*, 4.

[43] See, for example: Ed Gareth Poole and Guto Ifan, *The Welsh Tax Base: Risks and Opportunities after Fiscal Devolution* (Cardiff: Wales Centre for Public Policy, 2018), 34–39. https://www.wcpp.org.uk/publication/the-welsh-tax-base-risks-and-opportunities-after-fiscal-devolution/

[44] Guto Ifan and Cian Siôn, *Welsh Budget Outlook 2020* (Cardiff: Wales Fiscal Analysis, 2020), 55–59. https://www.cardiff.ac.uk/__data/assets/pdf_file/0010/2481634/welsh_budget_2020_report_formatted.pdf

[45] Welsh Government, *Reforming Local Government Finance in Wales: Summary of Findings* (Cardiff: Welsh Government, 2021). https://gov.wales/reforming-local-government-finance-wales-summary-findings

those who see their property move up several bands from large overnight increases to their bill.[46]

The impact of reforms on local authorities would also need to be considered. Any proposal could be designed to be revenue-neutral at a local authority level by using the standard spending assessment – which is used to calculate grant allocations – to compensate local authorities who see a reduction in their council tax base post-reforms (and vice versa). This may well be desirable given that local authorities have little control over relative growth in house prices.

Lastly, the profile of the UK government's spending plans may prove to be fortuitous, particularly if council tax reforms can be implemented before larger council tax increases are required nearer the end of the Spending Review period.

3.3. Non-domestic rates

The tax schedule for non-domestic (business) rates has been temporarily transformed by the grants and reliefs announced over the past 21 months. These have been a cornerstone of the devolved government's support to businesses affected by the pandemic. In 2021–22, the Welsh Government allocated £380 million to fund a 100% tax relief package for qualifying retail, leisure, and hospitality premises. In his October budget, the Chancellor announced that the 50% relief provided to retail, leisure and hospitality businesses in England this year would be extended for another year (subject to a cash cap of £110,000 per business). In addition, the multiplier used to uprate business rates in England will again be frozen in 2022–23. Together, these policy decisions triggered approximately £160m of consequential funding to be allocated by the Welsh Government in 2022–23.

An estimated 54,500 retail, leisure, and hospitality businesses are registered on the local rating list in Wales – a majority (29,000) of which already qualify for full tax relief under the Small Business Rates relief scheme.[47] A further 12,500 businesses are eligible for tapered relief. The pandemic-related relief has mostly been targeted at the 13,000 medium and large-sized businesses in the retail, leisure, and hospitality industries with a rateable value of more than £12,000. Of these, 8,250 (63%) operate in the retail sector.

Offering 50% relief to all businesses in the retail, leisure and hospitality sector would cost roughly £250 million. But there are grounds for placing an upper limit on the amount businesses can claim. Last year, several large supermarket chains in England repaid millions

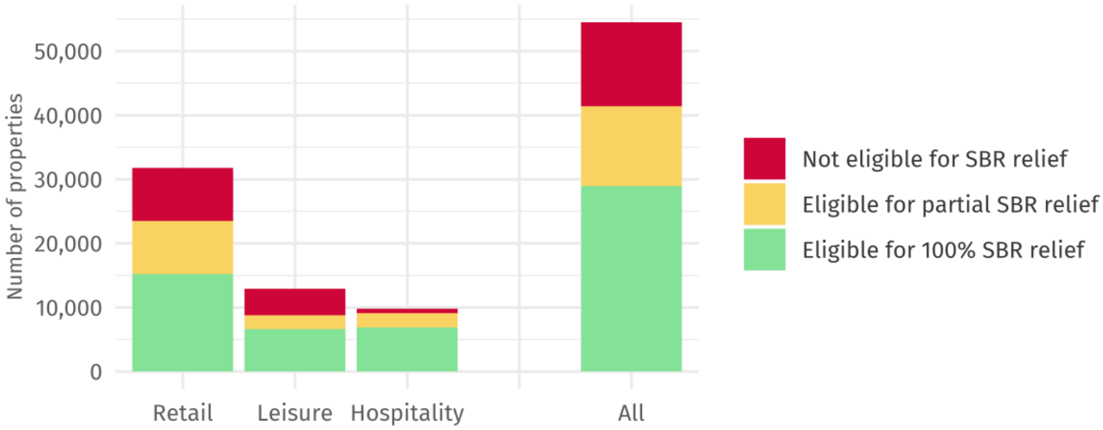
[46] Stuart Adam, Louis Hodge, David Phillips, and Xiaowei Xu, *Revaluation and reform of council tax in Wales: impacts on different councils and household types* (London: Institute for Fiscal Studies, 2020). https://ifs.org.uk/publications/14760

[47] Properties with a rateable value of less than £6,000 are eligible for 100% relief under the Small Business Rates Relief scheme, while those with a rateable value of more than £6,000 but less than £12,000 are eligible for tapered relief on their bills.

in business rates relief to the Treasury following a sharp uptick in sales.[48] Limiting the relief to businesses with a rateable value of less than £500,000 (as was Welsh Government policy last year) would reduce the cost to £190 million. The £110,000 cash cap implemented in England for 2022–23 equates to a rateable value of roughly £205,000 in Wales. Setting this as the upper threshold would halve the cost to £125 million whilst still allowing the Welsh Government to support approximately 25,000 businesses.

Figure 3.7

Estimated number of retail, leisure, and hospitality premises eligible for Small Business Rates relief, April 2021



Source: WFA analysis of VOA (2021) Stock of properties tables. ● Notes: The breakdown of leisure and hospitality premises eligible for partial and 100% relief is estimated.

The Welsh Government face a further decision on whether to freeze the multiplier which is used to uprate non-domestic rates bills. Since 2018–19, the multiplier has been increased in line with the 12-month CPI rate of inflation in the September preceding the start of the new financial year. Under normal circumstances, this implies that the multiplier is set to increase from 0.535 in 2021-22 to 0.551 in 2022–23 (a 3.0% increase in tax liabilities). Freezing the multiplier at its current level would cost an estimated £42 million next year. Whether or not it is frozen, the most recent inflationary pressures will not be reflected by the multiplier until 2023–24 meaning that businesses may still face a large increase in tax liabilities in April 2023.

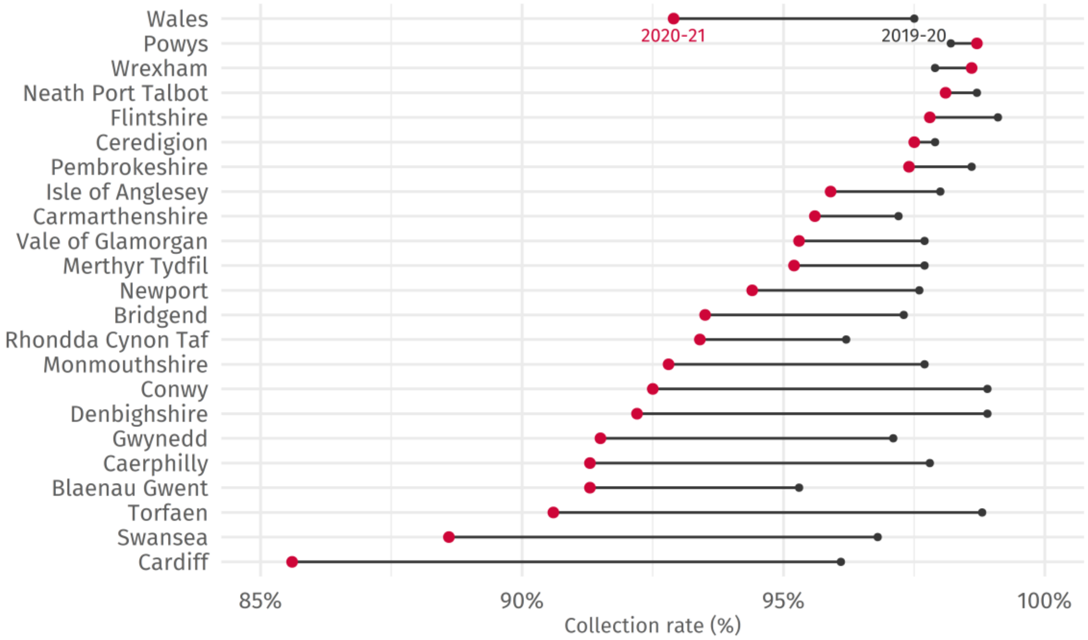
Collection rates have also been impacted by the pandemic. Figure 3.8 shows the change in collection rates between 2019–20 and 2020–21 by local authority. In 2020–21, the national collection rate was 92.9%, down from 97.5% in 2019–20 – with the reductions in collection being most pronounced in Cardiff and Swansea. This is likely due to the suspension of enforcement action at the beginning of the pandemic. The impact on local authority budgets

[48] Harriet Clarfelt and Jonathan Eley, “Tesco to repay £585m in business rates relief,” *Financial Times*, December 2, 2020. https://www.ft.com/content/13444e6c-4ed4-48eb-a86d-552158b2c62b

is partially offset by the fact that the amount of non-domestic rates revenue to be collected was considerably smaller than in previous years due to the Covid-19 tax relief funded by the Welsh Government. Additionally, the Welsh Government has shifted £100 million of central government funds into the local government and police settlements, while reducing the provision from NDR sums by the same amount, to "alleviate any ongoing impact on the NDR funding available for the local government and police settlements in future years".[49]

Figure 3.8

Non-domestic rates collection rate, 2019–20 and 2020–21



Source: StatsWales (2021) Collection of non-domestic rates, by year.

Under present arrangements, a revaluation of rateable values takes place every five years in Wales. Prior to the pandemic, the Welsh Government had brought the planned 2022 revaluation forward by a year to align with the timing in England. However, due to the pandemic, this revaluation has now been postponed until 2023.[50] While the decision to postpone is sensible and will allow rateable values to better reflect the impact of Covid-19, it nevertheless means that six years will have elapsed since the last revaluation exercise by the time the next revaluation takes place. In October 2021, the Chancellor announced that the gap between revaluations in England will be reduced from five to three years going forwards. This will help ensure that businesses' tax liability is calculated on more up-to-date rateable

[49] Welsh Government, *3rd Supplementary Budget for 2020 to 2021 – Explanatory notes* (Cardiff: Welsh Government, 2021), 8. https://webarchive.nationalarchives.gov.uk/ukgwa/20210404064736/https://gov.wales/3rd-supplementary-budget-2020-2021

[50] https://gov.wales/written-statement-non-domestic-rates-revaluation-wales

values and reduce the potential for large jumps between revaluations. Further announcements on business rates reforms are expected; however, those expecting a radical overhaul of the existing system will likely be disappointed. In the words of the Chancellor: “While the (UK) government plans to bring forward several substantive changes to improve the system, we see little value in ripping the system up and starting afresh as has been suggested by a small minority.”[51]

Non-domestic (business) rates are fully devolved to Wales; however, the Welsh Budget is still indirectly impacted by the amount of business rates collected in England due to the negative consequentials applied to the block grant. This means that planned reforms in England – and the subsequent impact on revenues – will also impact the Welsh Budget. Even if the Welsh Government is unlikely to go ahead with a major overhaul of the current regime, the past 21 months has shown that it already has considerable flexibility to target sector-specific support under current arrangements.

3.4. Adult social care reform

The Co-operation Agreement between the Welsh Government and Plaid Cymru commits the government to agree an implementation plan for social care reform by the end of 2023, with the ambition of delivering a National Care Service, free at the point of need.[52] The UK government similarly plans to reform the way adults pay for social care by introducing a £86,000 lifetime cap on the care costs paid by adults in England and increasing the means test threshold from £23,250 to £100,000. This will be funded by an increase to employer and employee national insurance contribution rates, termed the Health and Social Care Levy. Over the next three years, £3.6 billion will be used to reform how people in England pay for care and £1.7 billion will be used to support wider system reforms.

From a budgetary perspective, Wales stands to benefit from the decision to raise taxes at a UK-level (and to subsequently receive its population share in consequentials) rather than using the devolved tax levers. The Welsh Government will receive an estimated £600 million a year over the next three years because of the new levy, the proceeds of which are earmarked for health and social care spending. While it will be up to the Welsh Government to decide how to allocate this funding, if we assume that a similar proportion is committed to the social care sector as in England, this implies that the Welsh Government will have approximately £150 million available to implement reforms of adult social care in 2024–25. This is on top of the funding projections for local government outlined earlier in the chapter.

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[51] HM Treasury, *Business Rates Review: Final Report* (London: HM Treasury, 2021), 2. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1028478/BRR_final.pdf

[52] Welsh Government, *The Co-operation Agreement*, 3.

Whether or not the reforms can be funded using the proceeds from the levy alone will depend on how ambitious the proposed plans for reform are.

Last year, the Welsh Government commissioned a report by LE Wales exploring options for reforming care in Wales.[53] The cost of introducing free personal care services for those in receipt of domiciliary and residential care along similar lines to Scotland was estimated to be £192 million if implemented 2021, with a lower cost estimate of £131 million if a smaller number of individuals switch from privately purchased and informal care.

However, any reforms of the sector will need to address more than who pays for care, and how. It is widely recognised that low pay is endemic in the care sector. Notwithstanding the unfairness of current arrangements, the prevalence of low pay often hinders retention and long-term workforce planning.[54] The same report by LE Wales estimates the cost of introducing a real living wage for care workers at approximately £20 million in the first year of its implementation. More far-reaching proposals to align pay with the NHS Agenda for Change pay scale would cost an estimated £54 million.[55]

Whatever reforms are selected, they will need to be accompanied by a fair funding settlement that compensates local authorities for any additional costs incurred. In the absence of sufficient funding, the ability of local authorities to deliver other services could be compromised. There is precedent for this – when free personal care was rolled out in Scotland in 2002, the cost was initially underestimated in the planning group report.[56] There were several reasons for this. The original planning group report used population projections published by the ONS to forecast future demand, but the projected size of the older population was revised upwards significantly when the results of the 2001 Census were released. The lack of reliable data on private care provision and uncertainty about the extent to which those currently receiving informal care would apply for state-funded care once the policy had been implemented also made it difficult to gauge costs – this is also likely to be the case in Wales. Another unforeseen aspect which impacted costs in Scotland was the Department for Work and Pension’s decision to withdraw the Attendance Allowance – a tax-free social security benefit paid to people over the age of 65 who need help with personal care – from individuals in residential care who had all their disability-related needs met by the state. The Scottish Government were compelled to step in and recompense individuals impacted from its own budget.

[53] Shaan Devnani, Wesley Jessie, Siôn Jones, Rohit Ladher, Wouter Landzaat, and Pietro Patrignani, *Use of additional funding for social care – Final Report for Welsh Government* (London: LE Wales, 2020). https://gov.wales/sites/default/files/publications/2021-04/use-of-additional-funding-for-social-care-final-report.pdf

[54] Cian Siôn and Michael Trickey, *The future of care in Wales: Resourcing social care for older adults* (Cardiff: Wales Fiscal Analysis, 2020), 21–27. https://www.cardiff.ac.uk/__data/assets/pdf_file/0019/2427400/social_care_final2_aug20.pdf

[55] Devnani et al., *Use of additional funding for social care*.

[56] Siôn and Trickey, *The cost of free personal care*, 8–10.

While the decision to grapple with social care reforms is welcome (and overdue), consideration must also be given to the impact of the policy across age cohorts. It is unfortunate that the UK government resorted to using national insurance contributions rather than income tax to fund reforms. Unlike income tax, national insurance contributions are not paid on unearned income (e.g. from investments, pensions, and rent), and in the absence of other policy interventions, the proposed arrangement in England is tantamount to a transfer from working-age individuals to asset-rich pensioners. Given the evidence of a growing inter-generational wealth gap, and the increasing number of younger people who are priced out of the property market, the reforms are likely to further legitimise concerns about generational unfairness.[57]

[57] Siôn, “When ends don’t meet: tax rises and benefit cuts (Part 1)”.

4 Funding and spending pressures

This section analyses the spending pressures facing different areas of the Welsh budget over coming years in the context of the overall increase in the budget. Firstly, we analyse the spending pressures facing the NHS, the largest area of spending. Secondly, we consider other areas of the budget which may require interventions by the Welsh Government over coming years as it deals with the lingering effects of the pandemic on public services, businesses, and household finances. Lastly, we discuss some of the spending implications of the Co-operation Agreement between the Welsh Government and Plaid Cymru, and how they might be achieved given the increase in the budget and existing funding pressures.

4.1. NHS spending pressures

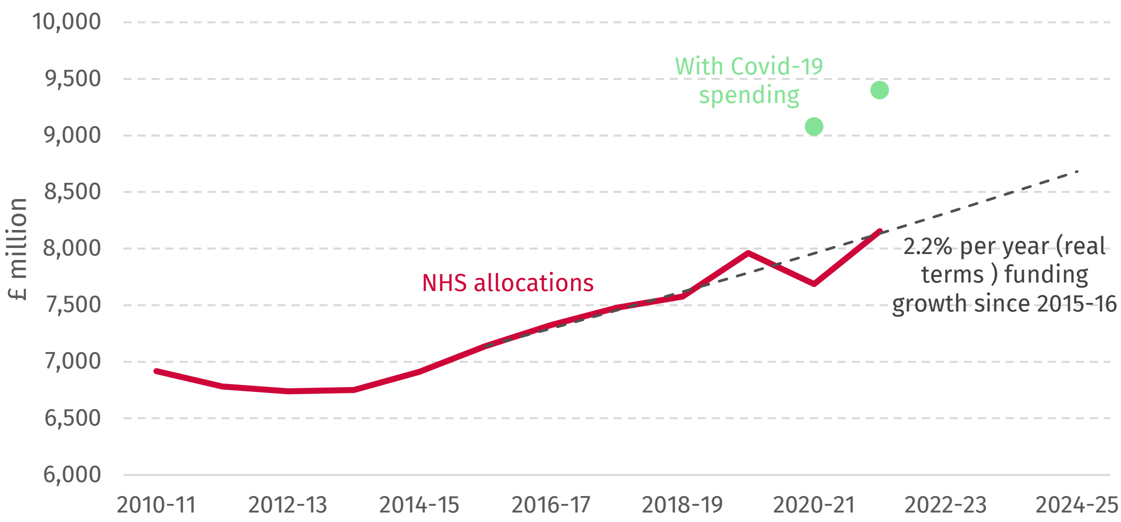
In 2016, modelling by the Health Foundation suggested funding for the Welsh NHS would need to grow by 2.2% a year in real terms to keep pace with spending pressures deriving from a growing and ageing population, and projected increases in chronic conditions.[58] As shown in **Figure 4.1**, actual trends in budgeted spending on the NHS (excluding Covid-19 related spending) has increased broadly in line with this estimated funding need since 2015-16. This means budgeted core spending on the NHS in 2021-22 (excluding Covid-19 spending) is now almost a fifth higher than 2010-11 levels in real terms, after real terms cuts in spending over the first years of austerity.

To estimate the broad funding pressures facing the Welsh NHS, we firstly make assumptions about **underlying pressures**, before factoring in how the pandemic will affect services over coming years. We assume underlying demand increases in line with Health Foundation modelling, as we did in our previous report on NHS pressures.[59] We make a slight adjustment to this projection to model 3% pay rises from 2022-23 to 2024-25 (in line with the increase for 2021-22) rather than the 2% above inflation assumed by the Health Foundation (we show the effect of assuming larger pay increases later in this section). We also estimate that the introduction of the Health and Social Care Levy in 2022-23 will increase costs by £54 million. We also assume that productivity increases by 0.9% a year, in line with long-run estimates of productivity in public service healthcare across the UK (we later model the productivity impact of the pandemic on funding pressures).

[58] Toby Watt and Adam Roberts, *The Path to Sustainability.* (London: The Health Foundation, 2016). https://www.health.org.uk/publications/reports/the-path-to-sustainability
[59] Ifan, *The NHS and the Welsh Budget*.

Figure 4.1

NHS allocations in Welsh Government budgets, 2010-11 to 2024-25 (real terms, 2021-22 prices)



Source: Authors' calculations based on Welsh Government (2021 and previous) budget documents. Last supplementary budget allocations for each year used.

In response to the Covid-19 pandemic, the Welsh Government made a series of large allocations to the NHS budget. These allocations amounted to £1.4 billion of revenue funding in 2020-21 to fund various pandemic responses, such as building up capacity, additional PPE supplies, the Test, Trace, Protect (TPP) strategy, and the deployment of vaccines.

So far, the Welsh Government has allocated £540 million to the NHS in the budget for 2021-22. As outlined in section 2.1, subsequent announcements have committed substantial additional resources to the NHS. Accounting for these announcements, the Welsh Government appears to have committed £851 million for ongoing costs of the pandemic on the NHS and for contact tracing in 2021-22. The **direct costs of Covid-19** on health spending after 2021-22 are highly uncertain. There are likely to be ongoing costs beyond this year for treating Covid-19 patients, the TTP programme, PPE requirements and revaccination efforts. As we did in our previous report on NHS pressures, we make a simple assumption that these direct Covid-19 costs fall by three quarters from 2021-22 to 2022-23 (to £213 million) and fall again to £53 million in 2023-24 and 2024-25. Relative to population, this is broadly in line with assumptions made by Warner and Zaranko in their modelling of pressures for England.[60]

[60] Max Warner, and Ben Zaranko, "Pressures on the NHS," in *The IFS Green Budget: October 2021*, eds. Carl Emmerson, Paul Johnson, and Ben Zaranko (London: Institute for Fiscal Studies, 2021), 231–294. https://ifs.org.uk/publications/15688

The Covid-19 pandemic is likely to have had a substantial impact on **productivity in the NHS**. Social distancing and heightened infection control will have reduced productivity considerably over the course of the pandemic. In line with the Office for Budget Responsibility assumption, we model the impact of a 1.2 per cent hit to productivity across NHS services.[61] This would increase cost pressures by over £100 million in each year. A larger hit to productivity would of course imply additional cost pressures.

As well as dealing with the immediate and ongoing costs of the pandemic, the Welsh Government has also made allocations for **post-pandemic recovery and clearing the backlog in elective care**. The 1st Supplementary Budget included an initial £100 million, followed by £100 million announced in August to help health boards' recovery plans (alongside £40 million of capital spending). Recurrent funding commitments have also been made for urgent and emergency care services (£25 million a year) and planned care services (£170 million).

Figure 4.2 provides a picture of activity in the Welsh NHS from January 2019 to September 2021. The overall waiting list for elective care has increased substantially during the pandemic, with the number of patient pathways waiting to start treatment reaching 669,000 by September 2021. This represents a 45% increase compared to January 2020. As seen in the top left panel of **Figure 4.2**, the number of patient pathways closed each month (through treatment, patients no longer waiting to be seen, or deceased patients) fell substantially in 2020 relative to 2019. Levels have recovered over 2021 but remained around a fifth lower than 2019 levels from April to September 2021.

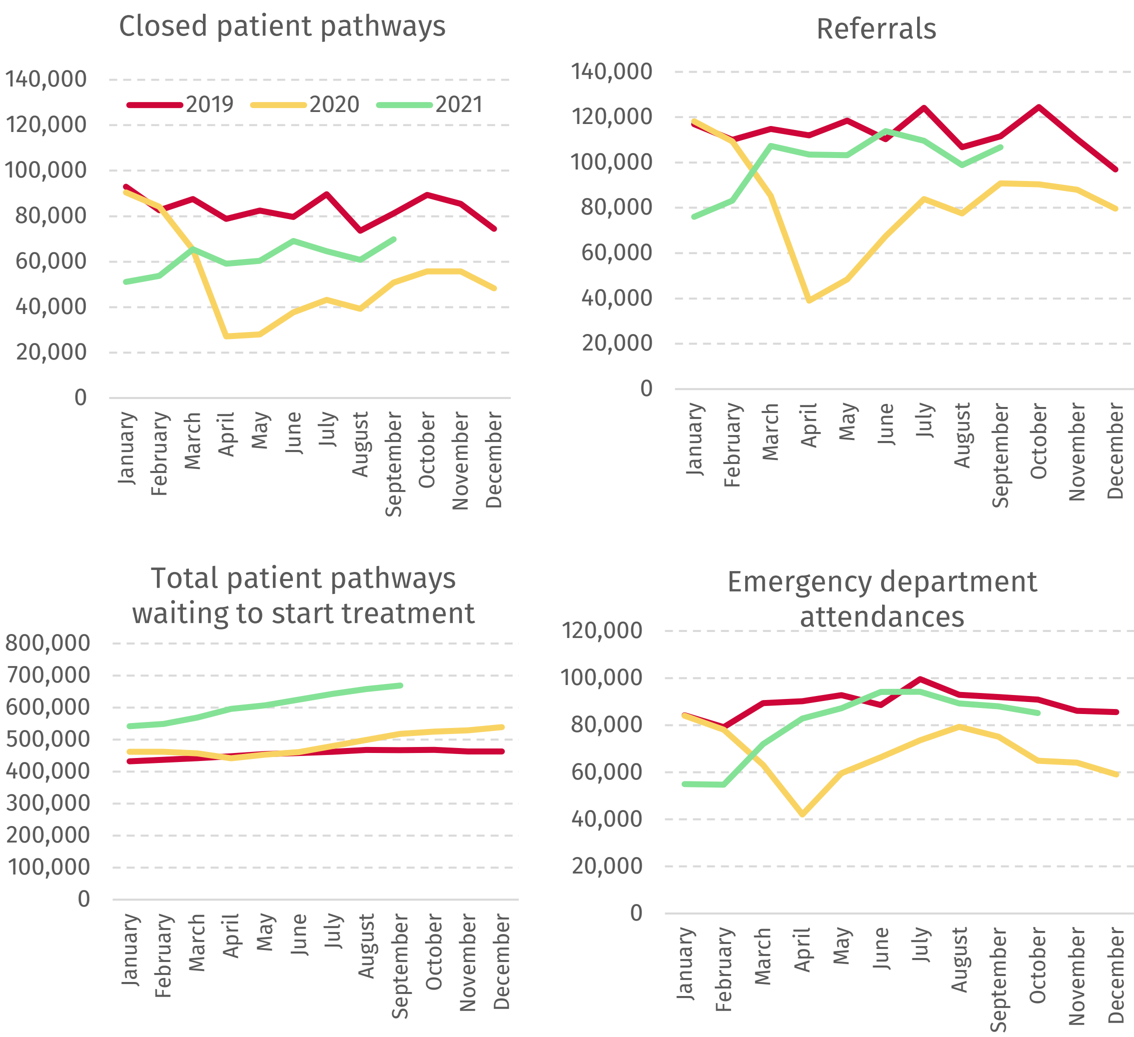
On the other hand, referrals to treatment have broadly recovered to 2019 levels in 2021, after a sharp drop during 2020. Overall, from March 2020 to February 2021, 447,000 fewer patients had been referred relative to the same periods in 2019. As we highlighted in our earlier NHS briefing, the extent of suppressed demand – and how and when it materialises – will be one of the key uncertainties facing the NHS. Meanwhile, emergency department attendances (shown in the bottom right panel) have recovered to 2019 levels.

The £195 million a year committed so far by the Welsh Government for emergency and planned care services is broadly in line with our estimate of the funding required to bring waiting lists down over a four-year period. This modelling assumed that 75% of "missing" patients returned during 2021-22 and used our central cost estimate of £1,800 per patient. We therefore assume recovery funding of £195 million in our central funding pressures estimate. This funding need could increase if "missing" patient pathways are more complex and more costly to treat, or if the Welsh Government wanted to reduce the years for recovery in waiting lists (though this would of course be subject to capacity constraints).

[61] Office for Budget Responsibility, *Fiscal Risks Report 2021*.

Figure 4.2

Number of closed patient pathways, outpatient referrals, patient pathways waiting to start treatment and emergency department attendances, January 2019 to September 2021



Source: Statswales (2021) Health and social care

The pandemic and associated policy measures will also have brought about additional **indirect demand pressures**, not least the effect on mental health. On one general measure, average mental health worsened by17% at onset of the pandemic, while the prevalence of mental health conditions across adults in Wales almost tripled.[62] At the same time, the pandemic made it harder to access mental health services.[63] The latest data on NHS expenditure by budget category showed that £810 million was spent on treating mental

[62] Jesús Rodríguez. *Covid-19 in Wales: the mental health and wellbeing impact* (Cardiff: Wales Fiscal Analysis, 2021) https://www.cardiff.ac.uk/__data/assets/pdf_file/0010/2533762/COVID-19-Mental-health-FINAL-08-07-2021.pdf

[63] https://research.senedd.wales/research-articles/a-mentally-well-wales/

health problems in 2019-20. Modelling for England projected a surge in referrals for mental health services, of up to 13% in 2021-22 and falling to 7% in 2023-24. In line with our previous report, we again project additional costs of £70 million in 2022-23, falling to £23 million in 2024-25.

As outlined above, we assume pay increases of 3% a year for 2022-23 to 2024-25. The pandemic has heightened the issues around NHS staff pay, especially given the declining real pay for staff over the last decade. There are also significant concerns around staff well-being, stress and burnout following the pandemic. The Welsh Government gave a bonus payment of £735 to NHS and social care staff to "recognise their extraordinary contribution" during the pandemic, at a cost of around £66 million.[64] The pressures on staff and the need to recruit additional doctors and nurses to recover from the pandemic suggests higher pay rises may be needed than our baseline assumption. We therefore assume an additional 1% each year in **pay increases** from 2022-23 to 2024-25 on top of our baseline scenario. This increases costs by £55 million in 2022-23, growing to £180 million by 2024-25.

Alongside these significant increases in costs associated with the pandemic, there may also be opportunities for **savings**. Firstly, the excess deaths associated with the pandemic may reduce some demands for public services.[65] Secondly, the pandemic has changed how the NHS operates which may reduce future costs, for example, if digital consultations continue after the pandemic. Based on estimates by Warner and Zaranko for England, we project these savings for Wales could amount to £39 million a year.

As shown in **Figure 4.3**, after accounting for these various spending pressures, we project that Covid-19 related spending pressures for the Welsh NHS next year could amount to just under £600 million a year in 2022-23, falling slightly in later years. Alongside our projections of underlying spending pressures, we estimate total funding pressures in 2022-23 could be approximately £970 million higher than core budget allocations for 2021-22, and £1,526 million higher by 2024-25. There are huge uncertainties surrounding all of the projections made of funding pressures and they could vary substantially from the assumptions we make.

In our illustrative spending scenario outlined in section 2.1.1, we assumed the Welsh Government "passed on" consequentials deriving from additional spending by NHS England on to the NHS in Wales. Doing so would increase NHS funding allocations by 11% in real terms by 2024-25, with the increase front-loaded next year. Under this illustrative spending scenario, this funding would be broadly sufficient to cover the projected funding pressures under our central assumptions. Consequentials from increased spending by the Department for Health and Social Care could also fund Covid-19 funding pressures over the next three years.

[64] https://gov.wales/nhs-and-social-care-staff-benefit-bonus-payment
[65] Office for Budget Responsibility, *Fiscal Risks Report 2021*.

Figure 4.3

Projected revenue funding pressures facing NHS relative to 2021-22 baseline

	2022-23	2023-24	2024-25
Underlying pressures	**370**	**686**	**1,005**
Covid-19 related pressures	**596**	**469**	**521**
Direct Covid-19 costs	*213*	*53*	*53*
Productivity assumption	*103*	*105*	*108*
Clearing backlog and recovery	*195*	*195*	*195*
Mental Health	*70*	*40*	*23*
Pay rises and burnout	*55*	*115*	*180*
Savings	*- 39*	*- 39*	*- 39*
Total pressures	**966**	**1,156**	**1,526**
Consequentials from NHS England spending	**919**	**1,246**	**1,550**
Other H&SC consequentials [1]	**265**	**259**	**189**

Source: Authors' calculations – see main text for assumptions made ● Notes: (1) This does not include consequentials we assume come from funding for adult social reform in England.

4.2. Other funding pressures

Apart from the two largest areas of spending already covered in this report – NHS and local government – the Welsh Government will also face funding pressures from other directions. As outlined in section 2.1, large allocations have been made for Covid-19 spending in 2021-22 across all budget areas. The extent to which these funding pressures will continue after 2021-22 remains uncertain.

A significant area of Covid-19 spending has been support for public transport. Covid-19 allocations for bus, rail and other transport services amounted to £365 million in 2020-21, while £70 million has been allocated so far for Transport for Wales in 2021-22 alongside £37.2 million for bus services. The need to support public transport over coming years will depend on how passenger numbers recover after the pandemic. The OBR estimates that around £2 billion a year may be needed to fill the hole in fare revenues of the new Great British Railways and Transport for London if passenger numbers do not return to pre-pandemic levels. If these projected trends are replicated in Wales, substantial revenue allocations may still be needed beyond this year.

Outside of schools spending (discussed in section 3), Covid-19 allocations have also been made to the higher and further education sectors. At the 1st Supplementary Budget for 2021-22, £33 million was allocated to post-16 education providers for additional teaching time for catch-up purposes. This funding may be required for future years to make up for lost learning during the pandemic.

Given the impact of the pandemic and associated policy responses, large allocations have been made to support businesses over the last two years. For 2021-22, £55 million was allocated at the 1st Supplementary Budget to help businesses still affected by Covid-19 restrictions to the end of June. Any further public health restrictions implemented over coming months or years will require further allocations to support affected businesses. The Welsh Government has also committed £35 million to help small and medium sized businesses recover from the pandemic this year. Despite the better outlook for unemployment, skills and training support will also need to be a priority over coming years, on top of the allocations made for work based learning and Personal Learning Accounts in 2021-22.

The Welsh Government has also used its Covid-19 funding allocations to support low-income households, for example through providing more funding for the Discretionary Assistance Fund and its Winter Fuel Support Payment. Given the economic outlook discussed in section 1, the Welsh Government could decide to fund additional interventions in this area over coming years, to maintain or expand the cash and in-kind support it provides to boost household incomes or reduce costs.

Although these are uncertainties around the path of the pandemic and its effects on all areas of the budget, it’s clear that further support for public services, businesses and individuals across these areas could amount to a substantial amount of funding over coming years. It may be prudent to keep some additional revenue funding unallocated for 2022-23 and beyond to respond to these various funding pressures if and when they arise.

4.3. Funding Co-operation Agreement policies

On 1 December 2021, the First Minister and the leader of Plaid Cymru signed a three-year Co-operation Agreement, which will cover 46 policy areas.[66] The improvement in the outlook for the Welsh budget over recent months is a key part of the context behind some of the announced policy proposals. Whereas the Welsh Labour manifesto promised very little in the way of additional spending and expansion of public services over coming years,[67] the policies contained in the Co-operation Agreement entail significant additional spending. The large spending commitments include:

- *Free School Meals for all primary school pupils*. A report commissioned by the Bevan Foundation recently estimated that this would cost an additional **£86 million a year** on top of current provision.
- *Expansion of early years childcare to include all two-year-olds*. Based on current costs of the childcare offer, we estimate this could mean an additional **£40 million a year**.

[66] Welsh Government, *The Co-operation Agreement*.
[67] https://www.cardiff.ac.uk/__data/assets/pdf_file/0020/2516114/senedd_briefing_27Apr21_online.pdf

- *Ambition for the creation of a National Care Service which is free at the point of need*. Depending on the nature of the reforms, free personal care services could cost approximately **£200 million a year** based on estimates from LE Wales last year (see section 3.4 for further discussion).
- Other funding implications may arise from other policy commitments, such as: a *national construction company*; *tackling homelessness*; *a publicly owned energy company*; *flood and coastal erosion risk management and mitigation; and media financial support.*

The significant commitments made in the agreement did raise questions of how the policies would be funded in the context of the Welsh budget outlook. As discussed in section 2.2, there is funding available to increase spending across all areas of the budget in real terms. However, as explored in sections 3 and 4, there are huge funding pressures facing public services over coming years.

As a way of showing how these commitments fit into the overall budget outlook, we can consider funding pressures across all areas of the budget and the extent to which there will be funding left-over to expand services like the Co-operation Agreement proposes. We therefore make the following assumptions:

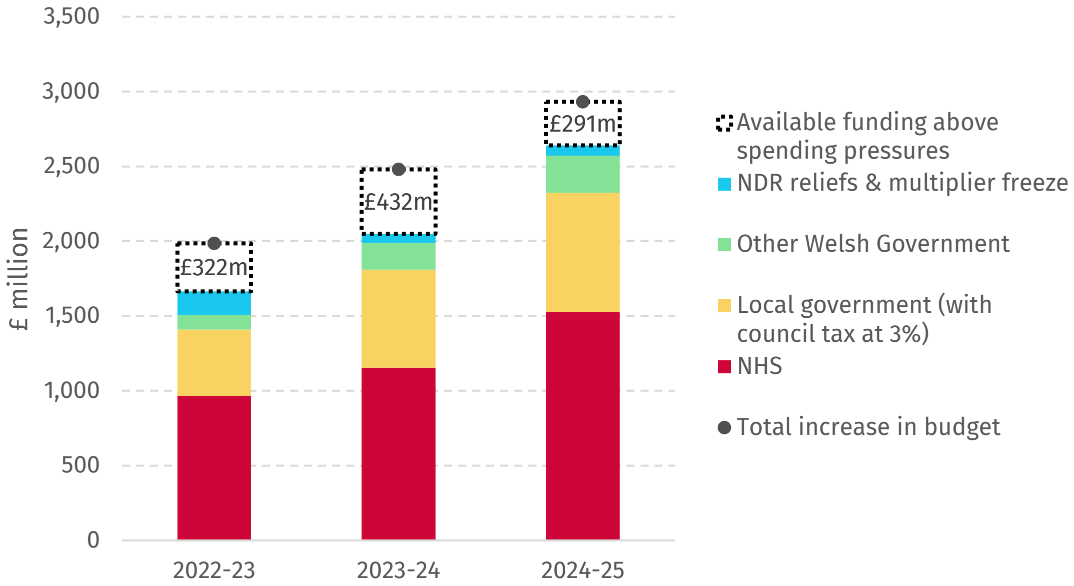
- The Welsh Government meets our central assumptions of NHS pressures from 2022-23 to 2024-25 (as shown in **Figure 4.3**).
- Funding for local government is increased so that our projected funding pressures by 2024-25 can be met with council tax increases of 3% per year (as set out in **Figure 3.4**).
- The Welsh Government also introduces NDR reliefs, and a multiplier freeze in 2022-23, matching the funding consequentials from business rates policies in England (discussed in section 3.3).
- Funding for all other Welsh Government spending increases in line with population growth and inflation.

Figure 4.3 shows these funding allocations in the context of the overall increase in the Welsh budget for day-to-day spending from the 2021-22 baseline. By 2024-25, funding for the NHS would amount to £1.5 billion above 2021-22 allocations, support for local government would grow by nearly £800 million, while other Welsh Government spending would increase by £250 million.

Therefore, there appears to be substantial funding available above the projected funding pressures included in this analysis, worth £322 million in 2022-23, £432 million in 2023-24, and £291 million in 2024-25. This funding could go towards meeting funding pressures that we haven't included (for example, such as those discussed in section 4.2), or towards funding policy proposals included in the Co-operation Agreement and the Welsh Government's Programme for Government. However, it should be noted that the slower real-terms growth in the block grant for the final two years of the Spending Review period provides less “headroom” for spending commitments by 2024-25.

Figure 4.3

Total modelled spending pressures facing the Welsh budget from 2021-22 baseline (nominal terms)



Source: Authors’ calculations – see main text for assumptions made.

This scenario again demonstrates the difference between the current outlook for the Welsh budget and the difficult trade-offs and decisions that had to be made throughout most of the previous decade. Despite huge funding pressures, the Welsh Government is in a position to expand devolved services once again, with funding available above ‘stand-still’ pressures projections. However, the medium to long-term sustainability of new spending commitments and Welsh public services in general still depend on UK government fiscal policy and whether the increase in departmental spending seen during recent years will continue after the current Spending Review period. If the UK government instead prioritises cutting taxes over coming years, the Welsh Government may need to consider using its own tax-raising powers to avoid a return to the difficult choices of the past decade.

5 Conclusion

As the Welsh Government prepares to publish its Draft Budget for 2022-23 later this month, ministers find themselves in an unusual position. Firstly, in contrast to recent years, a multi-year settlement from the UK government has provided greater certainty and could allow the Welsh Government to set a multi-year budget for the first time since October 2017. Secondly, the large increases to departmental spending by the UK government over recent months has meant the trade-offs to make between different areas of the Welsh budget are arguably less acute than for any budget of the previous decade. However, two factors temper this rosier outlook for the Welsh budget, namely: the lingering uncertainty surrounding Covid-19 (magnified by the emergence of the new Omicron variant); and the huge funding pressures facing most areas of the Welsh budget.

We project that the NHS in particular faces significant pressures from the direct and indirect costs of Covid-19. Increases to the NHS budget will likely take up over half of the projected increase to the budget over coming years. There are also significant funding pressures facing local authorities, with underlying cost and demand pressures, the lingering effects of the pandemic, and the need for recovery spending in schools. A key question for the Welsh Government relates to the extent to which the funding pressures facing local authorities should be met by central funding as opposed to council tax increases.

However, our modelling suggests that there will be substantial funding available above projected 'stand-still' funding pressures, which could go towards funding new policy proposals and expansion of services. The large spending commitments implied by the Co-operation Agreement between the Welsh Government and Plaid Cymru look broadly achievable over the next three years.

Meanwhile, the outlook for capital spending is relatively tighter. The Welsh Government will need to increase capital spending on the NHS to recovery from the pandemic, and there are strong arguments for increasing climate change investment over the next three years. This will require difficult choices and trade-offs for other capital spending given a declining capital block grant and very limited capital borrowing powers.

In conclusion, the experience of recent months has again shown the huge impact UK government fiscal policy can have on the Welsh budget outlook. The UK government's turn towards tax increases and higher departmental spending has transformed the Welsh Government's ability to meet spending pressures and expanding devolved services over coming years. When thinking of the longer-term sustainability of Welsh public services, Welsh policymakers still need to be mindful of potential future changes in the direction of UK fiscal policy.

A Methodology

Local government funding and spending projections

The approach used to project local authority spending pressures builds on that used in our previous reports.[68] The key assumptions and methods used are outlined below.

Base year

Our projections have been rebased using the most recent 2020–21 local government outturn data. Most pandemic-related spending is disaggregated by service area in the outturn tables; however, some costs are listed on a separate line (not elsewhere classified). The Covid-19 costs identifiable by service area and those that are not disaggregated are both deducted from the spending totals to calculate the 2020–21 (non-Covid) baseline for our model. The persistence of pandemic-related costs and income losses in future years is calculated separately using the methods described below.

Demand

A growing population is likely to increase demand for services. Our baseline assumption is that demand pressures grow in line with the ONS principal projection for population growth from 2018. We amend these demand projections for the two largest areas of spending – social care and education services.

Demographic change makes it likely that demand for adult social care services will exceed the underlying rate of population growth. A widely used model developed by Wittenberg et al. projects that demand in England will increase by 2.2% a year, ahead of the underlying rate of population growth in England (0.52% a year).[69] We adjust this projection slightly to reflect relative differences in the projected growth of different age cohorts in Wales. This implies that demand for care in Wales (which represents the total volume of formal care services delivered) grows by an average of 2.0% a year to 2026–27. This is adjusted by +/- 0.5 percentage point in our higher and lower cost scenarios, respectively.

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[68] Ogden, Phillips, and Siôn, “What’s happened and what’s next for councils”; Siôn and Ifan, *Local Government & the Welsh Budget*.

[69] Raphael Wittenberg, Bo Hu, and Ruth Hancock, *Projections of Demand and Expenditure on Adult Social Care 2015 to 2040*, Personal Social Services Research Unit (London: London School of Economics, 2018). https://www.pssru.ac.uk/publications/pub-5421/

Spending on children and families' social care services has increased rapidly in recent years, driven by a similarly sharp increase in the number of children looked after by local authorities. In our central scenario, we assume demand pressures in this area grow by 4.3% a year – the average rate of growth in the number of children looked after over the past three years. This is adjusted by +/- 2 percentage points to simulate different demand scenarios.

Input prices

We estimate changes in the price of inputs for most local authority services using a weighted average of earnings (85%) and the forecast GDP deflator (15%). Average earnings are assumed to grow in line with the OBR's forecast for average earnings from October 2021.[70] Local authority spending on adult social care is grown solely in line with average earnings. We estimate the additional impact of planned increases in the National Living Wage (NLW) on care workers by taking a population share of the Skills for Care estimate for England.[71] By doing so, we implicitly assume that the relative size of the care workforce and the pay distribution in England and Wales are broadly comparable. We do not incorporate the impact of NLW increases on other council workers nor do we include the cost of maintaining pay differentials in our model.

A separate model is used to estimate growth in schools' costs. Data for the 2019–20 academic year is used as a baseline to project the pay bill for teachers. This data is derived from evidence submitted by the Welsh Government to the Welsh Pay Review Body in 2020.[72] Future growth in teachers' pay is calculated using the same methodology outlined in a report by Luke Sibieta.[73] Sibieta assumes that starting salaries for teachers reach £30,000 by September 2022, as per the UK government's commitment in England. However, the indirect effect of the public sector pay freeze in 2021–22 is likely to have delayed this objective. We therefore assume that this target will now be reached by 2023–24.

Pay for other teachers, including teachers on the upper pay range, leadership scales, and unqualified teachers, are assumed to grow in line with OBR forecasts for average earnings in future years. Our projections are also adjusted to account for the split of each academic year across multiple financial years.

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[70] Office for Budget Responsibility, *Economic and fiscal outlook*.

[71] Skills for Care, *Pay in the adult social care sector* (London: Skills for Care, 2018) https://www.skillsforcare.org.uk/adult-social-care-workforce-data/Workforce-intelligence/documents/Pay-in-the-adult-social-care-sector-Sep19.pdf

[72] Welsh Government, *Welsh Government's Evidence to the Independent Pay Review Body: The 2020 teachers' pay award* (Cardiff: Welsh Government, 2020). https://gov.wales/sites/default/files/publications/2020-07/evidence-to-the-independent-welsh-pay-review-body-2020.pdf

[73] Sibieta, *Review of School Spending in Wales*.

We also incorporate the effects of the new Health and Social Care Levy on staff costs. The estimated additional costs to employers are added to councils' baseline pressures from April 2022.

Persistence of Covid-19 costs and income losses

In 2021–22, our estimate of Covid-19 pressures matches the allocations made with respect to the Hardship Fund in the Final Local Government Settlement, plus subsequent allocations. In future years, we assume that pandemic-related pressures persist at some proportion of the Hardship Fund allocations in 2020–21.

In 2022–23, Covid-19 pressures in the adult social care sector correspond to 25% of the Hardship Fund allocation in 2020–21. This falls to 12.5% in 2023–24 and 0% in 2024–25. In our higher cost scenario, these pressures fall from 33% of the 2020–21 allocation next year to 0% by 2026-27. In the lower cost scenario, we assume that no pandemic-related pressures continue beyond March 2022. Equivalent profiles are used to simulate the sustained impact of non-tax income losses.

These projections should be interpreted with caution as there remains considerable uncertainty about the persistence of pandemic-related costs and income losses – not least if new variants demand the reintroduction of measures to curb the spread of the virus.

Local authority funding

In future years, grants to local authorities are assumed to move in line with the Welsh Government's projected funding for services other than health (as the Welsh Government typically pledges to pass on funding received as a result of increases in English health spending to the NHS). Housing benefit and the associated administration grants paid by the Department for Work and Pensions are excluded from this analysis. See the narrative in Chapter 2 for further detail on our indicative spending scenario.

Projections of non-domestic rates revenues are taken from the OBR's October 2021 forecast. Our measure of council tax revenues equals the council tax requirement up to 2021–22, excluding any precepts for police, fire and rescue authorities, and community councils. The value of discounts offered through the council tax reduction scheme (CTRS) is deducted from the amount of council tax budgeted for collection. To do this, we assume that the value of the CTRS as a proportion of the amount to be collected is fixed at its 2020–21 level of 16% in future years.

We make no assumption about payments to or drawdowns from council reserves beyond what was budgeted to be drawn down in 2021–22.

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