

Welsh Election 2021

Fiscal outlook and challenges for the next Welsh Government

WELSH ELECTION BRIEFING

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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WELSH ELECTION BRIEFING 3

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Executive Summary

This briefing is the last in a series exploring the fiscal outlook for the next Senedd term and the challenges facing the next Welsh Government. Our findings in this briefing point to a challenging and uncertain outlook.

Key findings

- The Welsh Government's core day-to-day spending budget (excluding Covid-19) is set to recover its 2010-11 levels in 2021-22 but will remain approximately 4% below pre-austerity levels on a per-person basis. Spending outside the NHS is projected to still be 12% below pre-austerity levels in 2021-22.
- Covid-19 funding for day-to-day spending from the UK government amounted to £5.7 billion in 2020-21. The Welsh Government allocated relatively much less on Health and Social Services compared to the UK government for England, mainly explained by lower costs for PPE and test and trace. This allowed the Welsh Government to allocate more of a share of Covid-19 funding to business support, local government spending, as well as carrying funding forward into 2021-22.
- Available Covid-19 funding for 2021-22 amounts to £2.5 billion. On top of allocations and commitments made so far, the incoming Welsh Government will have just under £1 billion to commit to its Covid-19 response after the election in May.
- The outlook for the Welsh budget after 2021-22 is relatively austere, with no Covid-19 related funding planned by the UK government. Core resource funding is set to increase by an average of 1.6% a year in real terms from 2019-20 to 2025-26. If the UK government decides to return to pre-pandemic plans for total departmental spending, Welsh Government funding could increase by an average of 2.3% a year in real terms between 2019-20 and 2025-26.
- If the Welsh Government decided to "pass on" consequentials from NHS and schools spending in England, funding for local government would fall short of projected funding pressures, and other areas of the Welsh budget would need to be cut by £80 million in 2022-23. Meeting all the projected NHS pressures, including Covid-19 legacy costs, would entail massive cuts to all other areas of the budget.
- While not sufficient to cover the immediate fiscal challenges facing Welsh public services in 2022-23, over the medium term, increasing revenues from devolved income tax rates could play an important part in meeting spending pressures, funding enhanced public services and reliving the need for further regressive increases in Council Tax levels over coming years.

Recent trends in Welsh Government funding and spending

The last Senedd term was a period of considerable change for the Welsh budget.

- Following the devolution of taxes, the creation of a Wales Reserve, and some new borrowing powers, the fiscal framework and the composition of funds that make up the Welsh budget have changed significantly. The largest determinant of the size of the Welsh budget does however continue to be block grants from the UK government.
- The UK government also significantly increased its spending on public services during this time, with three successive chancellors announcing “an end to austerity”. By 2020-21, we estimate that the Welsh Government’s core block grant for day-to-day spending (excluding Covid-19 funding) was already £1.4 billion larger than what had been projected based on the outlook before the last Senedd election.
- The core day-to-day spending budget is set to recover its 2010-11 level in 2021-22 but will remain approximately 4% below pre-austerity levels on a per-person basis. Despite increases over recent years, spending outside the NHS is still projected to be 12% below pre-austerity levels in 2021-22.

Covid-19 spending

The Covid-19 pandemic has led to huge levels of additional spending by the Welsh Government, to support businesses, public services, and individuals through the crisis.

- Covid-19 funding for the Welsh government’s day-to-day spending totalled £5.7 billion in 2020-21. This was triggered by automatic transfers of funds from HM Treasury - known as ‘Barnett consequentials’ - from an estimated £99 billion of Covid-19 spending in England. The Welsh Government has carried forward £498 million of this spending to 2021-22, meaning available Covid-19 funding for this year amounts to £2.5 billion.
- Broadly comparing Covid-19 allocations made by the Welsh Government in 2020-21 and the source of consequentials by spending area in England, we estimate the Welsh Government allocated significantly less on Health and Social Services compared to the UK government in England, mainly explained by lower costs for PPE and the devolved element of the test and trace system. This allowed the Welsh Government to allocate a larger share of Covid-19 allocations to fund business support and local government spending, and allowed it to carry funding forward into 2021-22.
- On top of allocations and commitments made so far for 2021-22, we estimate the incoming Welsh Government will have just under £1 billion to commit to its Covid-19 response after the election in May.

Outlook for the Welsh Budget over the next Senedd term

The relatively benign outlook for spending in 2021-22 stands in stark contrast to a return to a relatively austere outlook in following years.

- Current UK government spending plans include no Covid-19 related funding for years after 2021-22, assume NHS and schools spending in England returns to pre-Covid-19 multi-year plans, and imply cuts for other areas of the budget compared to pre-pandemic plans.
- In our **baseline scenario** for Welsh Government funding, overall total resource funding is set to increase by an average of 1.6% a year in real terms between 2019-20 and 2025-26. Funding for day-to-day spending would be 6.5% higher than 2010-11 levels in real terms, and on a per person basis, funding would recover to pre-austerity levels by 2025-26.
- The UK government's spending plans are only *indicative* spending totals rather than firm plans, and the government may eventually decide to increase spending totals at the Spending Review later this year.
- We therefore model a scenario where the UK government returns to **pre-pandemic plans** for total departmental spending, and the additional spending is shared proportionately across all departments. Under this scenario, Welsh Government funding would increase by an average of 2.3% a year in real terms between 2019-20 and 2025-26.

Challenges and trade-offs for the next Welsh Government

Spending pressures are likely to materialise from numerous directions in the aftermath of the pandemic. In the face of such pressures, the current outlook suggests tough decisions and trade-offs for the next Welsh Government.

- We model the potential budget allocations to the main areas of spending under our baseline scenario by firstly assuming the Welsh Government "pass on" Barnett consequential from NHS and schools spending in England to the same spending areas in Wales. Remaining funding (or any overall budget cuts required) is shared proportionately across all other areas of spending.
- In this scenario, core NHS spending (excluding Covid-19 spending) would increase by an average of 2.5% a year between 2021-22 and 2025-26. Local government funding would increase by £51 million between 2021-22 and 2022-23 and would increase by an average of 0.9% a year in real terms to 2025-26.
- This would fall short of our projected local government funding pressures, even with annual council tax increases of 4.5% a year from 2022-23 onwards. Furthermore, under this scenario, all other Welsh Government service areas (some £3.1 billion – or 18%), would need to be cut by £80 million between 2021-22 and 2022-23.

- Under this baseline scenario, meeting all projected NHS spending pressures over coming years (including the legacy costs of Covid-19) would require massive – and likely unachievable – cuts to all other spending areas.
- If the UK government reverts to its pre-pandemic plans for total departmental spending, the Welsh Government would be in a much better position to meet spending pressures. Over the medium term, the Welsh Government would be able to meet the projected funding pressures in the NHS and increase funding for local government by an average of 2% a year in real terms.

Devolved taxes

In contrast to the austerity years at the start of the last decade, the Welsh Government now has some powers to influence the overall size of the Welsh budget.

- The most significant lever is the Welsh Rates of Income Tax. A 2p increase in all rates could raise up to £447 million in 2022-23 and £529 million a year by 2025-26. This would mean the Welsh budget for day-to-day spending would grow by an average of 2.0% from 2019-20 to 2025-26 and would bring day-to-day spending closer to our **pre-pandemic plans** scenario.
- While not sufficient to cover the immediate fiscal challenges facing Welsh public services in 2022-23, over the medium term increasing revenues from devolved income tax could play an important part in meeting spending pressures and funding enhanced public services. It may also relieve the need for further regressive increases in Council Tax levels over coming years.

Conclusion

In the face of huge post-pandemic pressures on public services, current UK government spending plans make for a difficult outlook for the Welsh budget. Ahead of the Senedd election, manifesto programmes will need to adequately respond to the huge challenges facing all areas of the budget. However, they also need to reflect the potential trade-offs that may be required in future Welsh budgets. The fiscal policy of the next Welsh Government will need to be flexible and responsive to the huge challenges in the aftermath of the pandemic.

1 Introduction

The Covid-19 pandemic has dominated the last year of the Senedd term. Over a matter of months, Welsh budget plans changed dramatically, triggered by the huge fiscal response to support businesses, public services and individuals through the crisis. As we approach the Senedd election on May 6th, manifesto programmes are promising to tackle some of the massive challenges facing many policy areas in the aftermath of the pandemic.

This briefing is the last in a series exploring the fiscal outlook over the next Senedd term and the challenges facing the next Welsh Government. Our previous briefings, on the NHS and local government finances, have pointed to the significant funding challenges facing public services over coming years. Our findings in this briefing point to a challenging and uncertain outlook facing the next Welsh Government. If UK government spending plans do not substantially change, a series of difficult choices and trade-offs will be needed. Welsh Government fiscal policy will need to be flexible and responsive to the economic and fiscal situation as it evolves.

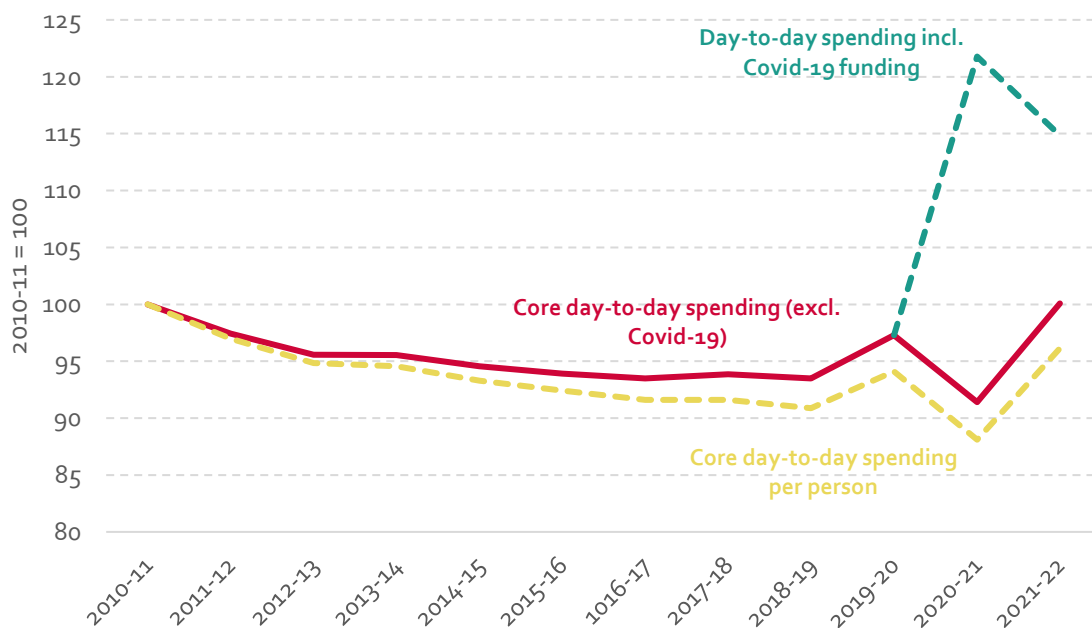
The report proceeds as follows:

- **Chapter 2** reviews the recent trends in Welsh Government funding and spending over recent years
- **Chapter 3** explores the huge changes to the Welsh budget brought about by the Covid-19 pandemic;
- **Chapter 4** presents the broad outlook for the Welsh Government budget for day-to-day spending over the next Senedd term;
- **Chapter 5** includes discussions about the likely choices and trade-offs this outlook implies for the next Welsh Government in terms of budget allocations to the main areas of spending;
- **Chapter 6** covers recent trends and the outlook for the Welsh Government's capital budget;
- **Chapter 7** concludes.

2 Recent trends in Welsh Government funding and spending

This section reviews the major trends in the Welsh Government’s budget for day-to-day spending over the last decade. Since the last Senedd election in May 2016, the composition of funding for the Welsh Government budget has changed significantly, with the devolution of taxes, the creation of a Wales Reserve, and some new borrowing powers (these changes are discussed in **Box 2.1**). Despite these changes, the largest determinant of Welsh Government budgets continues to be block grants from the UK government, the size of which are determined by spending plans in England on areas devolved to Wales. The last Senedd term also saw a major shift in the UK government’s spending plans for public services.

Figure 2.1
Real terms change in Welsh Government day-to-day (resource) funding, 2010-11 to 2021-22 (2010-11 = 100)



Source: HM Treasury (2015, 2016, 2017, 2018, 2019, 2020); Welsh Government (2021a, 2021b); and authors’ calculations

Note: Funding adjusted for inflation using the GDP deflator measure of inflation. A fall in public sector output during 2020-21 temporarily raised forecast GDP deflator, which drives the real terms fall in ‘core’ resource funding in 2020-21.

2020-21 figures also reflect the drop in Non-Domestic Rates revenue from Covid-19 rates reliefs and a Welsh Government budget switch from resource to capital and financial transactions funding. Covid-19 funding also reflects the Welsh Government decision to carry forward approximately £500 million of funding from 2020-21 to 2021-22.

Figures adjusted for the transfer of council tax benefit funding to the Welsh Government in 2013-14 and the farm subsidy spending in 2020-21.

Figure 2.1 shows the real-terms trend in funding for the Welsh Government budget for day-to-day spending, indexed to 100 at the start of the series in 2010-11. The budget fell sharply over the first two years of austerity (4.4% between 2010-11 and 2012-13). The real terms budget squeeze continued over subsequent years, with funding falling to 6.5% below 2010-11 levels by 2016-17.

At the time of the last Senedd election in May 2016, the UK government had planned further cuts to day-to-day spending on public services. The block grant for day-to-day spending was set to fall by a further 4% in real terms between 2016-17 and 2019-20. In reality, the UK government increased their spending plans significantly over the course of the last Senedd term, with three successive chancellors announcing “an end to austerity”.¹ Most significant was the multi-year spending commitment for the NHS in England in 2018, which increased consequential for the Welsh budget for 2019-20 and beyond. By 2020-21, we estimate the Welsh Government’s block grant for day-to-day spending (excluding Covid-19 funding) was nearly £1.4 billion larger than what had been projected based on the outlook before the last Senedd election. When Covid-19 funding is included, the block grant for day-to-day spending was £7.2 billion higher than expected. This stark discrepancy highlights the fundamental uncertainty facing Welsh Government budgets, and the difficulties of projecting available funding over coming years.

The Covid-19 pandemic has led to huge levels of additional spending by both the UK and Welsh Governments. Additional allocations to support public services and businesses in England through the pandemic triggered approximately £5.7 billion of additional consequential for the Welsh Government to use as part of its day-to-day spending budget in 2020-21, of which the Welsh Government has decided to carry forward £500 million to 2021-22. Covid-19 funding and the spending decisions taken by the Welsh Government are discussed further in **Chapter 3**.

As shown in **Figure 2.2**, the core day-to-day budget (excluding Covid-19 funding) for the Welsh Government will finally return to its 2010-11 level in 2021-22. Accounting for population growth, day-to-day spending fell to 9% below 2010-11 levels by 2018-19, and despite the growth in spending in recent years, it remains approximately 4% below pre-austerity levels in 2021-22. The Welsh population has also aged significantly since 2010-11, increasing demand pressures on public services. For example, the population aged over 75 increased by over a fifth between 2010 and 2021. As a share of the Welsh economy, Welsh Government day-to-day spending fell by nearly 5 percentage points between 2010-11 and 2018-19 (the latest available year of data).

The overall trends in the Welsh Government’s core day-to-day budget mask important differences for components of the budget. Since 2012-23, spending on the NHS has increased, accounting for a larger share of the total budget.² We estimate NHS budget allocations (excluding Covid-19 spending) are now around 18% higher than pre-austerity levels. This meant that spending on other areas of the budget fell significantly after 2013-14 – falling to 17% below

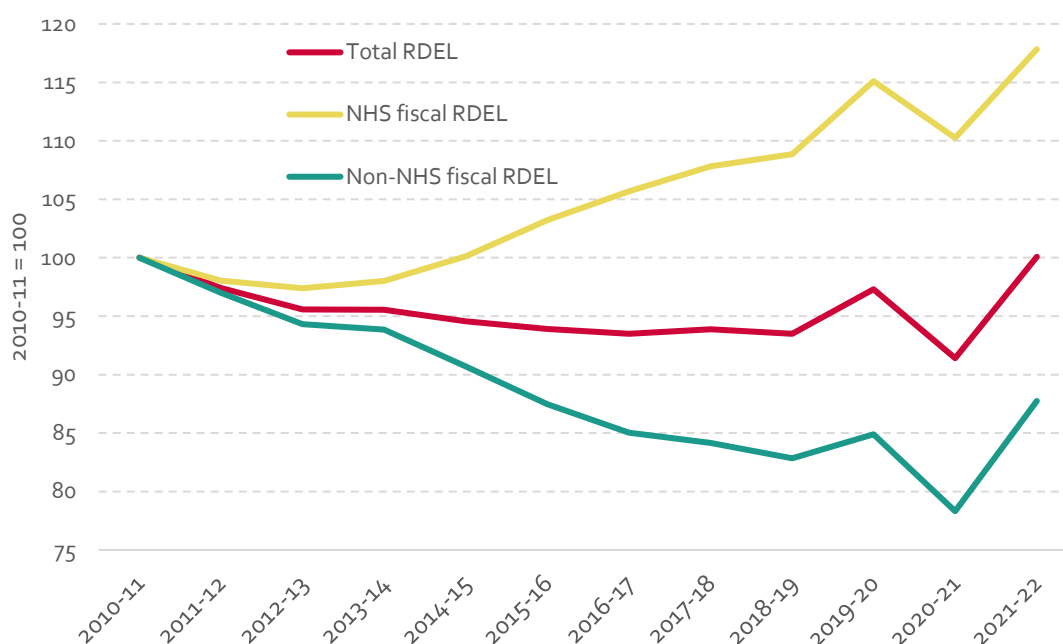
¹ For discussion on the differences between Conservative Manifesto spending plans from 2017 to 2019, see Ifan et al. (2019)

² For a discussion of NHS allocations over time and projected future funding pressures see Ifan, G. (2021)

2010-11 levels by 2018-19 in real terms. In more recent years, core non-NHS spending has also increased, but is still projected to be 12% below pre-austerity levels in 2021-22.

Figure 2.2

Real terms change in Welsh Government day-to-day budget allocations, 2010-11 to 2021-22 (2010-11 = 100)



Source: See figure 2.2; Welsh Government (2021a; 2021b) supplementary budget documents; and authors' calculations

Note: See notes for figure 2.1. Consistent series for NHS spending calculated by aggregating over several budget lines (see Ifan 2021 for detailed explanation). NHS budget allocations adjusted to be on a fiscal RDEL basis, by taking the ratio of fiscal to non-fiscal resource spending from MEG total.

One of the main casualties of austerity were local authority budgets. Specific and general grants (excluding redistributed Non-Domestic Rates revenue) fell by 16.8% between 2009-10 and 2019-20.³ Meanwhile, council tax revenues have increased significantly to mitigate the cuts in grants, from £830 million in 2009-10 to £1,369 million in 2019-20 (net of council tax benefit/council tax reduction scheme). This means that total local authority gross revenue expenditure fell by 6.0% over this ten-year period.

In March 2021, the Welsh Government set out its Final Budget spending plans for 2021-22. Relative to 2020-21 Final Budget plans, core fiscal resource budget allocations increased by £740 million, or 4.6% in nominal terms. As shown in **Figure 2.3**, the largest core budget allocations were made to the Health and Social services portfolio (£419 million). Meanwhile, the settlement for local authorities included a £176 million increase on the previous year.

³ See, Siôn (2021).

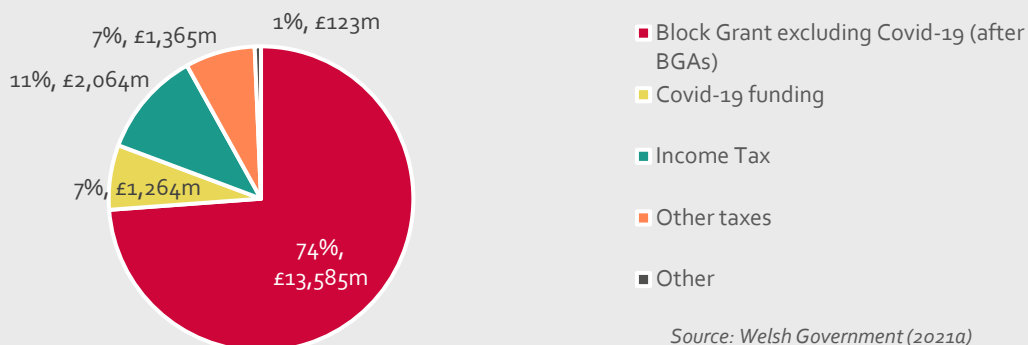
Box 2.1: How is funding for the Welsh Government budget determined?

At the beginning of political devolution in 1999, devolved spending was almost entirely funded from annual block grants from the UK government. While block grants remain the most significant determinant of Welsh Government budgets, recent years have seen significant changes to the Welsh fiscal framework.¹

The Welsh Government's block grant is equal to the block grant from the previous year and an annual change determined by the Barnett formula. This change equates to a population-based share of any change in UK government spending in England on services devolved to Wales. Since 2018-19, increments to the Welsh budget have been multiplied by a 'needs-based factor', currently set at 105%. This change has resulted in over £600 million of additional funding for the Welsh Government over four years.

The Welsh Government's revenues now also include: a devolved portion of income tax (£2,064 million in 2021-22); Non-Domestic Rates (£1,101 million); Land Transaction Tax (£231 million); and Landfill Disposal Tax (£33 million). **Figure B.1** shows the Welsh Government's day-to-day budget by source according to 2021-22 Final Budget plans.

Figure B.1: Funding for Welsh Government resource budget, 2021-22



To reflect the devolution of taxes to the Welsh Government over recent years, an adjustment is made to the size of the block grant. These Block Grant Adjustments (BGA) were equal to the revenues being transferred to the Welsh Government at the point of devolution and are updated each year according to changes in comparable UK government revenues in England and Northern Ireland. This means that as well as any tax policy change by the Welsh Government, it is the *relative* growth in revenues which impacts the size of the Welsh budget. This system was intended to incentivise the Welsh Government to boost economic performance while insulating the Welsh budget from UK-wide economic hits (e.g. during the Covid-19 pandemic).²

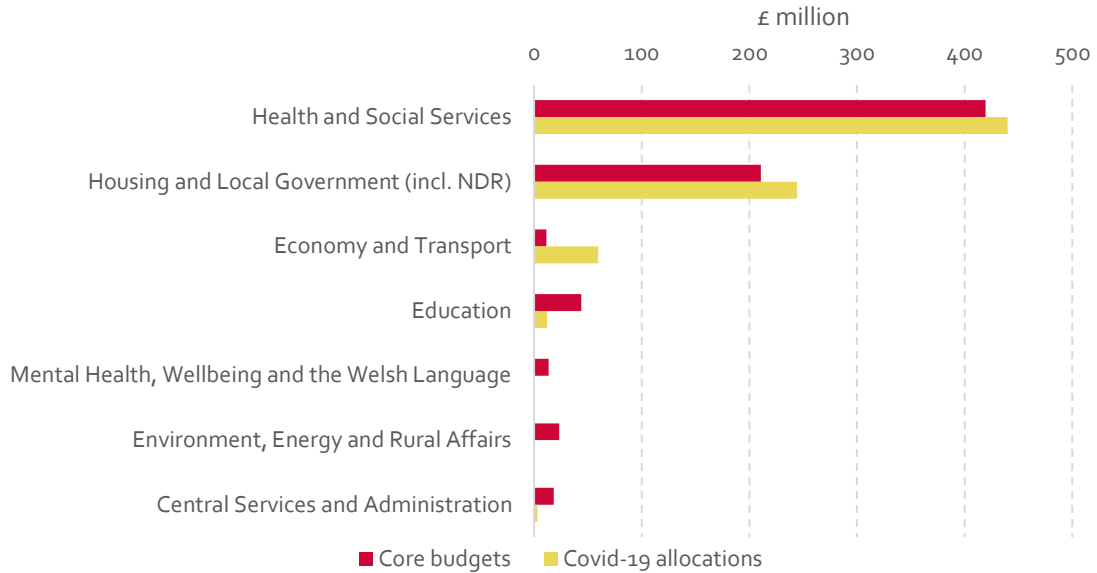
The Welsh Government also has a Wales Reserve, which it can pay into (up to an overall limit of £350 million) and draw-down funding when needed (up to £125 million a year for day-to-day funding). It also has some restricted borrowing powers, for capital (up to £150 million a year to an overall limit of £1 billion) and for day-to-day spending if revenues undershoot forecasts.

¹ For latest description of funding system, see HM Treasury (2020a).

² See, Poole, E., Ifan, G. and D. Phillips (2017).

Figure 2.3

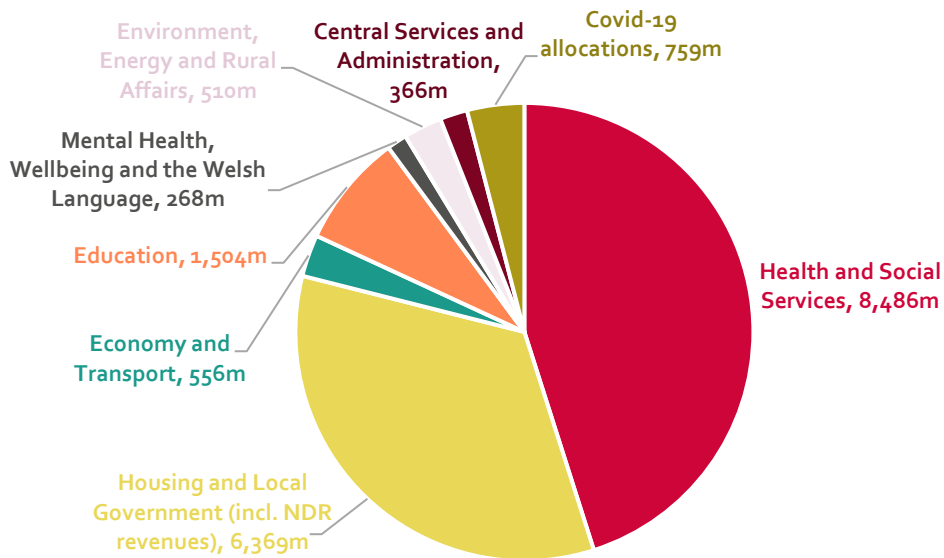
Final Budget 2021-22 fiscal resource allocations – change from Final Budget 2020-21 plans



Source: Welsh Government (2021a)

Figure 2.4

Welsh Government fiscal resource allocations in Final Budget 2021-22 plans



Source: Welsh Government (2021a)

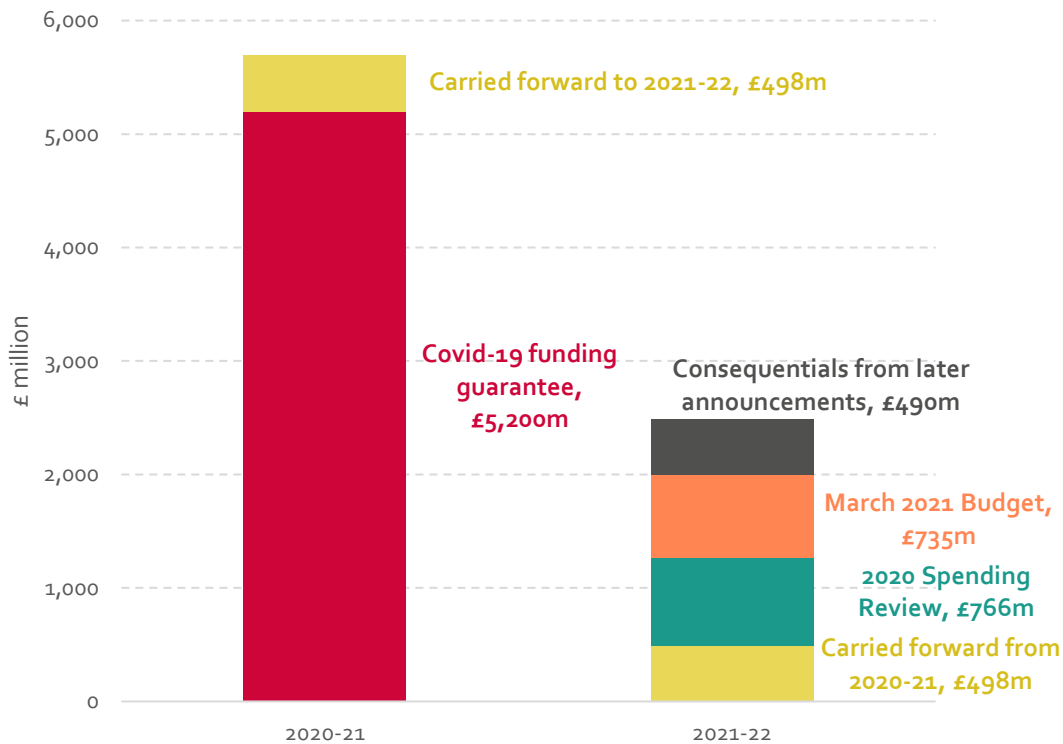
Figure 2.4 shows the total fiscal resource allocations made in Final Budget plans for 2021-22. Total fiscal resource allocations made by the Welsh Government to core budget lines (excluding Covid-19 spending) amounted to just under £17.0 billion. This figure includes Non-Domestic Rates revenue funding for local government budgets (which appears as Annually Managed Expenditure in budget documents). Core NHS services account for approximately £8.1 billion. Total support for local authorities, both through the local government settlement and various specific grants across all main expenditure groups, amounts to £5.7 billion. All other Welsh Government spending amounts to just under £3.1 billion.

So far, spending plans for 2021-22 also include £759 million in Covid-19 funding, but this will likely increase significantly over the course of the year (see **Chapter 3**). **Figures A.1** and **A.2** show the evolution of funding and spending allocations from the Welsh Government's day-to-day spending budget for both 2020-21 and 2021-22, as well as the latest projections using updated forecasts.

3 Covid-19 spending

The Covid-19 pandemic has led to huge levels of additional spending by both the UK and Welsh governments to support individuals, businesses, and public services through the crisis. This section analyses the Covid-19 funding from the UK government and the fiscal response by the Welsh Government.

Figure 3.1
Covid-19 related resource funding for the Welsh Government, 2020-21 and 2021-22



Source: Welsh Government (2021b); Welsh Government (2021a); Welsh Government (2020a); Welsh Government (2020b); and authors' calculations

Much of the UK government's fiscal response was on UK-wide programmes, such as the Coronavirus Job Retention Scheme (CJRS) and the Self-Employment Income Support Scheme (SEISS). However, beginning with the March 2020 budget, the UK government began to announce emergency fiscal measures in England, a decision which triggered automatic transfers of funds known as 'Barnett consequentials' for the Welsh Government. The additional funding coming to the Welsh Government increased significantly as new announcements

added to the size of the fiscal response. In July 2020, rather than continuing to apply the Barnett formula to individual spending announcements in England, the HM Treasury introduced a 'funding guarantee' system intended to provide the Welsh, Scottish and Northern Ireland governments with greater certainty for their spending during the pandemic response.. Set initially at £4 billion for 2020-21, funding for day-to-day spending increased to £5.7 billion by February 2021. This funding was based on estimated England-only Covid-19 spending by the UK government of approximately £99 billion. In addition, the Welsh Government also received £103 million for capital funding in 2020-21, most of which it will carry forward to 2021-22.

The most recent increase to the Welsh Government's Covid-19 funding for 2020-21 was announced on 15 February 2021. Since this was so close to the end of the financial year, the UK government allowed the devolved governments to carry this funding into 2021-22. As shown in **Figure 3.1**, this means that total Covid-19 funding for day-to-day spending in 2020-21 was £5.2 billion, with £498 million being carried into 2021-22. For 2021-22, £766 million of Covid-19 funding was announced by the UK government at the Spending Review in November 2020, while the March 2021 Budget contained £735 million of day-to-day spending.⁴ Subsequent announcements for Health and Social Care (18 March) and Business rates relief (25 March) in England will lead to approximately £490 million of additional funding for the Welsh Government.⁵ This brings total available Covid-19 funding available for the Welsh Government in 2021-22 to £2.5 billion – equivalent to roughly 48% of the level of Covid-19 funding received in 2020-21.

Figure 3.2 shows a breakdown of Covid-19 budget allocations made by the Welsh Government in the three supplementary budgets announced in 2020-21 and in the Final Budget for 2021-22. Covid-19 related allocations for 2020-21 total £5.26 billion, and the largest component of these allocations were made to the Economy and Transport budget. Including rates reliefs and business grants, budgeted economic spending amounted to £2.16 billion. Allocations made to the Health and Social Services portfolio accounts for the next largest share of budgeted spending, amounting to £1.5 billion – see Ifan (2020) for a breakdown of this spending. Funding for Housing and Local Government spending amounted to £819 million (excluding funding to finance for NDR reliefs). This allocation included the £661 million Local Government Single Emergency Hardship fund, to which local authorities were able to retrospectively submit claims for income lost and additional expenditure incurred because of the pandemic (Siôn 2021). Smaller Covid-19 allocations were made to the Education portfolio to support universities, colleges, and catch-up funding for schools, and to support for the cultural and sport sectors through the Mental Health, Wellbeing and the Welsh Language portfolio.

⁴ We assume that all of the March 2021 funding was additional Covid-19 funding.

⁵ See: <https://www.gov.uk/government/news/7billion-for-nhs-and-social-care-for-covid-19-response-and-recovery> and <https://www.gov.uk/government/news/business-rates-relief-boosted-with-new-15-billion-pot>

Figure 3.2
Welsh Government Covid-19 budget allocations

Covid-19 allocations	2020-21	2021-22
Health and Social Services	1,532	440
Housing and Local Government	1,151	244
<i>Of which: NDR reliefs</i>	332	0
<i>Of which: other Housing and Local Government spending</i>	819	244
Economy and Transport	2,219	60
<i>Of which: Transport</i>	365	37
<i>Of which: Economy spending</i>	1,824	22
Education	190	12
Mental Health, Wellbeing and the Welsh Language	104	0
Environment, Energy and Rural Affairs	22	0
Central Services and Administration	42	3
Total allocations in budget plans	5,260	759
<i>Unallocated in budget plans</i>		504
<i>Unallocated (including later consequentials)</i>		1,729

Source: Welsh Government (2021a); Welsh Government (2021b); Welsh Government (2020a); Welsh Government (2020b); and authors' calculations

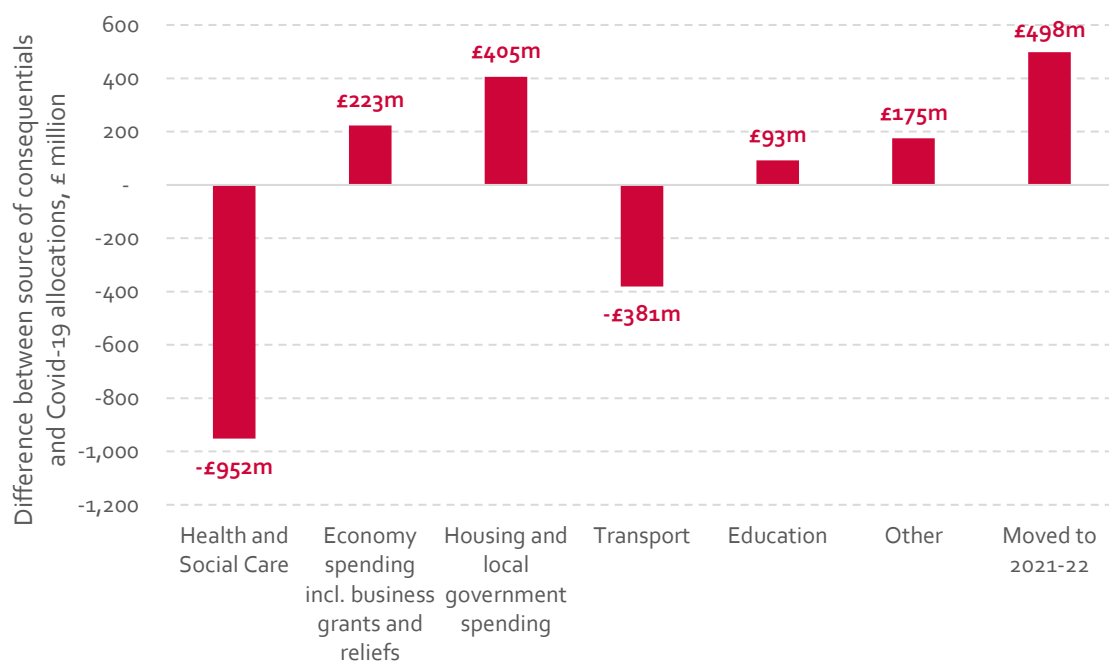
Honeysett et al. (2021) provide a breakdown of Welsh Government Covid-19 funding by source of UK government spending in England. This allows us to broadly compare the Welsh Government's fiscal response to that of the UK government in England and this points to substantial differences in spending allocations. Approximately £2.5 billion of the Covid-19 consequentials for day-to-day spending was triggered by Department for Health and Social Care spending in England. Housing, Communities & Local Government spending led to £948 million, of which £639 million related to funding for business rates reliefs in England. Spending by the Business, Energy & Industrial Strategy led to £1.3 billion of consequentials for Wales. A full breakdown is available in **Figure A.4** in the annex.

These figures represent budgeted and estimated spending in England. The eventual outturns of this spending and the allocations to the Welsh Government may deviate significantly from these totals given the uncertainty facing public services this year. There are also differences in how spending is categorised and reported by governments, which hinder precise comparisons between the fiscal response in Wales, Scotland, and England.

However, broadly comparing Covid-19 allocations made by the Welsh Government in 2020-21 (**Figure 3.3**) and the source of consequentials by spending area in England, we can see that the Welsh Government allocated almost £1 billion less on Health and Social Service compared to the consequentials stemming from Health and Social Care spending in England. As examined in Ifan (2021), one of the main explanations for this was lower spending on PPE and the devolved element of the test and trace system in Wales – a large area of additional spending in England. Funding for public transport was also substantially lower than allocations made in England, partly explained by the large allocations made to Transport for London by the UK

government. Meanwhile, lower spending in these areas allowed the Welsh Government to allocate a larger share of Covid-19 funding to fund business support, local government spending, and carry forward £498 million into 2021-22. The Welsh Government also appears to have allocated more for business support and less for health than the Scottish Government (Phillips 2021, p9).

Figure 3.3
Difference between Welsh Government Covid-19 resource spending and source of consequentials (spending in England by the UK government)



Source: Welsh Government (2021a); Welsh Government (2020a); Welsh Government (2020b); Honeysett et al. (2021); Honeysett and Brien (2020); and authors' calculations

In its Final Budget plans, the Welsh Government has so far allocated £759 million for its Covid-19 response in 2021-22. This includes £440 million for the NHS and a £206.6 million extension of the Local Government Hardship fund for the first six months of 2021-22. With the funding carried forward to 2021-22 and additional consequentials from the UK government, the Welsh Government has substantial additional funding to allocate in later supplementary budgets. This currently unallocated funding amounts to £1.7 billion (see **Figure 3.2**).

Some of this funding has already been committed by the Welsh Government. These commitments include:

- a £380 million NDR relief package for retail, leisure, and hospitality businesses with a rateable value of up to £500,000 for the entirety of 2021-22;⁶

⁶ <https://gov.wales/written-statement-covid-19-and-non-domestic-rates-relief-businesses-2021-22>

- a further £72 million to support schools;⁷
- £30 million for the extension of the Cultural Recovery Fund for the first six months of 2021-22;⁸
- £100 million initial funding for health and care services pandemic recovery plan;⁹
- Bonus payments for NHS and social care staff worth £735 per person – at an estimated cost of approximately £163 million.¹⁰

If these commitments are additional to Final Budget plans, they would amount to £745 million of further Covid-19 allocations. On this estimate, the next Welsh Government will have just under £1 billion to commit to its Covid-19 response after the election in May.

This picture for 2021-22 is contrasted with a relatively austere outlook for spending after this year (as discussed in **Chapter 4**). Most of the Covid-19 funding allocations made by the Welsh Government are largely time-limited, for example, covering the first six months of 2021-22 or one-off bonus payments. In contrast, Phillips (2021) details how several of the commitments recently made by the Scottish Government amount to *permanent* increases in spending but are likely to be funded this year by *temporary* Covid-19 funding. Such commitments, for example, awarding larger pay uplifts in the public sector, will likely need to be funded from core budgets from next year.

⁷ <https://gov.wales/extra-72m-support-learners-they-return-school>

⁸ <https://gov.wales/cultural-recovery-fund-extended>

⁹ <https://gov.wales/health-and-care-services-pandemic-recovery-plan-published> (we assume this funding is additional to the NHS allocations made in the Final Budget.

¹⁰ <https://gov.wales/nhs-and-social-care-staff-benefit-bonus-payment>

4 Outlook for the Welsh Budget over the next Senedd term

This chapter provides an outlook for the Welsh budget over the next Senedd term, which is an important consideration in various policies that will be put forward by parties at the Senedd election. It explores the implications of the UK government's current spending plans as well as the outlook for devolved revenues beyond 2021-22. Unfortunately, because final multi-year UK government plans will not be revealed until the Spending Review later this year, we have no firm UK government spending plans beyond 2021-22. The outlook for the Welsh budget is therefore highly uncertain. In [Section 4.1](#), we set out a baseline scenario for funding implied by current spending plans. In [Section 4.2](#), we explore some alternative projections for the Welsh budget, assuming UK government spending plans change. What these scenarios imply in terms of the options and trade-offs facing the next Welsh Government is discussed in [Chapter 5](#).

4.1 A 'baseline' scenario for Welsh Government funding

At the UK Budget in March, Chancellor Rishi Sunak chose to not set firm new fiscal rules during the pandemic response. However, he did state that the UK "in normal times should not be borrowing to pay for everyday public spending". Although the OBR's current forecasts suggest that this target would be met by 2025-26, this projection of a current budget balance by 2025-26 relies on medium-term spending plans which have been reined back significantly compared to pre-pandemic plans. The plans contain no Covid-19 related funding for years after 2021-22, assume that spending on the NHS and schools in England returns to pre-Covid-19 multi-year plans, and imply cuts for other areas of the budget. In cash terms, spending on "unprotected" departments in 2022-23 will be around £9 billion, or 8.5% lower than under pre-pandemic plans (Zaranko 2021).

In our projections of the Welsh budget, we use the Welsh Government's Final Budget plans for 2021-22 and the UK government's March 2021 budget documents as a starting point. Our 2021-22 baseline for our projections is outlined in the 'latest projection' columns of [Figure A.1](#) and [A.2](#) in Annex 1.

Our steps and assumptions for projecting the size of the Welsh budget are as follows:

- We assume the UK government maintains its multi-year funding commitments made to the NHS in England (reaching £149 billion in 2023-24) and schools spending in England (reaching £52.2 billion in 2022-23). After this point, we assume the UK government continues to increase funding for these services in England in line with forecast GDP growth.

- Outside of foreign aid and defence spending (which we assume continue to grow in line with GDP growth), we assume all other departments are grown uniformly in line with the total change in all other UK departmental spending (after accounting for Barnett consequentials). This is taken from March 2021 Budget plans (HM Treasury 2021).¹¹ Departmental spending funded by Business Rates income in England (which attract negative consequentials for the Welsh Government) is grown in line with OBR forecasts for total English business rates.
- These UK departmental spending plans allow us to calculate the change in the Welsh Government's resource block grant *before* Block Grant Adjustments (BGAs) are made.
- We project BGAs according to forecast growth in comparable UK government revenues, taken from the latest OBR forecasts.¹² In 2023-24, we make a small 'reconciliation' to account for changes in forecast revenues for income tax and accompanying BGA compared to what was budgeted for in 2020-21.
- We use the latest OBR forecasts for Welsh Government revenues from Non-Domestic Rates, the Welsh Rates of Income Tax, Land Transaction Tax, and Landfill Disposals Tax.¹³ This assumes Welsh Government tax policy remains unchanged.
- We make a small adjustment for an increase in Welsh Government principal repayment of borrowing.¹⁴ We also assume the Welsh Government does not draw-down any funding from the Wales Reserve for day-to-day spending after 2021-22.
- In terms of Welsh Government spending, we assume unallocated core spending in the Final Budget stays constant over future years (£69 million as of latest projection) and funding for sponsored bodies grows in line with inflation.

Based on these assumptions, **Figure 4.1** shows the path of projected funding for Welsh Government day-to-day spending (resource DEL) over the course of the next Senedd term. In cash terms, core funding (excluding Covid-19) is set to increase from £17.1 billion in 2021-22 to £19.3 billion in 2025-26.

The annual real-terms growth in **Figure 4.2** is calculated using the GDP deflator measure of inflation, which is set to fall slightly in 2022-23. This is primarily down to an unwinding of the effect of a fall in public sector output during 2020-21, which temporarily raised the forecast GDP deflator. As a result, the smaller cash terms increase in 2022-23 translates into a larger real terms increase. Overall, total resource funding is set to increase by an average of 1.5% a year from 2021-22 to 2025-26 in real terms, or by 1.6% a year from 2019-20 to 2025-26.¹⁵

¹¹ See 'Core RDEL excluding depreciation' series on page 37:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/966868/BUDG_ET_2021_-_web.pdf

¹² <https://obr.uk/topics/scotland-wales-and-northern-ireland/welsh-tax-forecasts/>

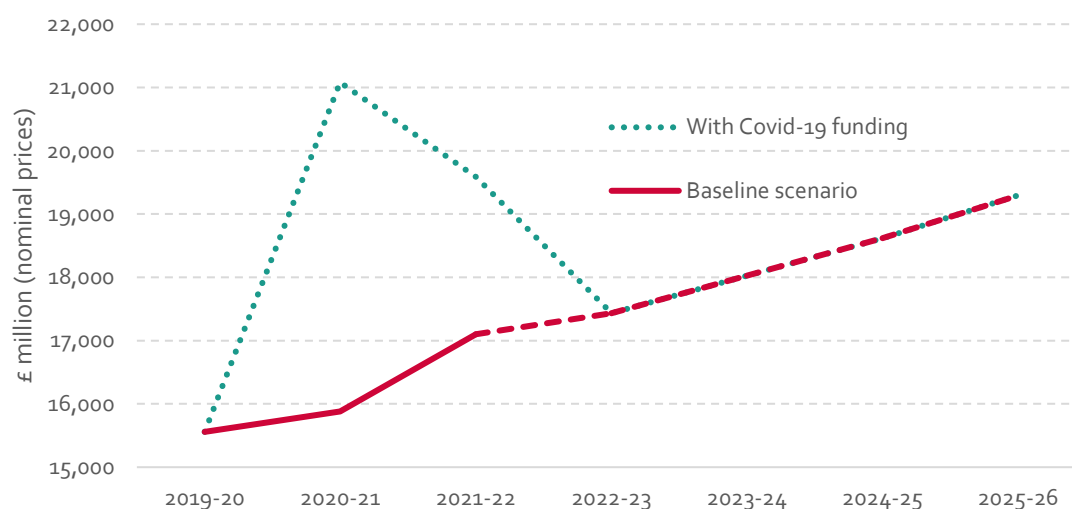
¹³ Ibid.

¹⁴ We assume repayments grow from 2021-22 according to the amounts projected "fall in the next five years" outlined in the Welsh Government's Draft Budget for 2020-21.

¹⁵ This figure excludes the effect of the transfer of farm subsidies to the Welsh budget from 2020-21.

Figure 4.1

Projected funding for Welsh Government day-to-day spending, 2019-20 to 2025-26 (nominal terms)



Source: Authors' calculations based on Welsh Government (2021a); Welsh Government (2021b); Welsh Government (2020c); HM Treasury (2021); Office for Budget Responsibility (2021a).

Notes: Figures for 2020-21 reflect a fall in NDR revenues associated with the rates relief, a budget switch to capital spending, and the transfer of farm subsidies to the Welsh budget.

Figure 4.2

Projected funding for Welsh Government day-to-day spending by source, 2021-22 to 2025-26 (nominal terms)

	2021-22	2022-23	2023-24	2024-25	2025-26
RDEL block grant (before BGA)	15,927	16,310	16,845	17,402	18,017
Block Grant Adjustments	-2,342	-2,511	-2,566	-2,758	-2,896
RDEL block grant (after BGA)	13,585	13,799	14,279	14,644	15,120
Covid-19 funding	2,489	0	0	0	0
Non-Domestic Rates	985	1,103	1,123	1,144	1,167
Welsh Rates of Income Tax	2,113	2,233	2,315	2,495	2,643
Land Transaction Tax	260	272	285	310	338
Landfill Disposal Tax	34	34	33	33	32
Borrowing repayments	-2	-7	-7	-7	-7
Wales Reserve	125	0	0	0	0
Total resource funding	19,589	17,433	18,027	18,619	19,293
Excluding Covid-19 funding	17,101	17,433	18,027	18,619	19,293
Annual real-terms growth		2.1%	1.4%	1.2%	1.4%

Source: As in Figure 4.1

Under this baseline scenario, funding for day-to-day spending would be 6.5% higher than 2010-11 levels in real terms, on a like-for-like basis. On a per person basis, funding would recover to pre-austerity levels by 2025-26.

4.2 Alternative scenarios for Welsh Government funding

The Office for Budget Responsibility (2021a) described the potential legacy of the pandemic for spending on public services as 'one of the most significant risks to the medium-term fiscal outlook'. In its assessment of spending plans in the March budget, the Institute for Fiscal Studies (2021) concluded the UK government will face pressures from all directions, that further top-ups are inevitable, and medium-term spending plans "simply look implausibly low". The UK government spending plans are only indicative spending totals rather than firm plans, and the UK government may eventually decide to increase spending totals at the Spending Review later this year.

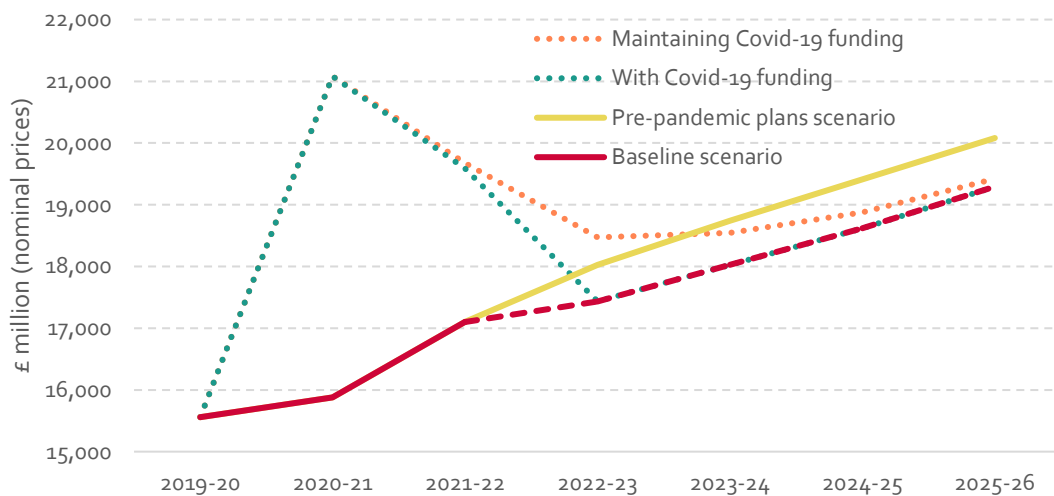
The '**baseline scenario**' for Welsh Government funding in the previous section therefore would appear to be at the low-end of what is likely over coming years. To illustrate the potential impact of a change of course in UK government spending plans, we model the impact of the UK government deciding to reverse the planned cuts in spending made in November 2020 and March 2021. We refer to this as a '**pre-pandemic plans scenario**' for Welsh Government funding. Reverting to pre-pandemic plans would increase the UK government's total departmental spending by £14.1 billion in 2022-23 compared to the baseline scenario, and by £16.6 billion by 2025-26. We assume this increase in spending would be shared proportionately across all departments (excluding Defence and Foreign Aid spending which remain linked to GDP growth). This means funding for the NHS and schools in England would increase beyond existing multi-year commitments and the implied cuts to 'non-protected' departments would not be implemented in 2022-23. As in the baseline scenario, we assume that one-off Covid-19 funding ends after 2021-22.

Under this alternative scenario, funding for the Welsh Government's day-to-day spending would be approximately £600 million higher in 2022-23 than under our baseline scenario, and would grow to nearly £20.1 billion by 2025-26, as shown in **Figure 4.3**. This would imply average annual growth of 2.6% between 2021-22 and 2025-26, and 2.3% a year between 2019-20 and 2025-26. Per person spending would reach 2010-11 levels by 2022-23 and would be 5.5% above pre-austerity levels by 2025-26.

We also model the effect of the UK government deciding to stick to its current budget plans for core departmental spending, while deciding to meet some post-pandemic pressures on public services by maintaining some one-off Covid-19 funding in years beyond 2021-22. We assume that the Covid-19 reserves are fully allocated in 2021-22, and that Covid-19 funding halves in cash terms each year thereafter. We refer to this as a '**maintaining Covid-19 funding scenario**'. This would imply that the Welsh Government receives over £1 billion in Covid-19 funding in 2022-23, falling to £130 million by 2025-26. As shown in **Figure 4.3**, this results in similar levels of overall funding in 2022-23 and 2023-24, while by 2025-26, total funding is similar to what it

would be in our baseline scenario. From the UK government’s perspective, such an approach may be attractive in controlling the longer-term increase in public spending in the aftermath of the pandemic. However, such an approach would make planning the recovery of public services difficult for the Welsh Government, and as explored in the next section, would still lead to difficult decisions.

Figure 4.3
Projected funding for Welsh Government day-to-day spending under different scenarios, 2019-20 to 2025-26 (nominal terms)



Source: See Figure 4.1

Figure 4.4
Projected funding for Welsh Government day-to-day spending under different scenarios, 2019-20 to 2025-26 (nominal terms)

	2021-22	2022-23	2023-24	2024-25	2025-26
Baseline scenario					
Core funding	17,101	17,433	18,027	18,619	19,293
Annual real-terms growth		2.1%	1.4%	1.2%	1.4%
Covid-19 funding	2,489	0	0	0	0
Pre-pandemic plans scenario					
Core funding	17,101	18,026	18,741	19,408	20,081
Annual real-terms growth		5.6%	1.9%	1.4%	1.3%
Covid-19 funding	2,489	0	0	0	0
Maintaining Covid-19 funding scenario					
Core funding	17,101	17,433	18,027	18,619	19,293
Annual real-terms growth		2.1%	1.4%	1.2%	1.4%
Covid-19 funding	2,572	1,037	519	259	130

Source: See Figure 4.1

5 Challenges and trade-offs for the next Welsh Government

Spending pressures are likely to materialise from numerous directions in the aftermath of the pandemic, on top of pre-existing, underlying pressures. Our previous election briefings have looked at the likely spending pressures facing key budget areas over the next four years, namely the NHS, schools, social care, and other local government services.¹⁶

This section explores what the current outlook for the Welsh budget means for the options and trade-offs facing the next Welsh Government. We model some of the high-level options for budget allocations to some of the main spending areas over coming years. The options we model do not reflect our assessment of the likely or 'correct' course of action – they are intended to only illustrate the scale of the challenges and trade-offs under the current outlook. They are also clearly not an exhaustive set of options, given there would be an infinite number of ways to allocate the Welsh Government's budget.

The starting point for our projections is the core budget allocations (excluding Covid-19 funding) made in Final Budget plans for 2021-22 (set out in **Chapter 2** and in Figure A.3 in Annex 1). There will be substantial Covid-19 funding left to be allocated in 2021-22. In future years however, any Covid-19 related costs will need to be funded from core budget allocations (unless the UK government changes its spending plans).

Trade-offs when allocating the Welsh budget

In the first scenario (**option 1**), we firstly assume the Welsh Government "pass on" Barnett consequentials from NHS and schools spending in England to the equivalent areas in Wales. Remaining funding (or any overall budget cuts required) are shared proportionately across all other areas of spending.¹⁷

Figure 5.1 shows the change in funding for the main areas of the budget under this scenario, and under our **baseline scenario** for Welsh Government funding set out in section 4. Funding for the NHS would increase by £360 million between 2021-22 and 2022-23 (excluding Covid-19 allocations). From 2021-22 to 2025-26, NHS spending would increase by an average of 2.5%. Excluding the effects of Covid-19 related volatility in the GDP deflator measure of inflation (described in the previous section), NHS spending would grow by an average of 2.1% in real terms between 2019-20 and 2025-26. This would meet the projected underlying (pre-pandemic) funding pressures previously projected by the Health Foundation (2016).

¹⁶ These are available here: <https://www.cardiff.ac.uk/wales-governance-centre/publications/finance>

¹⁷ In the scenarios outlined in this section, we split Welsh Government funding for Local Authorities by schools spending, social services, and other local government funding. This is done by splitting the Revenue Support Grant and redistributed NDR income according to the shares implied by spending assessment. Actual spending by local authorities may deviate from this.

While funding for schools would increase significantly, cuts would need to be made to government support for social services and other local government. In reality, since most Welsh Government funding for local authorities is hypothecated, it is the overall change in total local government funding which would matter for local authority budgets. In this scenario, funding would increase by £51 million between 2021-22 and 2022-23. Between 2021-22 and 2025-26, total funding for local government would increase by an average of 0.9% per year in real terms. Our analysis of the outlook for local government budgets over the next five years suggests this funding scenario would fall short of the projected funding pressures by £178 million in 2022-23 (Sion 2021), a shortfall that would reduce slightly to £132 million by 2025-26. This projection is based on the assumption that council tax increases by 4.5% a year from 2022-23 onwards, in line with recent average increases.

Figure 5.1
Change in Welsh Government spending from 2021-22 by service area, under 'baseline assumption' for the Welsh budget - spending option 1

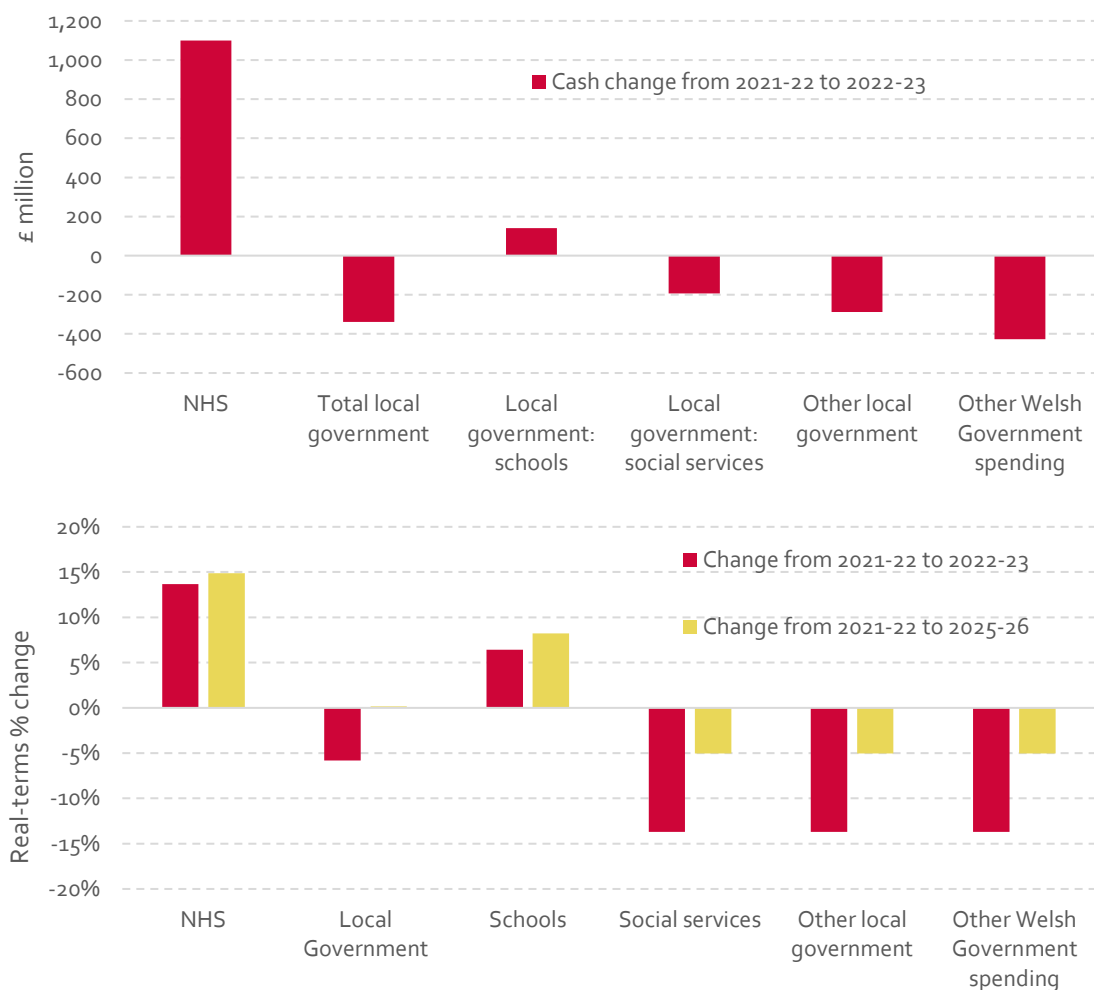


Source: authors' calculations – see main text for calculations and assumptions

NHS spending (£8.1 billion in 2021-22) and funding for local government (£5.7 billion) together account for 82% of the Welsh budget for day-to-day spending. In this scenario, all other Welsh Government service areas (£3.1 billion – or 18%), would need to be cut by £80 million between 2021-22 and 2022-23.

As explored in our report on NHS spending pressures, while simply passing on health-related consequentials to the NHS would likely be enough to cover underlying funding pressures, it would likely fall well short of post-pandemic pressures on the NHS. These Covid-19 legacy costs include some (though reduced) direct Covid-19 costs, losses in NHS productivity, the cost of clearing the backlog in elective care, and new demands on mental health services. Under our central assumptions for these costs, total NHS spending pressures are around £740 million above projected health-related consequentials in 2022-23, and remain around £360 million above consequentials between 2023-24 and 2025-26.

Figure 5.2
Change in Welsh Government spending from 2021-22 by service area, under 'baseline scenario' for the Welsh budget - spending option 2



Source: authors' calculations – see main text for calculations and assumptions

As an alternative scenario (**option 2**), we model the impact of the Welsh Government meeting the projected 'unfunded' NHS pressures from 2022-23 onwards from its core budget. As shown in **Figure 5.2**, this would require a £1.1 billion increase to the core NHS budget between 2021-22 and 2022-23. When Covid-19 funds are accounted for, this would mean that NHS spending in 2022-23 would be maintained at similar level to total spending on the NHS in 2021-22.

While this option would make it more likely that post-pandemic NHS pressures are met, it would require massive – and likely unachievable – cuts to all other spending areas. Total local government funding would be cut by £340 million in 2022-23 and would barely recover in real terms by 2025-26. This would lead to a huge shortfall relative to local government spending pressures in 2022-23 and would still average £360 million between 2023-24 and 2025-26. All other Welsh Government spending would need to be cut by £430 million in 2022-23 and would still be 5% below 2021-22 levels in real terms in 2025-26.

Spending choices under alternative scenarios for Welsh budget

We now consider the more optimistic scenario for the Welsh budget – the '**pre-pandemic plans scenario**' described in section 4.2. This scenario entails faster growth in the Welsh Government's block grant as a result of higher UK government departmental spending.

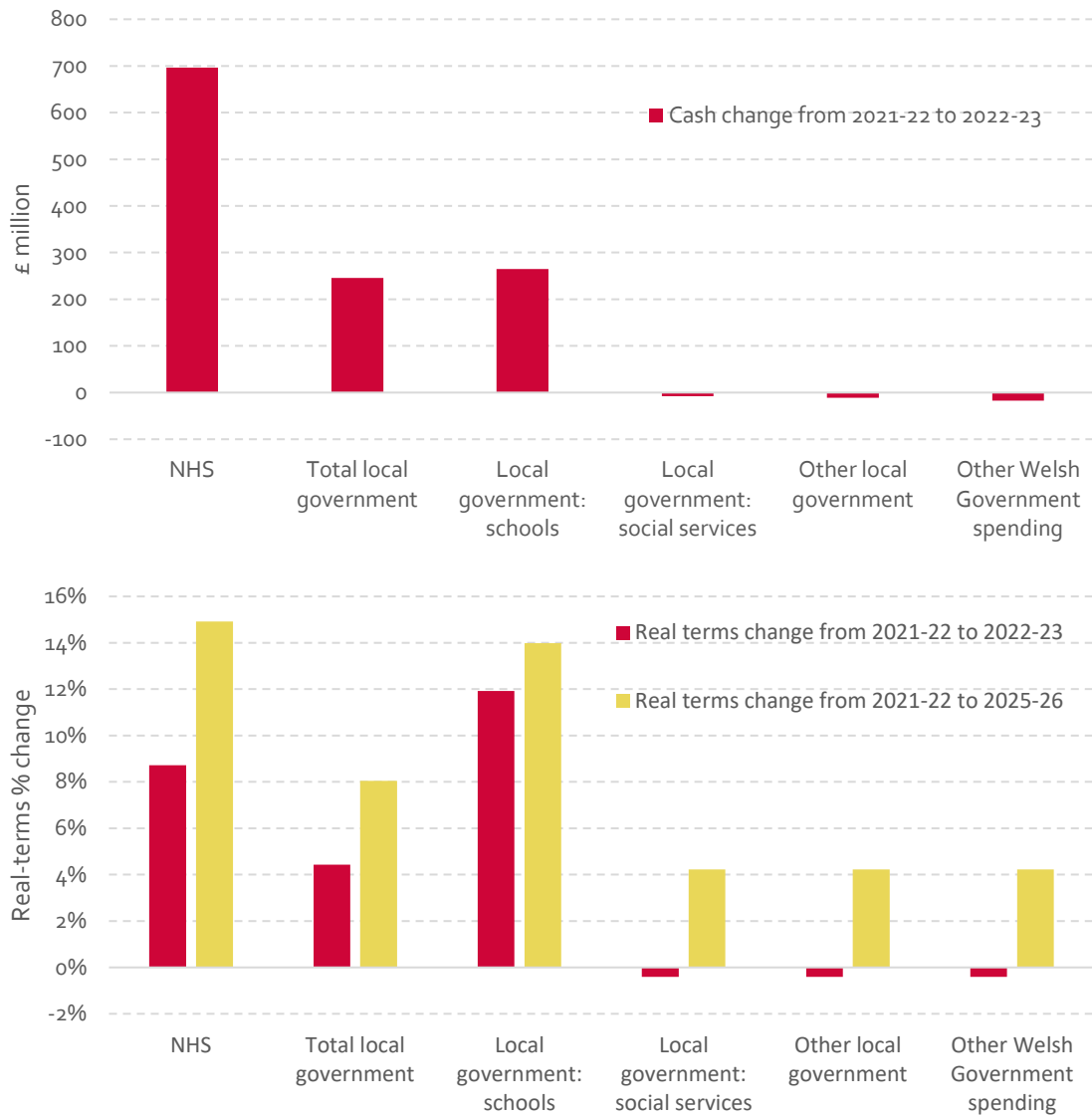
In the scenario shown in **Figure 5.3**, we again assume the Welsh Government directly passes on consequentials from NHS and schools spending in England. Given that the increase in UK government departmental spending is assumed to be spread proportionately over all departments, the NHS and schools consequentials are larger under this scenario. Allocations to the NHS would increase by just under £700 million between 2021-22 and 2022-23, a rate of growth which would substantially close the gap in total funding pressures compared to the scenario shown in **Figure 5.1**. By 2023-24, the increased health-related consequentials would be sufficient to fund all the projected post-Covid-19 legacy costs on the health services.

Meanwhile under this scenario, total funding for local governments would increase by £245 million, driven by higher levels of schools-related consequentials. Between 2021-22 and 2025-26, funding for local government would increase by an average of 2% a year in real terms. This would be sufficient to fully match the projected spending pressures faced by local governments over the course of the next Senedd term (assuming a 4.5% annual increases in council tax levels). All other areas of the budget in this scenario would increase by an average of 1% a year in real terms.

The '**maintaining Covid-19 funding scenario**' described in **Chapter 4** would alleviate some of the acute unfunded spending pressures in 2022-23. Over the course of the next Senedd term however, such a spending approach by the UK government would likely lead to the same medium-term funding trade-offs and choices described in **Figure 5.1** and **5.2** as the Covid-19 funding diminishes.

Figure 5.3

Change in Welsh Government spending from 2021-22 by service area, under 'pre-pandemic plans scenario' for the Welsh budget - spending option 1



Source: authors' calculations – see main text for calculations and assumptions

Other choices to be made by the next Welsh Government

The scenarios described above outline some of the possible spending allocations to the main areas of the budget. There are of course alternative paths for both Welsh Government revenue and spending allocations. There are also important decisions to be taken within each spending areas.

One of the key factors which will influence the shape of the Welsh budget over coming years is **public sector pay**. Responsibility for setting pay in the public sector in Wales is split between the Welsh and UK governments. The Welsh Government is ultimately responsible for setting pay in the NHS, for teachers, and the devolved civil service, which is informed by the independent pay review bodies. Meanwhile, the pay for other local government staff is negotiated at an England and Wales level by the National Joint Council for Local Government Services.¹⁸

Several parties have already made commitments to significantly increase the salaries of care workers during the next Senedd term. There is a strong case for a substantial pay increase in the social care sector – the median pay for those working Welsh care homes is only £8.89 an hour. For comparison, the Real Living Wage is currently set at £9.30 an hour.¹⁹ We broadly estimate that the cost of introducing the Real Living Wage in 2021-22 would amount to £20 million, compared to a baseline scenario where wages continue to increase in line with the National Living Wage. The trends in pay for teachers and other local government staff will also have a large influence on the cost pressures faced by local government.

The extent of the overall funding pressures to be faced by the NHS in coming years is also critically dependent on trends in pay. In its evidence to the NHS Pay Review Body, the UK government recommended a 1% increase in pay.²⁰ We estimate that following the Scottish Government in proposing a 4% pay rise for most NHS staff in Wales would cost the Welsh Government an additional £93 million next year. The Royal College of Nursing have called for a 12.5% pay increase for nursing staff, overturning a decade of declining real terms pay levels.²¹ As we show in our previous election briefing, restraining pay growth in the NHS to below the long-run average of earnings growth may allow higher levels of activity for a given level of resources. However, given the reductions in pay over the last decade, and the enormous pressures the pandemic has created for NHS staff, such an approach may likely be incompatible with the need to recruit and retain staff.

There are also some areas which come under the 'other Welsh Government spending' umbrella in the previous analysis that will face particular challenges over the course of the next Senedd term. For example, the **higher education** sector may need additional support in the face of major disruption to student numbers and revenue streams. Further resource support for **public transport** may also be needed over future years if passenger numbers do not recover quickly. The next Welsh Government will also need to fund actions related to business support, skills, and employability, to support the **economic recovery**. Given the disproportionate impact of the Covid-19 pandemic on poorer households, tackling **poverty** will also need to be a key priority of the next government. For example, funding delivered through, what the Bevan Foundation (2020) term, the "Welsh Benefits System" (i.e. cash or in-kind help provided to boost household incomes or reduce costs) could be maintained and expanded.

¹⁸ For overview of public sector pay policy and the pay bill in Wales, see Ifan and Sion (2019).

¹⁹ See Sion, C. (2020)

²⁰ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/966702/DHS_C-written-evidence-to-the-NHSPRB-2021-to-2022.pdf

²¹ <https://www.rcn.org.uk/news-and-events/news/uk-nhs-pay-rcn-submits-official-case-for-12-5-rise-250121>

In this regard, a key aspect for household finances that the next Welsh Government will be able to influence will be **Council Tax** increases. In our baseline scenarios of local government funding pressures, we assume Council Tax levels increase by 4.5% a year over the next four years, in line with recent averages. If funding for local government falls short of spending pressures, then increases could be greater still. If the next Welsh Government wishes to limit the increases to Council Tax, then either more funding will need to be diverted to local government budgets or funding pressures facing schools, social services and other local government services will be unmet. This strengthens the case for making the Council Tax system fairer. However, meaningful reform may take several years to implement.

Devolved taxes

In contrast to the austerity years at the start of the last decade, the Welsh Government now has some powers to influence the overall size of the Welsh budget. The most significant lever is the Welsh Rates of Income Tax, currently set at 10p in the pound at the basic, higher, and additional rates and raising £2.1 billion for the Welsh budget. The Welsh Government has the ability to vary each rate as it wishes, which would have a direct effect on the Welsh budget. Given the trade-offs facing the next Welsh Government described in the previous section, one option would be to increase income tax rates.

One concern is the potential economic impact of such an increase – though this is highly uncertain. Tax increases will reduce the take home pay for those whose tax liability increases, which would cut private spending in the economy. Meanwhile, a devolved tax increase in Wales would be matched by increased government ability to spend more money, which would boost demand. In the short run, the net effect would be influenced by the multiplier impacts of a balanced budget increase in government spending. This could be positive or negative at the margin depending on which ‘multiplier’ effect (from reduced household spending or from higher government spending) is greater. Tax increases may also influence the behaviour of individuals. Higher marginal rates of income tax may influence people’s decisions regarding work – for example, deciding to retire or take on fewer hours. Over the longer term, a tax increase could impact growth by influencing the relative competitiveness and attractiveness of the Welsh economy. This effect may also be balanced out through increased investment in government spending on education, skills, and infrastructure.

Concerns have also been raised around the impact on personal finances of taxpayers, especially in the aftermath of the pandemic.²² However, an income tax rise would have the largest impact on the personal finances of those least financially affected. Given the sectoral impact of Covid-19 and the differences in ability to work from home, those on lower incomes in Wales were more likely to have lost income and employment over the last year.²³ Meanwhile there is some evidence that higher income households have increased their savings during the pandemic.²⁴ In terms of the impact of an income tax rise, 45.7% of Welsh adults do not pay any income tax and the incomes of Welsh households in the lowest quintile would be largely unaffected. A 1p

²² For example, see: <https://www.bbc.co.uk/news/uk-wales-politics-56667000>

²³ Rodriguez (2020a) and Rodriguez (2020b)

²⁴ <https://www.bankofengland.co.uk/bank-overground/2020/how-has-covid-affected-household-savings>

increase at the basic rate would mean households would see a 0.6% reduction in their weekly disposable income.²⁵

Figure 5.4 shows the mechanical change (excluding any behavioural responses) in total projected devolved revenues from income tax resulting from a 1p or 2p rise in all rates from 2022-23 onwards. Some behavioural responses from taxpayers would be expected from such a tax rise, especially for higher-earning taxpayers. Our previous estimates suggest the Welsh Government would be sheltered from this behavioural response, given the small share of revenues devolved.²⁶

Figure 5.4
Projected Welsh Government revenues from Welsh Rates of Income Tax change in 2022-23 (with no behavioural effect)

	2021-22	2022-23	2023-24	2024-25	2025-26
No change in WRIT	2,113	2,233	2,315	2,495	2,643
+1p increase in all rates	2,113	2,456	2,546	2,745	2,907
+2p increase in all rates	2,113	2,680	2,778	2,994	3,172

Source: Authors' calculations from Office for Budget Responsibility (2021b)

In these scenarios, a 2p increase in all rates could raise up to £447 million in 2022-23 and £529 million a year by 2025-26. Note that because this is the 'mechanical' effect of the tax change only, a slightly larger increase in rates would most likely be required to raise this amount of additional revenue. Assuming our baseline scenario for the Welsh block grant, the Welsh budget for day-to-day spending would grow by an average of 2.2% a year between 2021-22 and 2025-26 (or 2.0% between 2019-20 and 2025-26). As shown in **Figure 5.5**, this would bring day-to-day spending closer to our 'pre-pandemic plans scenario' described in **Chapter 4**.

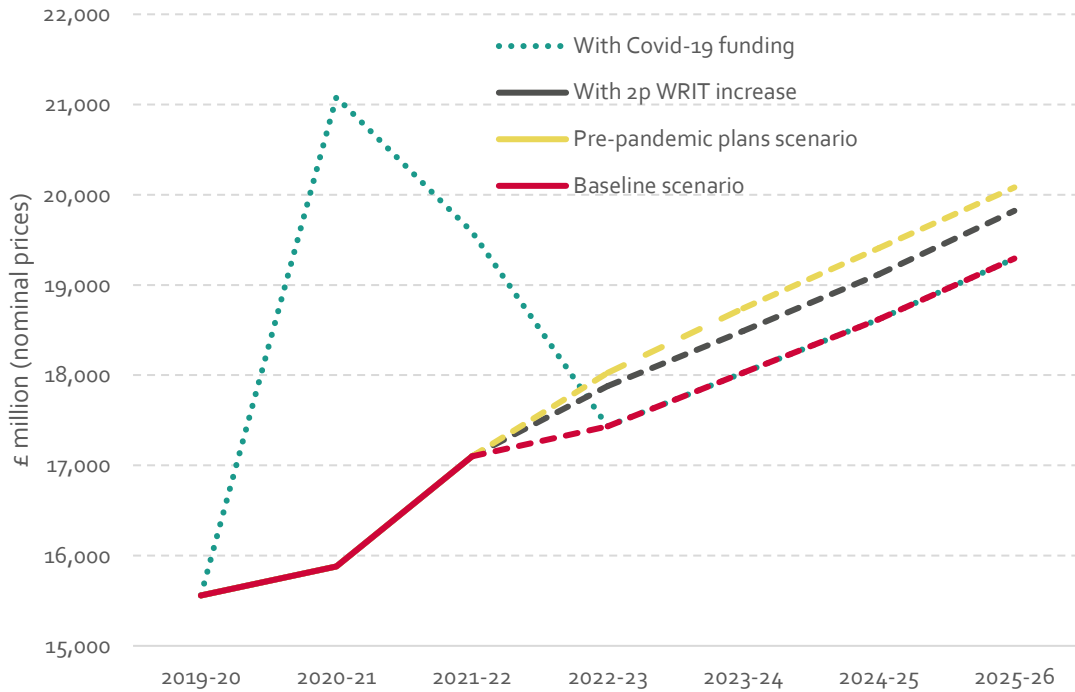
Figure 5.6 shows the potential changes to budget allocations this scenario would allow. Apart from the income tax increase, this scenario is as described in **option 1**, where the Welsh Government passes on NHS and schools consequentials resulting from English spending these areas. We also assume that the additional revenues from the income tax increase are targeted at meeting our projection of unfunded pressures on the NHS. This would still leave some projected unfunded pressures in 2022-23. Thereafter, the additional revenues from the tax increase would be greater than the projected NHS funding pressures, releasing some further funding for all other services after this point. Funding for local government spending would increase around 1.2% a year in real terms between 2021-22 and 2025-26, while all other Welsh Government spending would grow by an average of 0.6% a year over the same period, despite falling in 2022-23.

²⁵ Ifan and Sion (2020)

²⁶ Wales Fiscal Analysis (2020)

Figure 5.5

Projected funding for Welsh Government day-to-day spending under different scenarios, 2019-20 to 2025-26 (nominal terms)



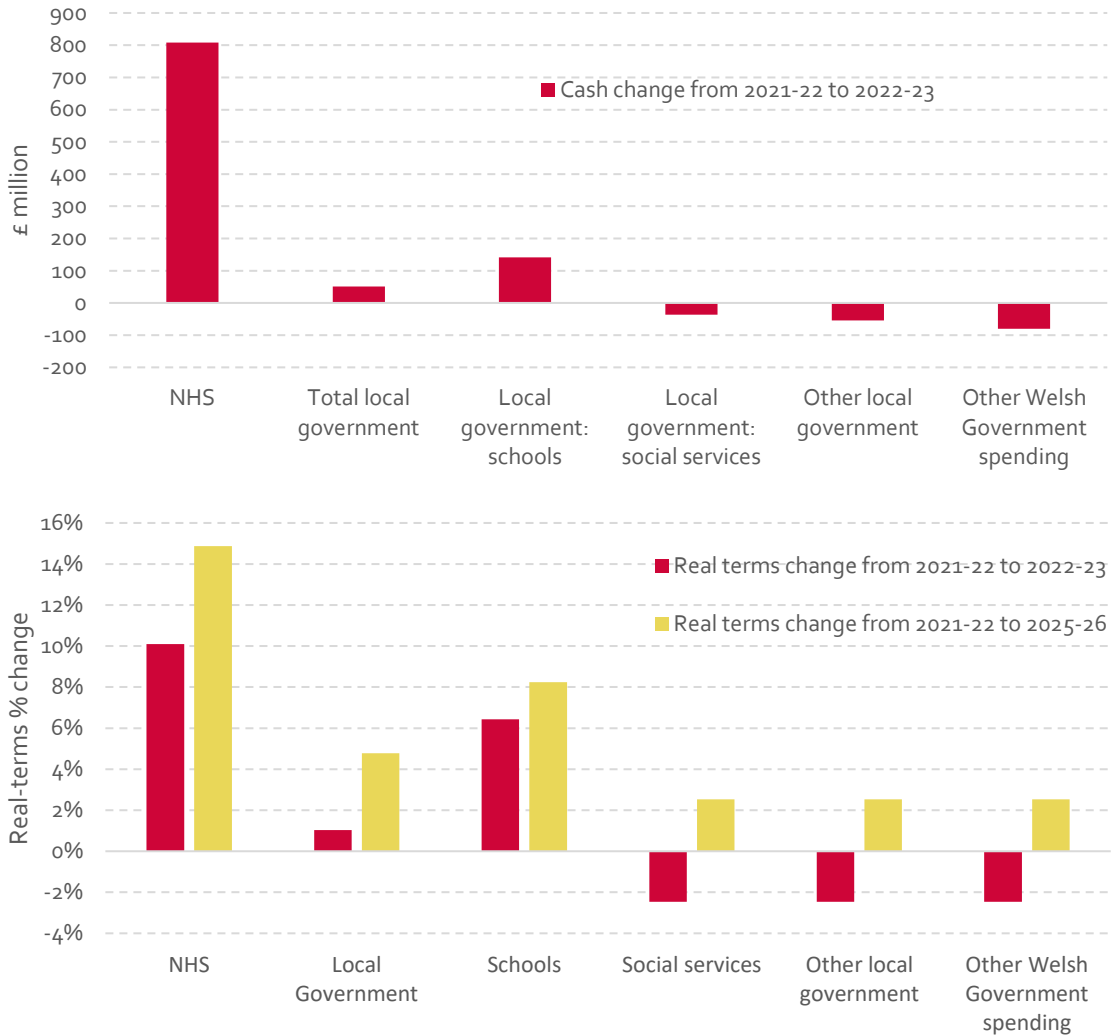
Source: as in Figure 4.1

From this scenario we can conclude that using the Welsh Rates of Income Tax is not likely to be sufficient to fully cover the immediate fiscal challenges facing Welsh public services in 2022-23. However, over the medium term, increasing revenues from devolved income tax could play an important part in meeting spending pressures and funding enhanced public services. The economic and behavioural effects of tax rate change are of course highly uncertain. But there are also risks in ruling out income tax rises. Using council tax in its current form to meet local government spending pressures over the next five years will substantially impact household finances.

The UK government's fiscal policies will of course play a key part in considerations over whether and when to use the income tax powers. The UK government could change course on its spending plans, as well as committing further resources for certain public services in England, most notably the social care sector. However, given the UK government's aim of a current budget balance in the medium term, coupled with the commitment to not raise the main rates of Income Tax, VAT, or National Insurance, devolved tax policy could become a key part of meeting future challenges.

Figure 5.6

Change in Welsh Government spending from 2021-22 by service area, under baseline scenario for the Welsh budget and 2p rise in all WRIT - spending option 3



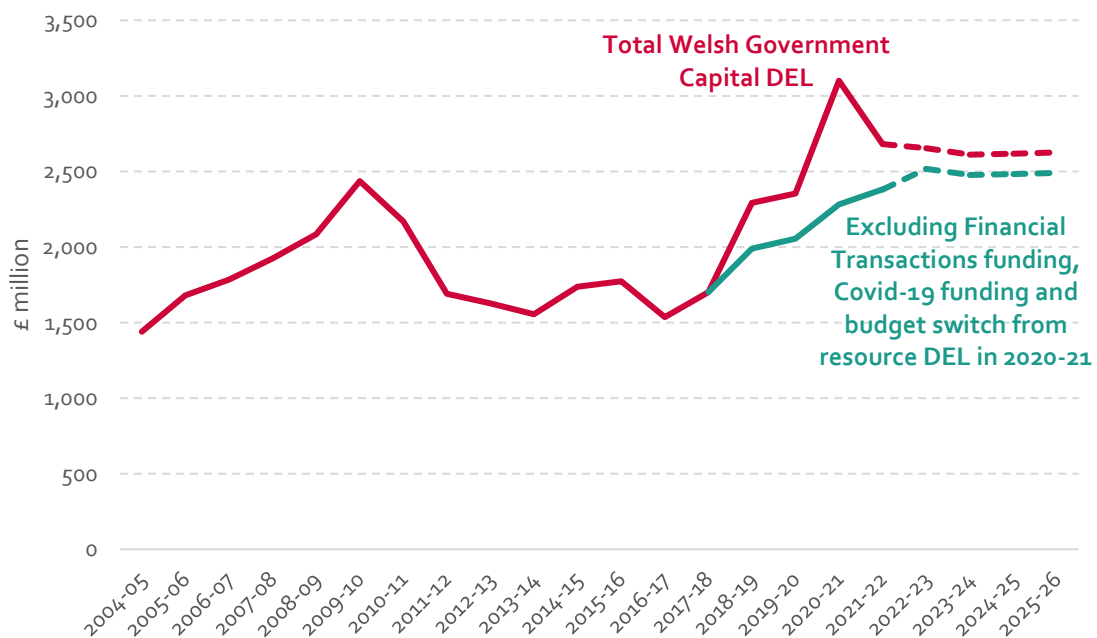
Source: authors' calculations – see main text for calculations and assumptions

6 Capital spending

The previous chapters have covered recent trends and the outlook for the Welsh budget in terms of day-to-day spending. This section turns our attention to capital funding and spending – the amount invested in new schools, hospitals, and other infrastructure. This spending will play a key part in the Welsh economic recovery and in the rebuilding of public services.

The Welsh Government’s capital budget has grown significantly over the course of the last Senedd term. **Figure 6.1** shows the trend in total funding for the Welsh Government budget (red line). In recent years, the Welsh Government has received significant capital funding in the form of Financial Transactions. This funding is ring-fenced, can be used to lend money to the private sector, and largely needs to be paid back to the Treasury. Financial Transactions amounted to £284 million in 2019-20 and accounted for an average of 12% of the capital budget between 2018-19 and 2020-21.

Figure 6.1
Funding for the Welsh Government Capital Budget, 2004-05 to 2025-26



Source: HM Treasury (2015 and previous, 2016, 2017, 2018, 2019, 2020); Welsh Government (2021a, 2021b); Welsh Government (2020a, 2020b, 2020c); HM Treasury (2021) and authors’ calculations

In 2020-21, the Welsh Government also received some capital consequentials as a result of the UK government's Covid-19 response. This funding amounted to £103 million, based on estimates by Honeysett et al. (2021). Most of this funding has been carried forward to 2021-22. The Welsh Government also switched a significant part of its resource budget (£501 million) to capital funding in 2020-21. This budget switch funded about £188 million of the Welsh Government's Covid-19 response and Reconstruction Package, as well as non-Covid-19 allocations, including £270 million for the Development Bank of Wales legacy funding.²⁷

The green line in **Figure 6.1** provides a more consistent basis for assessing the trend in capital funding over recent years, accounting for the factors outlined above. Capital funding on this basis has increased substantially over recent years, recovering from the cuts made during the first part of the last decade. However, the increase in capital funding is below the increases made in the aftermath of the financial crisis of 2007-08 and remains at a similar level to its 2009-10 peak in real terms. Over recent years, the Welsh Government has gained some limited powers to borrow for capital purposes. The Welsh Government can borrow up to £150 million a year up to an overall limit of £1 billion but is yet to make full use of these powers.

Our projections of capital spending over the course of the next Senedd term makes several assumptions about UK government and Welsh Government decisions. Firstly, we base our projections on UK government total capital spending plans from the March 2021 Budget. The Spending Review 2020 also contained some multi-year spending plans for some capital projects. We firstly consider any Barnett consequentials resulting from these plans. We then assume that all other UK departmental capital spending changes proportionately in line with the remaining capital DEL not subject to multi-year plans. We assume the Welsh Government makes full use of its borrowing powers between 2021-22 and 2025-26. These assumptions mean that the total Welsh capital budget is set to remain at around £2.6 billion a year in real terms over the course of the next Senedd term.

Unfortunately, we cannot determine the path of Financial Transactions funding in the UK government's spending plans. We therefore assume the share of capital funding accounted for by Financial Transactions stays at its 2021-22 level (approximately 5%). This means that the Welsh Government's core capital budget (excluding Financial Transactions) funding is set to stay at around £2.5 billion a year in real terms over the course of the next five years. Although not growing in real terms, this would amount to the highest sustained level of capital funding for the Welsh Government over a number of years.

Figure 6.2 contains the capital budget allocations made by the Welsh Government for 2020-21 (both originally in the Final Budget and after supplementary budget allocations) and for 2021-22 (Final Budget plans). The largest share of planned spending in 2021-22 is accounted for by the Economy and Transport portfolio. A large portion of this funding is allocated to the Transport for Wales (£275 million), National Transport Infrastructure budget lines (£128 million), and the Sustainable Travel (£204 million) budget lines. The next largest share of capital

²⁷ See: <https://developmentbank.wales/news-and-events/development-bank-wales-welcomes-welsh-government-ps270m-capitalisation-wales>

spending goes to the Housing and Local Government portfolio. This largely consists of funding for Local Government capital spending (£198 million) and Social Housing Grants (£300 million).

Some areas of capital spending may need to see significant increases in spending over coming years. For example, the need for recovery and additional activity in the NHS over coming years would require substantial amounts of capital investment in infrastructure, facilities, and equipment, over and above pre-Covid-19 plans. Growing the NHS capital budget in line with underlying resource funding pressures (excluding Covid-19 pressures) entails spending £100 million more per year by 2025-26. This suggests that the next Welsh Government will also need to make trade-offs between spending areas when it comes to capital spending.

Figure 6.2

Welsh Government capital budget allocations, 2020-21 and 2021-22

	Capital DEL				Financial Transactions		
	2020-21 Final Budget	2020-21 3rd Suppl. Budget	Final Budget 2021-22	Final Budget 2021-22 (% of total)	2020-21 Final Budget	2020-21 3rd Suppl. Budget	Final Budget 2021-22
Health and Social Services	369	444	383	15%	0	0	0
Housing and Local Government	559	725	728	29%	151	184	126
Help to Buy Repayments					0	0	-60
Economy and Transport	705	983	807	32%	85	156	14
Education	218	400	279	11%	0	0	2
Mental Health, Wellbeing and the Welsh Language	38	79	51	2%	16	0	0
Environment, Energy and Rural Affairs	155	155	198	8%	2	0	0
Central Services and Administration	30	22	39	2%	1	1	2
Total allocations	2,074	2,808	2,485	100%	254	341	83

Source: Welsh Government (2021b); Welsh Government (2021a)

7 Conclusion

Uncertainty has been a feature of Welsh budgets over the course of the last Senedd term – among them being the referendum and decision to leave the European Union, hung parliaments and snap elections, and substantial changes in the fiscal and spending plans of four successive UK Chancellors. However, the uncertainties of the first years of the Senedd term pale in comparison to the those that Welsh policymakers have faced during the Covid-19 pandemic and will now face over coming years.

The pandemic led to a huge fiscal response to support businesses, public services, and individuals. Starting from the next Spending Review later this year, the UK government will need to make big fiscal choices which will shape the economic recovery and the rebuilding of public services across the UK. For the Welsh Budget, current spending plans make for a difficult outlook in the face of huge post-pandemic pressures on public services.

This challenging outlook and uncertainty over future funding put political parties contesting the Senedd election in a difficult position. Manifesto programmes need to adequately respond to the huge challenges facing all areas of the budget. However, they also need to reflect the potential trade-offs for future Welsh budgets. Alongside setting out specific policy proposals and desired outcomes, politicians should articulate the options they will consider if they form the next Welsh Government and how these would be prioritised under different economic and fiscal policy scenarios. The fiscal policy of the next Welsh Government will need to be flexible and responsive to the huge challenges in the aftermath of the pandemic.

Annex 1

This annex provides some tables to support the analysis made in sections 2 to 5 of the main report.

Figure A.1 shows the change in Welsh Government funding for day-to-day spending in 2020-21 and 2021-22. Our latest projections include the latest forecasts for devolved revenues and the latest projections of Covid-19 funding in 2021-22 based on UK government announcements (see section 3 for more details).

Figure A.2 shows Welsh Government day-to-day spending allocations for 2020-21 and 2021-22, based on our analysis of Welsh Government budget documents. In our latest projections, we adjust the allocations to Housing and Local Government to offset any change in forecast Non-Domestic Rates revenues.

Figure A.3 provides a breakdown of Welsh Government day-to-day spending allocations by Main Expenditure Group in 2021-22 Final Budget plans, highlighting spending for the NHS and local government budgets. This is used as the starting point for our projections in section 5.

Figure A.4 provides a breakdown of Covid-19 related funding consequential in 2020-21 by source of spending in England by UK government departments.

Figure A.1

Sources of funding for Welsh Government budget for day-to-day spending, 2020-21 and 2021-22

Funding source	2020-21			2021-22	
	2020-21 Final Budget plans	2020-21 3rd Suppl. Budget	2020-21 Latest projection	2021-22 Final budget	2021-22 Latest projection
Core RDEL block grant	12,404	12,599	12,599	13,585	13,585
Covid-19 funding	0	5,200	5,200	1,264	2,489
Wales Reserve	125	125	125	125	125
Non-Domestic Rates	1,136	692	768	1,101	985
Welsh Rate of Income Tax	2,200	2,170	2,170	2,064	2,113
Land Transaction Tax	250	176	190	231	260
Landfill Disposals Tax	36	28	31	33	34
Principal repayment of borrowing	-2	-2	-2	-2	-2
Total fiscal resource DEL funding	16,148	20,988	21,081	18,400	19,589
Fiscal resource DEL funding excluding Covid-19 funding	16,148	15,788	15,881	17,137	17,101

Source: Welsh Government (2021a, 2021b); Office for Budget Responsibility (2021b); and authors' calculations

Figure A.2**Welsh Government budget allocations for day-to-day spending, 2020-21 and 2021-22**

	2020-21			2021-22	
	2020-21 Final Budget plans	2020-21 3rd Suppl. Budget	2020-21 Latest projection	2021-22 Final budget	2021-22 Latest projection
Core budget allocations by MEG					
Health and Social Services	8,067	7,961	7,961	8,486	8,486
Housing and Local Government	3,922	3,953	3,876	4,167	4,283
Local Government funding from Non-Domestic Rates	1,136	692	768	1,101	985
Economy and Transport	544	452	452	556	556
Education	1,460	1,468	1,468	1,504	1,504
Mental Health, Wellbeing and the Welsh Language	255	204	204	268	268
Environment, Energy and Rural Affairs	244	454	454	510	510
Central Services and Administration	348	372	372	366	366
Total allocated to core budgets	15,975	15,557	15,557	16,958	16,958
Unallocated	105	101	194	105	69
Sponsored bodies	66	70	70	73	73
Covid-19 allocations					
Health and Social Services	0	1,532	1,532	440	440
Housing and Local Government	0	1,151	1,151	244	244
Economy and Transport	0	2,219	2,219	60	60
Education	0	190	190	12	12
Mental Health, Wellbeing and the Welsh Language	0	104	104	0	0
Environment, Energy and Rural Affairs	0	22	22	0	0
Central Services and Administration	0	42	42	3	3
Covid-19 allocations	0	5,260	5,260	759	759
Unallocated Covid-19	0	0	0	504	1,729
Total Welsh Government Resource Budget	16,147	20,988	21,081	18,400	19,589

Source: Welsh Government (2021a, 2021b); Office for Budget Responsibility (2021b); and authors' calculations

Figure A.3**Welsh Government budget allocations for day-to-day spending, 2021-22**

	Fiscal resource excluding Covid-19 – 2021-22	Covid-19 fiscal resource spending – 2021-22	Fiscal resource including Covid-19 – 2021-22
Health and Social Services	8,486	440	8,926
NHS spending	8074	440	440
Local authority spending	151	0	151
Housing and Local Government	4,167	244	4,411
Local authority spending	3,950	207	4,156
Economy and Transport	556	60	616
Local authority spending	96	34	130
Education	1,504	12	1,516
Local authority spending	417	35	453
Mental Health, Wellbeing and the Welsh Language	268	0	268
NHS spending	63	0	0
Local authority spending	26	0	26
Environment, Energy and Rural Affairs	510	0	510
Local authority spending	37	0	37
Central Services and Administration	366	3	369
Local authority spending	5	1	6
Fiscal resource allocations (excluding NDR)	15,857	759	16,616
Non-Domestic Rates	1,101	0	1,101
Local authority spending	1046	0	1,046
Total Fiscal Resource	16,958	759	17,717
of which:			
NHS spending	8137	440	8,514
Local authority spending	5,729	277	6,006
Other spending	3,093	42	3,197

Source: Welsh Government (2021a)

Note: Our breakdown of NHS spending assumes that fiscal resource DEL (which excludes depreciation) is allocated across budget lines proportionally to total resource DEL (which includes depreciation).

Figure A.4**Covid-19 funding by UK government department spending**

UK government department	2020-21 consequentials (£ million)	2021-22 consequentials (£ million)
Housing, Communities & Local Government	948	637
Business rates relief	639	449
Repayment of English business rates	- 105	
Local Government funding	414	188
Business, Energy & Industrial Strategy	1,294	270
Environment, Food & Rural Affairs	20	0
Work and Pensions	12	0
Health & Social Care	2,484	907
Transport	746	123
Education	97	47
Digital, Culture, Media & Sport	97	6
Total Covid-19 related funding	5,697	1,991

Source: Figures for 2020-21 taken from Honeysett et al. (2021) and Honeysett, L. and Brien, P. (2020); figures for 2021-22 taken from UK March 2021 Budget documents (HM Treasury 2021) and authors' calculations

Note: the Welsh Government decided to carry forward £498 million of the consequentials for 2020-21 to 2021-22.

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