Dadansoddi Cyllid Cymru
Wales Fiscal Analysis

Welsh Budget Outlook 2022

WALES FISCAL ANALYSIS

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Preface

Declaration of funding

Wales Fiscal Analysis is hosted by the Wales Governance Centre and the School of Law and Politics at Cardiff University, and funded through a partnership between Cardiff University, the Welsh Government, the Welsh Local Government Association, Solace Wales, and the Wales Council for Voluntary Action. The programme continues the work of Wales Public Services 2025 hosted by Cardiff Business School, up to August 2018.

About us

Wales Fiscal Analysis (WFA) is a research body within Cardiff University's Wales Governance Centre that undertakes authoritative and independent research into the public finances, taxation, and public expenditures of Wales.

The WFA programme adds public value by commenting on the implications of fiscal events such as UK and Welsh budgets, monitoring and reporting on government expenditure and tax revenues in Wales and publishing academic research and policy papers that investigate matters of importance to Welsh public finance, including the impact of Brexit on the Welsh budget and local services, options for tax policy, and the economics and future sustainability of health and social care services in Wales.

Working with partners in Scotland, Northern Ireland, the UK, and other European countries, we also contribute to the wider UK and international debate on the fiscal dimension of devolution and decentralisation of government.

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Welsh Budget Outlook 2022

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Executive Summary

Facing a sea of red ink in the Office for Budget Responsibility's (OBR) November Economic Outlook, the Chancellor's 2022 Autumn Statement speech was a sombre coda to a year in which the UK's fiscal and economic climate took a dramatic turn for the worse. Russia's illegal war in Ukraine triggering vastly higher energy costs, inflation running at levels not seen for decades, anaemic economic growth, and the failed 'Trussonomics' experiment in unfunded tax cuts that prematurely ended the term in office of the former Prime Minister and Chancellor. Each alone would be a crisis for the UK's economic institutions; together they are a perfect storm for the economic and fiscal stability of Wales and the UK as a whole.

It is against this gloomy backdrop that we present the third annual **Welsh Budget Outlook** report, setting out the latest forecasts for devolved and local spending, analysing the spending pressures from inflation and tighter settlements, examining the budgetary impact of devolved and local taxes, and exploring the difficult set of policy options that governments face in the next five years.

UK economic and fiscal outlook

- The OBR now forecasts that GDP will fall by 1.4% in 2023, and in contrast to more optimistic forecasts in its November 2021 outlook, expectations for unemployment and government borrowing were both revised sharply upwards. Instead of falling next year, unemployment is now expected to rise from 3.6% today to 4.9% in 2024.

- The OBR also reported that Consumer Price Index (CPI) inflation is set to reach a 40-year high of 11% in Q4 of 2022, for an annualised average of 9.1% in 2022 and 7.4% in 2023.

- In the context of this sharply deteriorated fiscal outlook, the Chancellor announced that the Autumn Statement "delivers a consolidation of £55 billion", of which "just under half" would come from tax rises and "just over half" from spending cuts. Most of the spending cuts are pencilled in for the last three years of the five-year forecast term – beyond the next scheduled UK General Election.

Outlook for the Welsh Budget

- Unforeseen higher inflation has significantly eroded the real terms value of the Welsh Government's plans for day-to-day spending from 2022–23 to 2024–25. Additional UK government funding announced at the Autumn Statement will allow the Welsh Government to top-up its spending plans at the Draft Budget for 2023–24 and support businesses through the Non-Domestic Rates system. However, even after these additional allocations, the losses from higher inflation since budgets were set last year could amount to approximately £800 million in 2023–24 and £600 million in 2024–25.

- If the Welsh Government “passes on” Autumn Statement consequentials deriving from NHS spending in England, average annual increases in spending would amount to 2.4% per year in real terms from 2021–22 to 2024–25 – still below the 2.7% real terms growth planned when budgets were originally set in December 2021. Spending will likely fall short of the funding pressures felt by the health service in the aftermath of the pandemic.

- Spending outside of the NHS and local government is set to fall by 2.5% in real terms over the next two years (after a large increase in 2022–23). If the Welsh Government wanted to replicate its 2022–23 cost-of-living support measures in 2023–24, it would require an additional £126 million to be found from other spending areas.

- In contrast to the years of austerity budgets in the 2010s, the Welsh Government does now have the power to vary the size of its budget at the margin by using its income tax powers. A 1p increase in all three Welsh Rates of Income Tax would increase revenues by approximately £275 million in 2023–24 and £288 million in 2024–25. This would represent a 1.4% increase in the Welsh budget in each year. Doing so could reduce the aforementioned loss to planned spending from higher inflation to approximately £340 million in 2024–25.

- We estimate funding for day-to-day spending would increase by 1.2% per year in real terms from 2024–25 to 2027–28 after the UK government pencilled in slower growth in departmental spending following the current Spending Review period. This could imply cuts to non-NHS spending averaging 0.5% per year in real terms.

Public sector pay

- The devolved and local government public sector pay bill was approximately £9.1 billion in 2020–21, accounting for over half of day-to-day spending. Decisions made on pay have a significant impact on public sector cost pressures, the quality of public services delivered, as well as the personal finances of approximately 245,000 employees.

- We estimate that pay deals of 5% in 2022–23 (in line with pay recommendations) and 3.5% in 2023–24 (in line with average earnings) will increase the devolved public sector pay bill by £288 million a year relative to assumed budgeted-for increases –

equivalent to the cost of 7,000 public sector workers. This would still represent a real terms pay cut of 7% over two years for public sector workers and would see pay continue to fall relative to the private sector. Meanwhile, protecting public sector pay against inflation by 2023–24 would cost an additional £1 billion on top of assumed budgeted plans – equivalent to the cost of 24,000 public sector workers.

Local government finance

- If passed on in full, the additional funding announced at the Autumn Statement for schools and social care in England could more than double the planned increase to the Welsh local government settlement next year from £175 to £360 million. By 2024–25, the settlement would be £221 million more generous than what was implied by last year's plans.

- Even with additional funding over the next two years, we project that annual council tax increases of 2% would leave local authorities £345 million short of the amount required to meet cost and demand pressures by 2024–25.

- If the next UK government sticks to the lean spending plans pencilled in by the current government, this funding gap could grow to £660 million by 2027–28. This would almost certainly imply a return to an era of spending cuts and above-inflation council tax increases after a brief hiatus over the pandemic.

- Low interest rates on fixed loans from the Public Works Loan Board (PWLB) made borrowing an attractive way to finance capital expenditure during the 2010s, when the real value of Welsh Government grants was in decline. However, a steep rise in the cost of borrowing will make financing new capital projects considerably more expensive. As of mid-November, the interest rate on a 1-year loan from the PWLB was 4.2%, up from 1.0% as recently as June 2021.

Devolved taxes

- In the face of a challenging budget outlook, there might be a case for reviving the debate around the use of devolved income tax powers. Allowing for potential behavioural and migration effects, putting a penny on the basic, higher, and additional rates next year would raise approximately £237, £33, and £5 million respectively.

- As it stands, most businesses in the retail, leisure, and hospitality sector face a double whammy in April 2023 as the last of the Covid-19 reliefs ends and the inflation-indexed multiplier used to calculate liabilities increases by 10.1%. The decision to freeze the multiplier in England next year permanently boosted the Welsh budget by £90 million. The reliefs for retail, leisure, and hospitality premises in England triggered a one-off £115m budget boost.

- Targeted grants would be a more effective way of delivering support to the non-domestic sector than a blanket relief on non-domestic rates bills to ensure that small businesses and charities can equally access support. Although 77% of rateable properties have a rateable value of less than £12,000, they collectively contribute less than 5% of overall tax liabilities.

- We estimate that the additional council tax paid by owners of second homes will amount to £17.6 million in 2022–23, with local authorities netting an additional £5.7 million from owners of long-term empty homes. As councils deliberate over new powers to impose larger council tax premiums on empty and second homes, expect further debate around the role of taxation – not only as a means of funding public services, but also to nudge behaviour to achieve desired economic and societal outcomes.

Household income

- Taken together, the cost-of-living measures announced by the UK and Welsh governments between February and May 2022 delivered £1,300 of support for the average household in Wales. The Energy Price Guarantee might save a typical household a further £800 this Winter.

- The Chancellor announced further targeted payments to low-income households, pensioners, and individuals in receipt of disability benefits in 2023–24. These payments will boost the disposable income of Welsh households in the poorest income decile by 10% next year. This is in addition to the 10.1% uplift planned for most benefits (including the state pension) in April 2023.

- The absence of other support measures, including the council tax and energy bill rebates, as well as the decision to increase the energy price cap to £3,000 from April, means that most households will receive less support in 2023–24 than they did this year. A household eligible for next year's £900 means tested payment will still be paying more than twice as much on energy as they did three years ago. A household which does not meet the eligibility criteria for any of the additional targeted payments will be paying three times as much.

- Rising food prices are now a key driver of the headline inflation rate. Even pre-pandemic, UK households in the poorest income quintile were spending more than twice as much on food and non-alcoholic beverages (as a proportion of their income) than households in the top income quintile.

- The longer-term outlook for households remains bleak. By 2027, real disposable incomes in Wales will be over £10,000 lower than had the pre-financial crisis trend been sustained.

This third annual **Welsh Budget Outlook** report does not therefore make for pleasant reading. Presented in the midst of a fiscal and budgetary 'perfect storm' of record global energy prices and inflation, the potential for severe real terms public sector wage cuts, anaemic post-pandemic economic recovery, nosediving household disposable incomes that will wipe out eight years of growth, and a self-inflicted experiment in unfunded tax cuts that severely weakened the UK's economic credibility – all will test Welsh households, the UK's economic institutions and the Welsh Government to the limit.

In the short term, the Chancellor increased NHS, schools, and social care spending in England – all of which the Welsh Government can use to protect public services in Wales. Looming on the horizon, however, inflationary pressures and the harsh fiscal consolidation pencilled in after the next general election threaten the return of the austerity politics playbook that had only recently been jettisoned by the UK government.

1 UK economic & fiscal outlook

Facing a sea of red ink in the Office for Budget Responsibility's (OBR) November Economic Outlook, the Chancellor's 2022 Autumn Statement speech was a sombre coda to a year in which the UK's fiscal and economic climate took a dramatic turn for the worse. Russia's illegal war in Ukraine triggering vastly higher energy costs, inflation running at levels not seen for decades, anaemic economic growth, and the failed 'Trussonomics' experiment in unfunded tax cuts that prematurely ended the term in office of the former Prime Minister and Chancellor. Each alone would be a crisis for the UK's economic institutions; together they are a perfect storm for the economic and fiscal stability of Wales and the UK as a whole.

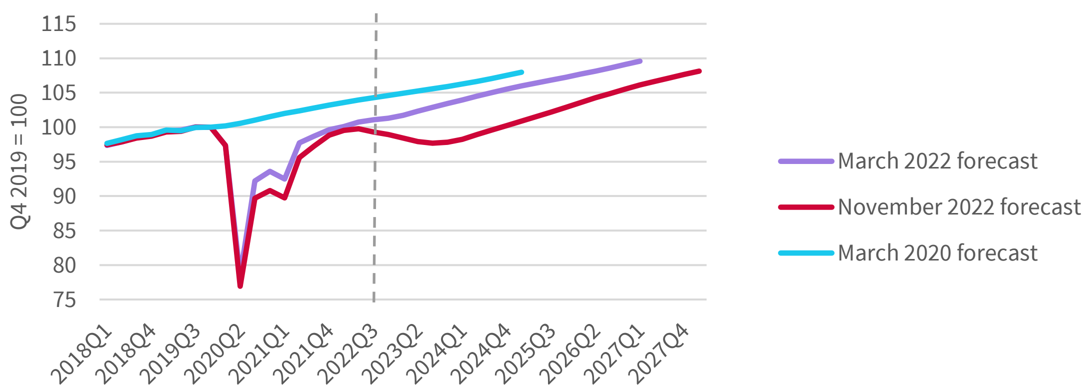
It is against this gloomy backdrop that we present the third annual **Welsh Budget Outlook** report, setting out the latest forecasts for devolved and local spending, analysing the spending pressures from inflation and tighter settlements, examining the budgetary impact of devolved and local taxes, and exploring the difficult set of policy options that governments face in the next five years.

1.1. UK economic outlook

The OBR's Economic and Fiscal Outlook set out a picture of high inflation and low growth that laid bare the UK's dire state of economic affairs. In response, the Chancellor prioritised further household support and protection for some areas of spending, while promising fiscal consolidation after the next General Election due in two years' time.

Figure 1.1

Real Gross Domestic Product: Quarterly GDP and forecasts



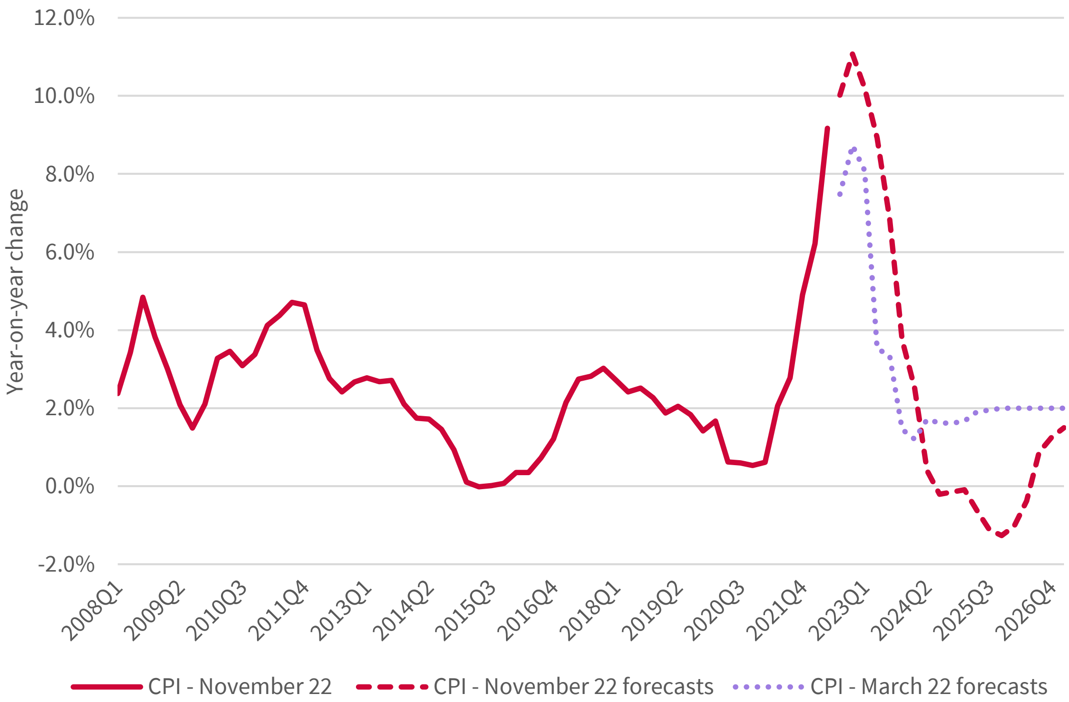
Source: OBR (November 2022) Economic & Fiscal Outlook.

As illustrated in **Figure 1.1**, the latest outlook continues the OBR's successive downward adjustments of expectations for post-pandemic economic growth. The OBR now forecasts that GDP will fall by 1.4% in 2023, and in contrast to more optimistic forecasts in its November 2021 outlook, expectations for unemployment was revised sharply upwards. Instead of falling next year, unemployment is now expected to rise from 3.6% today to 4.9% in 2024. In a Welsh context, this could result in 20,000 to 25,000 more people out of work.

As starkly illustrated in **Figure 1.2**, the OBR also reported that Consumer Price Index (CPI) inflation is set to reach a 40-year high of 11% in Q4 of 2022, for an annualised average of 9.1% in 2022 and 7.4% in 2023. This already extraordinarily high level would have been even higher without the UK government's energy price guarantee which limits a typical household's annual energy bill to £2,500 this winter and £3,000 next winter.

Figure 1.2

Consumer Price Index inflation (including March 2022 forecasts)

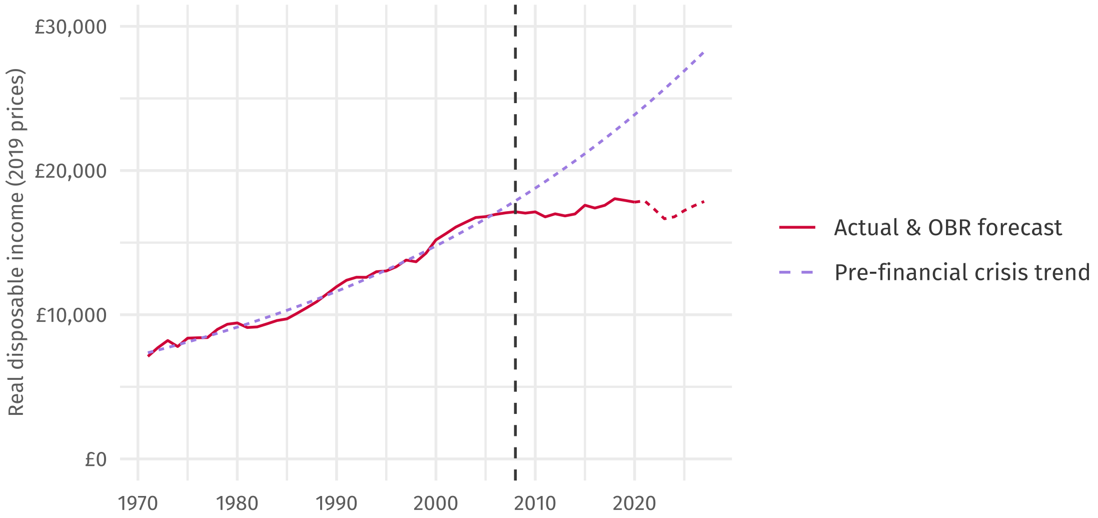


Source: OBR (November 2022) Economic & Fiscal Outlook.

This combined economic hit from energy costs, inflation and low growth will reduce household disposable income by 7% over the next two years – the largest drop since records began and one which will wipe out the previous eight years of growth. This generational squeeze on household incomes, falling house prices and interest rate rises will tip the economy into a recession. As shown in **Figure 1.3**, by 2027, Welsh incomes will be over £10,000 lower than had the pre-financial crisis trend been sustained.

Figure 1.3

Estimated real disposable income per person in Wales

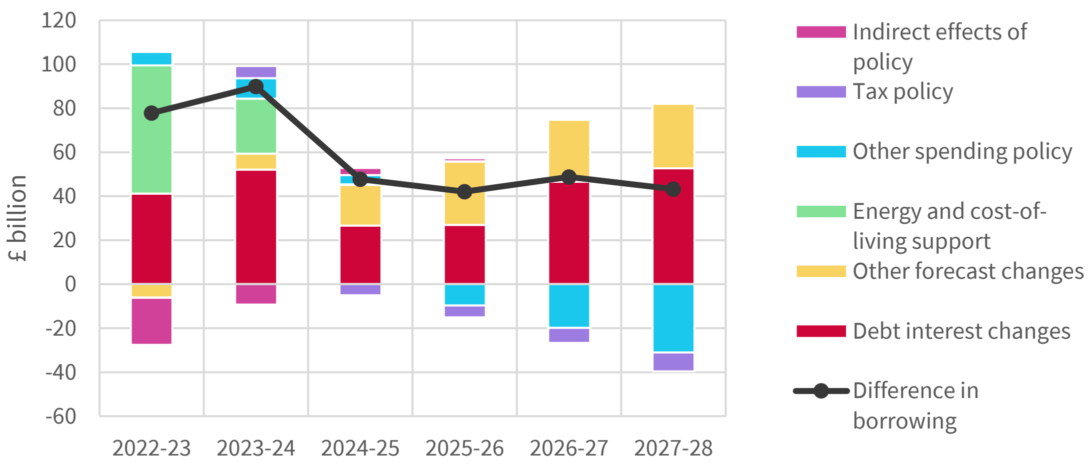


Source: WFA analysis of ONS (2022) UK Economic Accounts; OBR (November 2022) Economic and Fiscal Outlook.

The bleak economic outlook and higher expected interest rates have also reflected in a weakening fiscal outlook. Underlying forecast revisions have increased the OBR's estimates of government borrowing by an average of £54 billion a year (**Figure 1.4**), three-quarters of which being a consequence of higher debt interest spending.

Figure 1.4

Public sector net borrowing: changes since March 2022

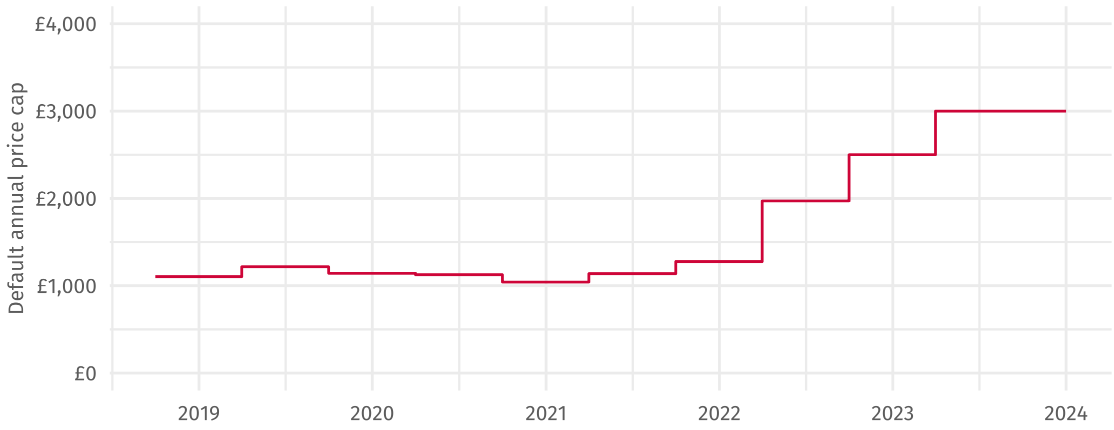


Source: OBR (November 2022) Economic & Fiscal Outlook.

Although the Chancellor reduced the cost of the government's energy price guarantee by allowing a typical household's annual energy bill to rise from £2,500 to £3,000 in April 2023 (**Figure 1.5**), the scheme still significantly raises the borrowing forecast in 2022-23 and 2023-24. Targeted payments will offer some reprieve to pensioners and those in receipt of means-tested and disability benefits; however most other households will still be paying nearly three times as much on energy as they did three years ago.

Figure 1.5

Annual price cap for a typical household paying by direct debit



Source: WFA analysis of Ofgem (2022) Default price cap level; UK government announcements.

Perhaps to ease potential market concern about the backloading of fiscal consolidation, the Chancellor adopted two new fiscal targets. The first is that underlying debt must fall as a share of GDP by 2027-28, the second, that public sector borrowing must not exceed 3% of GDP in that same year. Tax policies and spending cuts lower borrowing by an average of £37 billion a year in the final three years of the forecast, meaning the Chancellor just about meets his new targets. Such forecasts should however be considered tentative given the degree of uncertainty in the latter part of the forecast period beyond the next UK general election.

1.2. Fiscal consolidation of £55 billion

In the context of this sharply deteriorated fiscal outlook, the Chancellor announced that the Autumn Statement "delivers a consolidation of £55 billion", of which "just under half" would come from tax rises and "just over half" from spending cuts. Hunt argued that such an approach would make the recession shallower and keep inflation and unemployment from reaching even higher peaks. Yet as noted above, most of the spending cuts are pencilled in for the last three years of the five-year forecast term – beyond the next scheduled UK General Election.

The Treasury found additional tax receipts by revising income tax, taxes on capital gains and dividends, and imposing additional windfall taxes. The decision to freeze the personal allowance and the higher rate income tax threshold until April 2028 causes a tax effect known as 'fiscal drag', in which ever-increasing numbers of taxpayers are 'dragged' into higher tax bands as their earnings and inflation increase. And far from being eliminated as had been proposed at the September 'mini-budget' by Hunt's predecessor, the 45p Additional rate of income tax will now be paid on incomes above £125,140 rather than £150,000. This change will approximately double the number of Welsh taxpayers who pay the 45p rate of income tax. The tax-free thresholds for Capital Gains Tax and taxes on dividends were reduced, and new windfall taxes were imposed on energy profits and electricity generating companies.

On the spending side, the Chancellor chose to protect NHS and schools spending, at least for the last two years of the current spending period. The NHS in England will receive a budget boost of £3.3 billion in each of the next two years, and schools in England will receive an additional £2.3 billion per year. Along with significant (but mostly temporary) Business Rate cuts in England and an additional £1 billion on social care next year, this additional spending on public services that are devolved to Wales means the Welsh Government will automatically receive a £1.2 billion 'Barnett consequential'. These funds can be used to meet the extreme pressures in the Welsh NHS and social care sector, or for other areas of demand in next month's Welsh budget.

Despite higher inflation, capital spending plans to 2024-25 were not revised upwards and real terms cuts to capital spending have been pencilled in beyond 2027-28. This results in a gloomy outlook for the Welsh Government's capital budget. The Chancellor did, however, recommit to several named rail infrastructure projects in England, including the northern extension of HS2 from Birmingham to Manchester. As "England and Wales" projects – ostensibly because rail infrastructure is deemed devolved to Scotland and Northern Ireland but not to Wales – this continues the oddity whereby Scotland and Northern Ireland (but not Wales) will receive large multi-year capital funding boosts via the Barnett formula from UK government spending on these projects.

This third annual **Welsh Budget Outlook** report is presented in the midst of a fiscal and budgetary 'perfect storm', a set of economic circumstances more severe than either the UK's withdrawal from the European Union or a global pandemic that required previously unimaginable shutdowns of the economy. Record global energy prices and inflation, anaemic post-pandemic economic recovery, and a self-inflicted experiment in unfunded tax cuts that severely weakened the UK's economic credibility have all reopened the austerity politics playbook that had only recently been ditched by the UK government.

2 Welsh budget outlook

In October 2021, the UK government argued the 2021 Spending Review had delivered "the largest annual funding settlement to Wales since devolution". Core funding for day-to-day spending (excluding one-off Covid-19 funding) would grow by around £2 billion from 2021-22 to 2022-23, and by £2.9 billion to 2024-25. Two large increases to departmental spending in England had transformed the outlook for the Welsh budget. We concluded in December 2021 that this additional funding would be broadly sufficient to meet the huge funding pressures facing public services and leave some room for new policy proposals, such as those contained in the Cooperation Agreement between the Welsh Government and Plaid Cymru.[1]

Over the past year, much higher-than-expected inflation has eroded the real-terms value of that budget settlement. The Welsh Government's indicative spending plans to 2024-25 have seen a significant hit. Top-ups to spending on health, social care, and schools in England from last month's Autumn Statement means there will be some additional consequentials to allocate at the Draft Budget for 2023-24. However, the Welsh Government faces difficult decisions in dealing with the increased cost pressures facing devolved public services.

This chapter firstly focuses on funding for day-to-day spending and the effects of recent changes. Secondly, we assess some of the options and trade-offs for the Welsh Government as it sets its Draft Budget for 2023-24. Lastly, we consider the outlook for public sector pay in the face of high inflation and relatively squeezed budgets.

2.1. Changes to Welsh Government funding

In December 2021, the Welsh Government set spending plans for 2022-23, with indicative spending plans for the following two years to 2024-25. For day-to-day public spending, the plans suggested an average annual increase of 3.3% in real terms from 2021-22 to 2024-25, with the increase front-loaded to 2022-23.[2] NHS spending was set to increase by an average of 2.7% a year over this period, with a similar increase to core Local Government funding. Spending across all other areas was set to significantly increase (by an average of 5.5% per year), influenced by replacement EU funding for agriculture, additional funding for social care services and post-Covid-19 transport funding.

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[1] Guto Ifan and Cian Siôn, *Welsh Budget Outlook 2021,* (Cardiff: Wales Fiscal Analysis, 2021). https://www.cardiff.ac.uk/__data/assets/pdf_file/0008/2590280/wbo2021_full_07Dec2021.pdf

[2] This calculation includes spending funded by Non-Domestic Rates (classed as Annually Managed Expenditure in the budget) and uses the OBR's October 2021 GDP deflator, using readjusted Final Budget plans for 2021-22 as the baseline.

Three factors have influenced the outlook for the Welsh Government's spending plans, which we consider in turn: the impact of higher inflation; changes to forecasted devolved tax revenues and associated block grant adjustments; and additional consequentials announced by the UK government at the Autumn Statement on 17 November.

Impact of higher inflation

The first major change to the Welsh Government's spending plans has been the unforeseen increase in inflation levels. The OBR now forecasts CPI inflation to reach 10.1% over 2022-23, up from the 3.7% forecasted in October 2021.

While the CPI garners most attention, real-terms changes in public spending are usually calculated using the GDP deflator - a measure of inflation in the domestic economy. The increase in the forecasted GDP deflator over 2022-23 to 2024-25 is less pronounced; the OBR is now forecasting an average of 3.1% per year, compared to 2.3% when budgets were set. The GDP deflator is lower in the short term because it is not influenced by higher import prices and in the medium term because of weak demand and slower growth in planned government spending.[3]

By this measure, inflation reduces the planned average annual real terms increase in Welsh Government spending from 2021-22 to 2024-25 to 2.4% per year (see **Figure 2.1**). It would require an additional £400 million in 2022-23, £609 million in 2023-24, and £509 million in 2024-25 to restore the original real-terms value of the Welsh Government's spending plans.

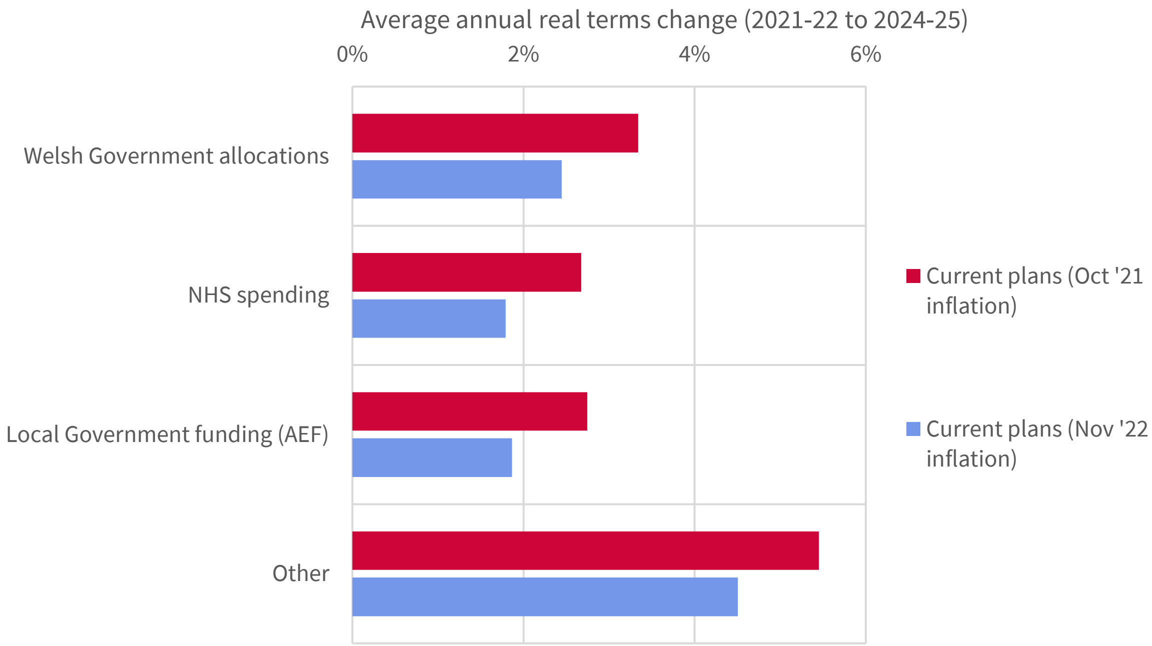
However, the GDP deflator is probably not a good measure of the cost pressures facing public services over coming years. One of the main drivers of increased cost pressures will be public sector pay awards. As discussed in Section 2.3, pay increases will likely need to be well above levels expected when budgets were set. Public services are also facing their own significant increases in energy costs. For example, in August it was anticipated that NHS energy costs for 2022-23 had increased sharply to £156 million, up from £61 million in 2021-22. Energy costs support measures for the non-domestic sector after March 2023 remain uncertain.

The OBR state that the true impact of inflation on public services will probably lie somewhere between that suggested by the GDP deflator and CPI inflation. Taking a mid-point between these two measures of inflation would imply an additional £983 million would be required in 2024-25 to fully restore the original real terms value of the Welsh Government's spending plans.

[3] Ben Zaranko, *Spending on public services,* (London: Institute for Fiscal Studies, 2022). https://ifs.org.uk/sites/default/files/2022-11/Spending-on-public-services-Ben-Zaranko.pdf

Figure 2.1

Average annual real-terms change in spending plans from 2021-22 to 2024-25



Source: Wales Fiscal Analysis calculations from Welsh Government budget documents. • Notes: Total day-to-day spending allocations refers to fiscal resource allocations and redistributed non-domestic rate revenues. Local Government funding refers to Aggregate External Finance

Devolved tax and block grant adjustment forecasts

The Welsh Government's budget plans will also change with new forecasts for devolved tax revenues from the OBR and projections of the associated block grant adjustments.[4]

Budgeted income tax revenues were based on the October 2021 OBR forecasts. Revenues have since been revised upwards, by £166 million in 2023-24 and £178 million in 2024-25. The net effect on the Welsh Government's budget plans depends on the *relative* change in revenues compared with the associated Block Grant Adjustments (BGAs), which are linked to forecasts of comparable UK government revenues in England and Northern Ireland. Slightly larger upward revisions of comparable revenue forecasts suggest **a negative change to the Welsh budget of £14 million in 2023-24** (relative to original budget plans).

Offsetting this change is the effect of reconciliations made to reflect revenue outturns for 2020-21 published by HMRC in July.[5] Devolved revenues were £30 million lower than

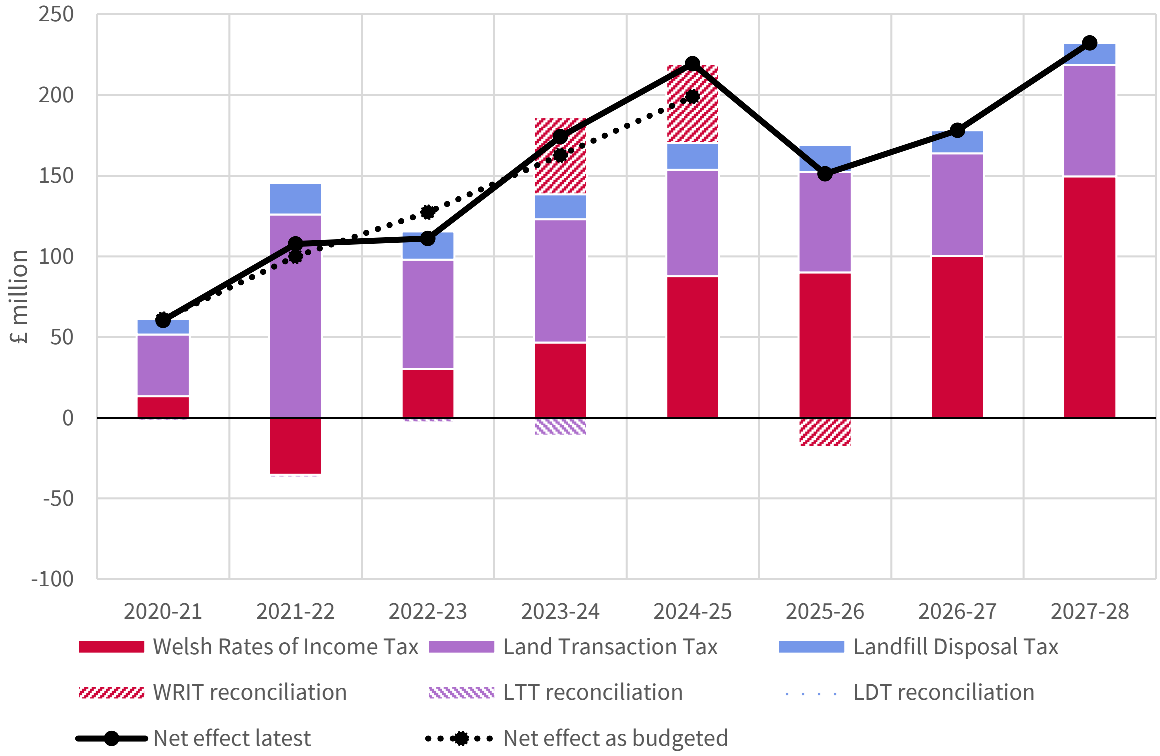
[4] Office for Budget Responsibility, *November 2022 Devolved Tax Forecasts* (London: Office for Budget Responsibility, 2022). https://obr.uk/download/november-2022-devolved-fiscal-forecast-charts-and-tables/

[5] https://www.gov.uk/government/statistics/welsh-income-tax-outturn-statistics-2020-to-2021/welsh-income-tax-outturn-statistics-2020-to-2021

budgeted for in 2020-21, which means £30 million will be deducted from devolved revenues in 2023-24. Meanwhile, BGAs should have been £77 million lower than budgeted for, meaning **a net positive effect of reconciliations of £48 million in 2023-24**. A positive **net reconciliation of £49 million is currently forecasted for 2024-25**, with devolved revenues set to be £337 million higher than budgeted for in 2021-22 (compared to a £287 million increase in the BGAs).

Figure 2.2

Net effect of tax devolution on the Welsh Government budget, 2020-21 to 2027-28 (devolved revenues minus block grant adjustments)



Source: OBR (November 2022) Economic & Fiscal Outlook. • Notes: The net effect on the Welsh budget is determined by the growth in devolved revenues relative to the growth of the Block Grant Adjustments.

Forecasts for Land Transaction Tax (LTT) revenues were significantly revised downwards in the OBR's November 2022 forecasts, by £89 million in 2023-24 and £123 million in 2024-25, reflecting the deteriorating outlook for the housing market in Wales. After accounting for changes in projected BGAs, this also leads to **a negative net change to the Welsh budget of £12 million in 2023-24 and £30 million in 2024-25**.

Adding to the LTT BGA for 2023-24 is a reconciliation for comparable revenues in 2021-22. The BGA should have been around £11 million higher, meaning a **reconciliation will be applied to the 2023-24 BGA**.

The overall impact of forecast changes and reconciliations is positive in 2023-24 (+£11 million) and in 2024-25 (+£20 million). This still represents a worsening of the outlook for devolved revenues compared to that based on the OBR's forecasts from March 2022. **The overall net effect of tax devolution is still consistently positive across the Spending Review period, by an average of £168 million a year** (Figure 2.2). This net benefit to the Welsh budget is set to grow to £232 million by the end of the forecast period in 2027-28.

Additional consequentials from the Autumn Statement

As part of the Autumn Statement on 17 November, the UK government announced additional departmental spending on the NHS, social care, and schools in England – the first top-ups to spending plans since the Spending Review in October 2021. They also announced business support measures through the Business Rates system in England. This triggered consequential funding for the Welsh Government worth £1.2 billion in 2023-24 and 2024-25.

A breakdown of these consequentials by source of English spending and across years has not been published by the UK government.[6] We estimate the broad composition of these consequentials by analysing the change in the Welsh Government's block grant, our projections of Block Grant Adjustments, and available information on the UK government's Autumn Statement measures. These estimates are outlined in **Figure 2.3**.

Figure 2.3

Estimated change in Welsh Government funding after Autumn Statement 2022

	2022-23	2023-24	2024-25
Difference in total fiscal resource DEL	**-16**	**655**	**492**
of which:			
Barnett consequentials		644	471
Health		193	193
Social Care		60	101
Schools		137	137
Household Support Fund		50	0
Business Rates		266	123
Other (residual)		-62	-82
Tax, BGA and reconciliation changes	-16	11	20

Source: WFA analysis of Autumn Statement 2022 and OBR (2022) November 2022 Devolved Tax Forecasts. ●
Notes: Other (residual) line is a balancing item after known measures are accounted for – the negative consequentials reflect the removal of funding for the employer costs associated with the Health and Social Care Levy. This table excludes the effects of IFRS16 accounting changes which have been applied to the 2023-24 and 2024-25 block grants. Business Rates consequentials are calculated from the Autumn Statement policy costings document – these are rough approximations only because possible indirect effects on other revenues (e.g. Corporation Tax and Income Tax Self-Assessment revenue) are also included in the costings given.

[6] Further information on Welsh Government funding is expected alongside the next Block Grant Transparency publication.

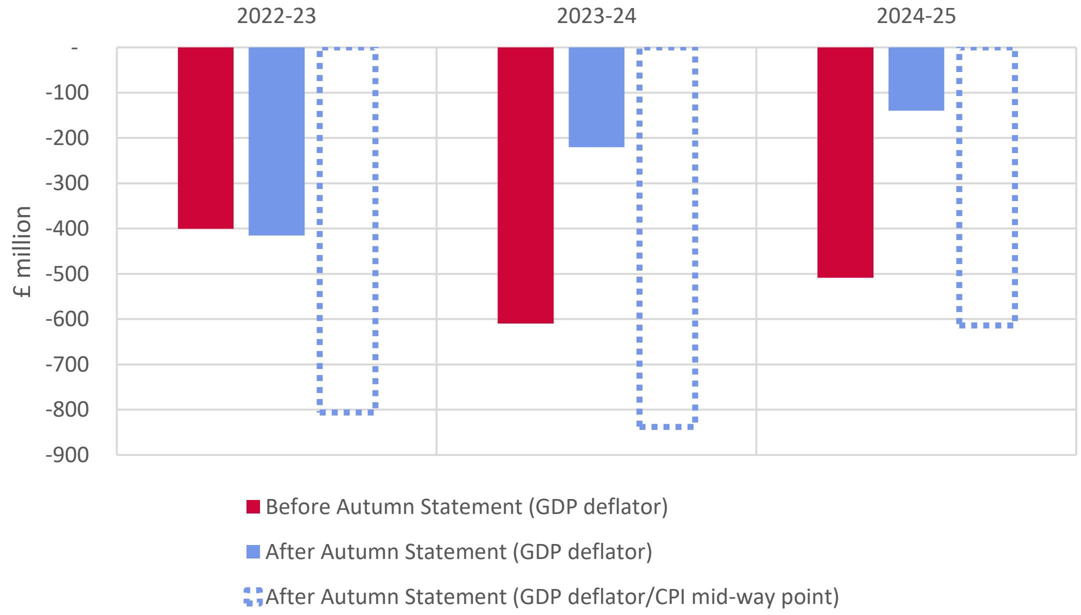
We estimate funding for day-to-day spending increases by £655 million in 2023-24 and £492 million in 2024-25, relative to the Welsh Government's existing budget plans. Funding derived from business rates measures in England amounts to £266 million in 2023-24 and £123 million in 2024-25. We estimate £193 million derives from additional UK government spending on the NHS in England, while another £137 million derives from English schools spending. The remainder of consequentials derive additional social care funding for English local authorities and the extension of the Household Support Fund in England to March 2024.

To assess the implications of these changes to the Welsh Government budget, **Figure 2.4** shows the hit to spending plans from higher inflation, before and after the Autumn Statement. We assume the Welsh Government uses consequentials deriving from business rates measures in England to lower non-domestic rates revenues in Wales, while using other funding to increase its public spending plans.

Using the GDP deflator measure of inflation, funding changes from the Autumn Statement reduces the loss to original spending plans to £220 million in 2023-24 (from £609 million before the Autumn Statement) and to £140 million in 2024-25 (from £509 million). However, if we alternatively use the mid-way point between the GDP deflator and CPI measures of inflation (as discussed above), **the real terms loss in the Welsh Government's spending power amounts to over £800 million in 2023-24 and £600 million in 2024-25, even after the additional funding announced at the Autumn Statement**.

Figure 2.4

Estimated loss from higher inflation to day-to-day spending plans, 2022-23 to 2024-25



Source: WFA analysis of Autumn Statement 2022; Welsh Government budget documents; OBR (2022) November 2022 Devolved Tax Forecasts.

Post-Spending Review 2021 plans

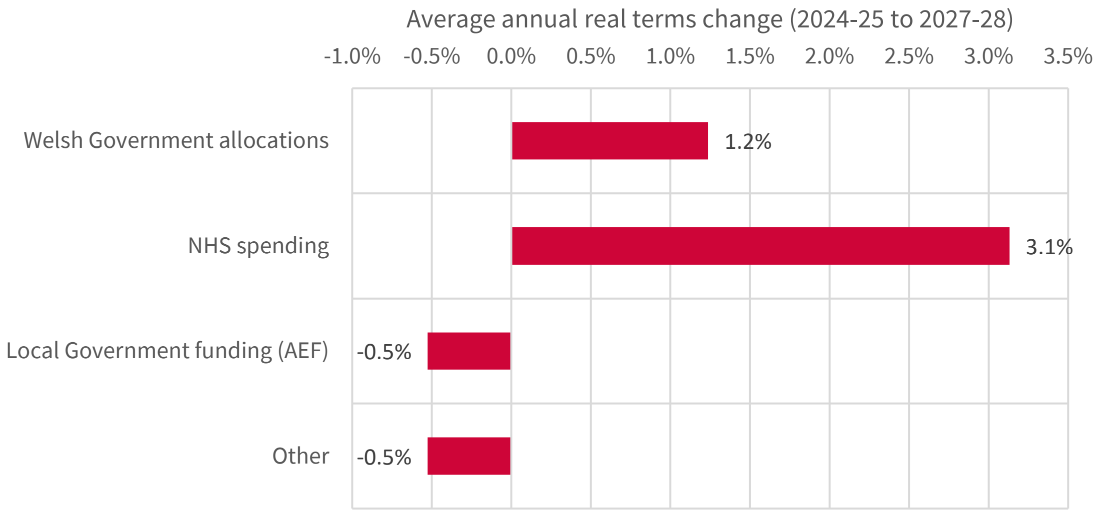
At the Autumn Statement, the UK government also pencilled in slower growth in departmental spending after the current Spending Review period as part of fiscal consolidation measures. Day-to-day departmental spending is set to increase by an average of 1% per year in real terms after 2024-25, meaning spending will be £21.5 billion a year lower by 2027-28 than previous plans suggested.

If implemented after the next UK General Election, this restraint in spending would have big consequences for Welsh Government funding. Although a detailed breakdown of UK spending plans and block grant funding after 2024-25 is not yet available, we follow the OBR's assumptions of post Spending Review 2021 plans to project Welsh Government funding from 2025-26 to 2027-28.[7]

We estimate that Welsh Government funding for day-to-day spending would increase by an average of 1.2% per year from 2024-25 to 2027-28, with the increase being driven by our assumptions on NHS spending in England. As shown in **Figure 2.5**, if the Welsh Government decided to "pass-on" consequentials from NHS spending in England to the Welsh NHS, this would imply cuts to all other areas of spending, averaging 0.5% per year in real terms over the three years.

Figure 2.5

Average annual real terms change in day-to-day spending, 2024-25 to 2027-28



Source: WFA analysis of Autumn Statement 2022; OBR (2022) November 2022 Economic and Fiscal Outlook; OBR (2022) November 2022 Devolved Tax Forecasts. • Notes: Day-to-day spending allocations refers to fiscal resource allocations and redistributed non-domestic rate revenues. Local Government funding refers to Aggregate External Finance

[7] Namely, we assume that: spending on the NHS in England grows by 3.1% a year; per-pupil schools spending in England is held flat in real terms; and defence and foreign aid spending is increased in line with GDP growth. We also use the latest forecasts for devolved tax revenues.

2.2. Options for the Welsh Government

With no change to block grant funding this year from the Autumn Statement, the scope for mitigating the real terms hit to the Welsh Government's budget in 2022-23 appears limited. The Welsh Government's latest plans for 2022-23 included £152 million of unallocated fiscal resource spending, which could be allocated at its 2nd Supplementary Budgets. It also currently plans to draw down £34 million from the Wales Reserve in 2022-23 – this could be increased to £125 million (increasing available funding by £91 million). Beyond this, funding priorities (e.g. enhanced public sector pay deals) will need to come from reallocating existing spending plans, or from late in-year consequentials as a result of the UK government's supplementary estimates.

Beyond 2022-23, the Welsh Government has some scope to revise its indicative spending plans for 2023-24 and 2024-25 to adjust to the very different circumstances now facing public services. To broadly illustrate the options available to the Welsh Government as it prepares its Draft Budget for 2023-24, we firstly analyse its plans for three main areas of spending: NHS spending, local government funding (through aggregate external finance), and all other spending. Secondly, we assess how changes to the Welsh Rates of Income Tax could affect these budget plans.

Revising current spending plans

On current indicative spending plans for 2023-24 and 2024-25, the Welsh Government will increase NHS spending by an additional £226 million in 2023-24 (to £9.2 billion) and by a further £200 million in 2024-25 (to £9.4 billion).[8] With inflation (as measured by the GDP deflator) set to be over 3.2% next year, this would equate to a real-terms fall in spending of 0.7% in 2023-24 (shown in **Figure 2.6**), and would be flat in real-terms from 2022-23 to 2024-25.

On current plans, funding for local government is set to increase by £176 million in 2023-24 and by a further £128 million in 2024-25. Aggregate External Finance would amount to £5.4 billion in 2024-25 - a 1.3% real terms increase from 2022-23 levels.[9]

Meanwhile, all other day-to-day spending in the Welsh Budget amounts to just under £5 billion in 2022-23. Other spending areas increased significantly from 2021-22 to 2022-23 but is now set to fall by £16 million in 2023-24. One reason for this fall is that 2022-23 spending plans included £162 million for cost-of-living support measures, which do not feature in spending plans for 2023-24. Overall, all other spending (outside the NHS and local government funding) is set to fall by 2.2% in real terms from 2022-23 to 2024-25.

[8] This definition of NHS spending includes the following budget expenditure lines: 'Delivery of Core NHS Services' and 'Delivery of Targeted NHS services' (less 'A Healthier Wales' allocations).

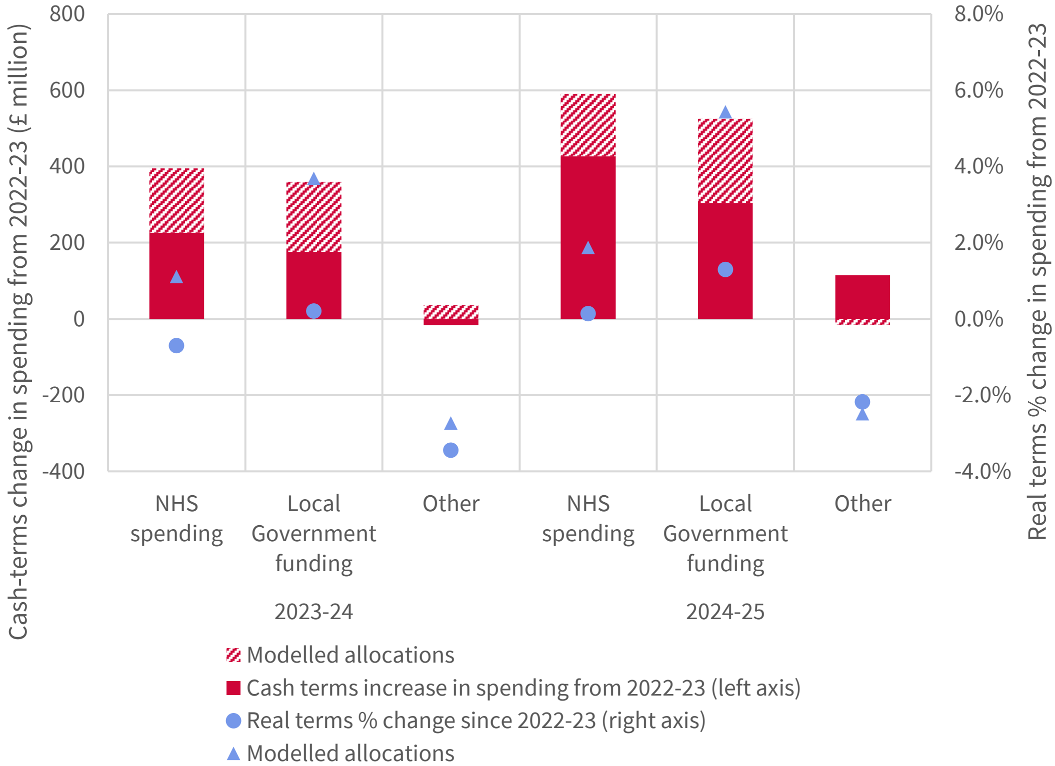
[9] This excludes Specific Grant Funding to Welsh local authorities (covered in 'other spending' category here), which amounts to £1.2 billion.

To illustrate the impact of the changes in Welsh Government funding, we make the following assumptions:

- The Welsh Government passes on estimated consequentials deriving from Business Rates measures in England to businesses in Wales through lower Non-Domestic Rates (so that this funding is not available for public services);
- Planned NHS spending in 2023-24 and 2024-25 are increased by the same amount as the consequentials deriving from increased NHS spending in England (as outlined in Figure 2.3);
- Estimated consequentials deriving from social care and schools spending in England are passed on to Welsh local authorities through local government funding;
- All other changes to Welsh Government funding (other consequentials and tax forecast changes in Figure 2.3) are allocated proportionately across all spending areas – this means a part of the increase to NHS and local government spending is offset by the removal of the Health and Social Care Levy employer costs from budgets.

Figure 2.6

Illustrative Welsh Government resource allocations in 2023-24 and 2024-25 (change from 2022-23 allocations)



Source: WFA analysis of Welsh Government allocations

Were the Welsh Government to follow these illustrative allocations, spending on the NHS would grow by 1.1% in real terms from 2022-23 to 2023-24, and by 1.9% by 2024-25. From 2021-22 to 2024-25, the average annual increase in spending would amount to 2.4% in real terms – still below the 2.7% real terms growth planned when budgets were originally set in December 2021. Given the increased cost pressures over the last year, this means spending will likely fall short of the funding pressures felt by the health service in the aftermath of the pandemic.[10]

Meanwhile, Local Government funding would see the biggest gain in funding – an additional £184 million in 2023-24 and £221 million in 2024-25 (on top of current spending plans). This would result in spending increasing by an average of 3.2% in real terms per year from 2021-22 to 2024-25, higher than the original 2.7% average increase originally planned.[11] This additional funding is discussed in the context of our projections of the funding pressures faced by local authorities in the next chapter. Even with this additional funding, further significant increases to council tax levels are likely to be required.

In this illustrative scenario, spending on all other areas of the Welsh Budget would still fall by around 2.5% in real terms over the next two years. There would be some additional funding – approximately £37 million – to allocate on top of current plans in 2023-24. However, if the Welsh Government wanted to replicate its 2022-23 cost-of-living support measures in 2023-24, approximately £126 million would need to be found from other spending areas.

Changing the Welsh Rates of Income Tax

In the context of a challenging outlook for public services spending, the Welsh Government could use the income tax powers devolved to it by the Wales Acts 2014 and 2017. In contrast to the years of austerity budgets in the 2010s, the Welsh Government does now have the power to vary the size of its budget at the margin. Welsh ministers have previously ruled out increasing tax rates whilst the impact of the pandemic on household finances endured.[12] While the outlook for household finances have worsened over the last year, so too has the budgetary outlook. In the wake of tax cuts announced by the UK government at the mini budget, the First Minister Mark Drakeford remarked that he was “powerfully considering” the idea of increasing the Welsh Rates of Income Tax.[13] While those tax cuts have since largely been reversed, it remains a possible consideration ahead of the Draft Budget for 2023-24.

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[10] Guto Ifan and Cian Siôn, *Welsh Budget Outlook 2021*, (Cardiff: Wales Fiscal Analysis, 2021). https://www.cardiff.ac.uk/__data/assets/pdf_file/0008/2590280/wbo2021_full_07Dec2021.pdf

[11] This comparison uses the forecast GDP deflator from October 2021 and November 2022 – as discussed in section 2.1, this likely understates the increase in inflationary pressures felt by public services.

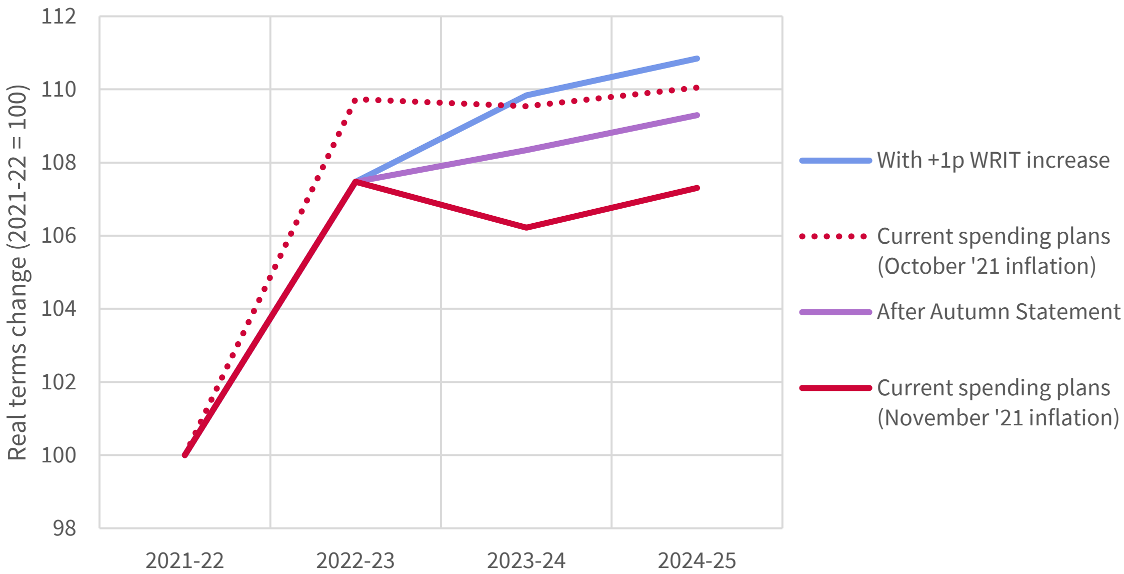
[12] Welsh Government, *Tax policy work plan 2021 to 2026* (Cardiff: Welsh Government, 2021), 2. https://gov.wales/tax-policy-work-plan-2021-to-2026-html

[13] Will Hayward, “How much money Wales could raise by increasing income tax,” *Wales Online*, 17 October 2022, accessed 11 November 2022. https://www.walesonline.co.uk/news/politics/how-much-money-wales-could-25266834

This section analyses how an income tax change would influence the Welsh budget, while Chapter 4 discusses the possible distributional impact. For simplicity, we consider a 1p increase across all the Welsh Rates of Income Tax for 2023-24 and 2024-25. Using the latest OBR forecasts and assuming a similar behavioural impact to the Welsh Government's 2021 'Ready Reckoner',[14] we estimate this tax policy would increase revenues by **£275 million in 2023-24** and **£288 million in 2024-25**. This would represent a **1.4% increase in the Welsh budget** in both years.

Figure 2.7

Illustrative Welsh Government resource allocations in 2023-24 and 2024-25 (change from 2022-23 allocations)



Source: WFA analysis of Welsh and UK government budget documents; OBR (2022) November 2022 Devolved Tax Forecasts; Welsh Government (2021) Welsh Rates of Income Tax Ready Reckoner

Figure 2.7 shows the real terms change in Welsh Government day-to-day spending plans from 2021-22 to 2024-25 under different scenarios. Given the vastly different inflationary environment over the past twelve months, the dotted red line shows the original real terms spending increase using the inflation forecasts from October 2021; compare this with the lower solid red line which shows the same increase given the revised inflation forecasts (as measured by the GDP deflator). The purple line shows spending plans with assumed changes in funding from the Autumn Statement included. The blue line indicates how spending plans would change under a hypothetical policy to increase all income tax rates by 1p. In this case,

[14] Welsh Government, *Welsh Rates of Income Tax Ready Reckoner* (Cardiff: Welsh Government, 2022). https://gov.wales/sites/default/files/publications/2021-12/welsh-rates-of-income-tax-ready-reckoner-2022-to-2023.pdf. The potential behavioural response of Higher Rate taxpayers could be revised upwards in light of new evidence from Scottish income tax changes, see: https://www.gov.uk/government/publications/estimating-scottish-taxpayer-behaviour-in-response-to-scottish-income-tax-changes-introduced-in-2018-to-2019

spending would increase by 2.2% in real terms from 2022-23 to 2023-24, as opposed to 0.8% under our post-Autumn Statement assumptions. Day-to-day spending would surpass its originally planned real terms level in 2023-24 and 2024-25, with the additional funding from the Autumn Statement and the tax increase offsetting the hit from higher inflation. However, as discussed previously and shown in **Figure 2.4**, the actual loss to the Welsh budget from higher inflation is set to be higher than that suggested by the increase in the GDP deflator. Using our alternative estimate of inflation (a mid-point between the GDP deflator and CPI measures), day-to-day spending in 2024-25 would still be around £340 million lower than originally planned even after this income tax increase.

2.3. Public sector pay

The devolved and local government public sector pay bill was approximately £9.1 billion in 2020-21, accounting for over half of day-to-day spending.[15] Decisions made on pay therefore have significant impact on public sector cost pressures, the quality of public services delivered, as well as the personal finances of approximately 245,000 employees.[16] At a time of high inflation and pressures on public services – and after a decade of pay restraint and austerity - these decisions look increasingly difficult.

Recent trends in the public sector pay bill

During years of austerity budgets, the number of public sector employees in Wales fell from 326,000 in 2009 to a low of 289,000 in 2016 (**Figure 2.8**). The employee headcount has recovered over more recent years, reaching 312,000 by 2022. Much of the recent increase can be accounted for by growth in NHS staffing numbers, which increased from 87,000 in 2016 to 101,000 in 2021.[17] Non-NHS public sector employee numbers remains well below pre-austerity levels.

In the context of tight austerity budgets, the fall in public sector employee numbers since 2010 may have been greater had it not been for a policy of pay restraint in the public sector. Broadly speaking, austerity was delivered partly by squeezing public sector pay relative to inflation and relative to growth in private sector pay.[18] Recent research suggests the public-

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[15] This estimate is based on analysis of annual reports and accounts of public sector employers in Wales as well as outturn expenditure data for local government. For methodology and sources, see Guto Ifan and Cian Siôn, The *Public Sector in Wales*, (Cardiff: Wales Governance Centre, 2019). https://www.cardiff.ac.uk/__data/assets/pdf_file/0010/1517176/public_sector_june_final.pdf

[16] This estimate based on the headcount for Welsh Government, the NHS, and local government (less Police staff) in Wales.

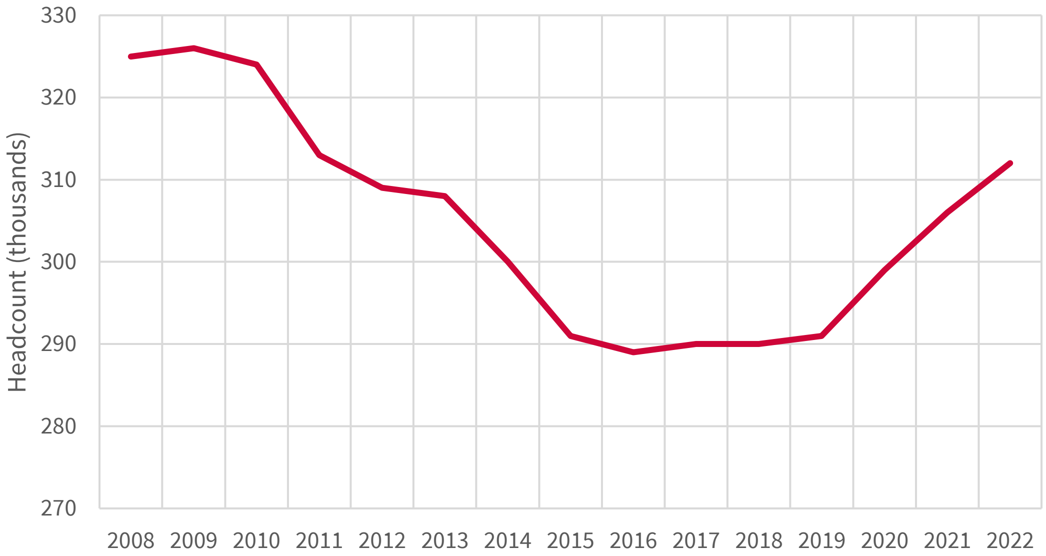
[17] Welsh Government, *Evidence to the NHS Pay Review Body*, (Cardiff: Welsh Government, 2022). https://www.nhsconfed.org/system/files/2022-02/NHS%20Pay%20Review%20Body%20Evidence%20Report%202022-23.pdf

[18] Guto Ifan, "Public sector pay and inflation – the implications for the Welsh budget and public services," *Thinking Wales Blog*, accessed 21 November 2022. https://blogs.cardiff.ac.uk/thinking-wales/public-sector-pay-and-inflation-the-implications-for-the-welsh-budget-and-public-services/

private pay differential is “now less favourable to the public sector than at any point in the past 30 years”.[19]

Figure 2.8

Public sector employment in Wales (headcount, excluding effects of major reclassifications)



Source: ONS (2022) Public sector employment, June 2022 edition

Devolved public sector pay is mainly determined by the Welsh Government, informed by independent pay review bodies, which make non-binding pay recommendations. This year, most NHS workers will receive a £1,400 pay rise (increased to 4% for Agenda for Change bands 6 and 7), while doctors and dentists will receive a 4.5% raise. Teachers are set to receive a 5% pay rise. The pay of other local government staff is determined on a Wales, England, and Northern Ireland basis. In July, council employees were offered a flat-rate pay increase of £1,925.

For most public sector workers, these pay deals of close to 5% represent a significant real terms pay cut, with CPI inflation set to be 10.1%. Several trade unions have balloted for strike-action in response. At the same time, these increases are probably above what the Welsh Government would have expected as it set its budget plans for 2022-23 and beyond.

Modelling the fiscal implications of public sector pay deals

To illustrate the pressures on the Welsh budget from the need for higher public sector pay, we model three alternative scenarios for public sector pay deals:

[19] Ben Zaranko, “Public spending, pay and pensions”, In *IFS Green Budget 2022*, (London: Institute for Fiscal Studies, 2022) https://ifs.org.uk/sites/default/files/2022-10/Public-spending-pay-and-pensions-R219.pdf

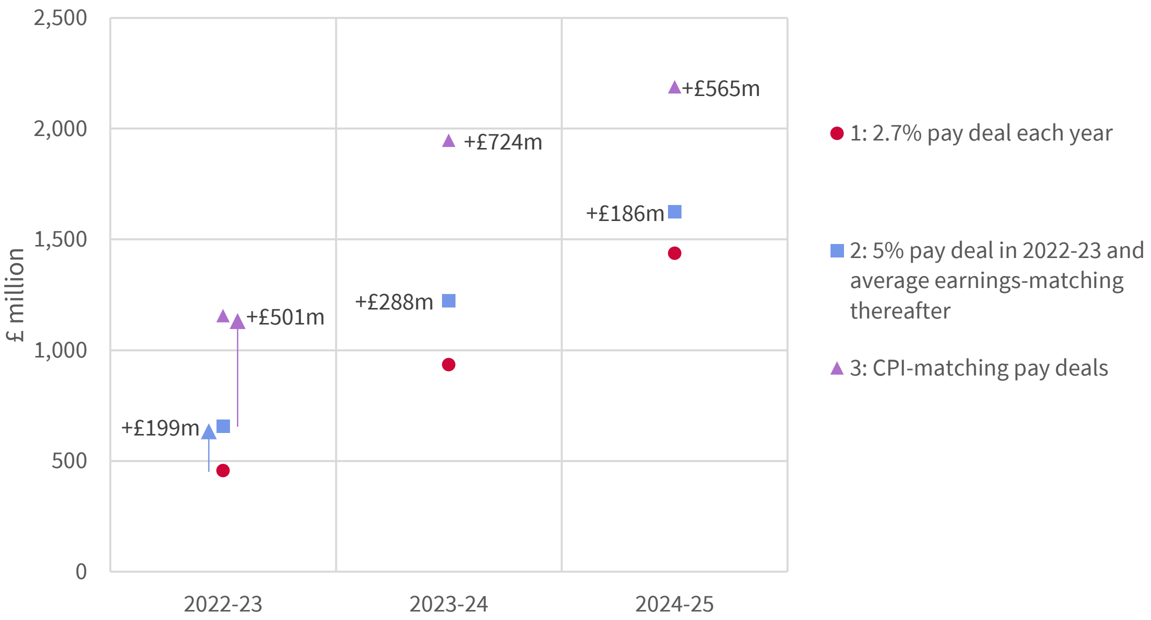
1. We assume that the Welsh Government was budgeting for a 2.7% nominal-terms increase in public sector pay over 2022-23 to 2024-25 – matching the average for forecast CPI inflation over these years.
2. We model the costs of a 5% average increase in 2022-23 (broadly in line with announced pay deals this year), followed by matching the forecast for UK-wide average earnings growth in 2023-24 (3.5%) and 2024-25 (1.6%).
3. We model the costs of pay deals which match forecast CPI inflation in 2022-23 (10.1%), 2023-24 (5.5%), and 2024-25 (0%).

In each scenario, we assume that public sector employment continues to grow in line with recent trends.

Figure 2.9 shows the increase in the devolved and local government public sector pay bill from 2021-22 onwards. Under the first scenario, which assumes the Welsh Government had planned for 2.7% pay rises across 2022-23 to 2024-25, we estimate the total pay bill would have increased by £456 million in 2022-23 (compared with 2021-22), and by £1.4 billion in 2024-25.

Figure 2.9

Modelled increase in the devolved and local public sector pay bill, 2022-23 to 2024-25 (cash-terms increase from 2021-22)



Source: Authors' calculations

If we instead assume that pay increases average 5% this year (scenario 2), we estimate an additional £199 million would be added to the devolved pay bill which would need to be funded from this year's budget. To put that into perspective, the increase in cost would be the equivalent of employing approximately 5,000 workers across the Welsh Government, NHS, and local authorities in Wales.

In the third scenario, which protects public sector workers from a real-terms pay cut, a CPI-matching increase of 10.1% across the public sector would add an additional £700 million to the pay bill in 2022-23 – approximately the cost equivalent of employing 17,000 public sector workers. The difference between scenarios 2 and 3 (£501 million) represents the likely overall real terms cut to public sector pay under current announced pay settlements.

The difference between the three scenarios grows significantly in 2023-24. In scenario 2, we estimate that the devolved public sector pay bill will be around £288 million higher in 2023-24 than what would have been originally budgeted for (i.e. scenario 1) – equivalent to the cost of around 7,000 public sector workers. Recall however that even this middle scenario, the assumed pay increases would still represent a real terms pay cut of 7% over two years for public sector workers, and would result in pay continuing to fall relative to private sector pay. On the other hand, protecting public sector pay against inflation by 2023-24 would cost an additional £1 billion on top of assumed budgeted plans – equivalent to the cost of 24,000 public sector workers.

Looking specifically at the NHS pay bill, we expect that the announced pay deal for staff in 2022-23 will cost an additional £94 million relative to a 2.7% pay rise, equivalent to around 1% of planned day-to-day spending in 2022-23. Meanwhile, a CPI inflation-matching increase of 10.1% this year would cost an additional £267 million on top of the current pay offer. Alternatively, a pay increase mirroring the one announced by the Scottish Government would cost an additional £89 million.[20]

The large and unforeseen increase in inflation means that public sector pay will have to increase by more than was planned when budgets were set. However, in the context of the budget outlook described in previous sections, it appears likely that public sector pay will again fall in real terms. The Welsh Government faces a series of tricky decisions, balancing the additional costs of higher pay rises for public sector employers against the risks of large real terms pay cuts - for example, a further rise in recruitment and retention issues, the threat of industrial action, and a deterioration in the quality of public services. In the absence of further additional funding from the UK government or significant increases in devolved income tax rates, funding for higher public sector pay deals will need to be found either from non-pay budgets or from reduced public sector employment.

[20] https://www.bbc.co.uk/news/uk-scotland-63798633

3 Local government

This year, local authorities received the most generous settlement (in cash terms) since the advent of devolution.[21] However, cost pressures from higher inflation, and the modest increases to the settlement expected in future years, mean that the outlook for council finances is much gloomier. We project that annual council tax increases of 2% would leave local authorities with a £565 million funding gap in 2024–25 (this is the shortfall in funding required to meet councils' cost and demand pressures). The Welsh Government could opt to pass on consequentials resulting from additional spending on schools and social care in England, thereby reducing this gap to £345 million.

If, after the General Election, the next UK government sticks to the lean spending plans pencilled in by the current government, they will launch council finances onto an unsustainable trajectory. We project that the funding gap could grow to £880 million by 2027–28 (reduced to just under £660 million if local authorities receive additional funding from consequentials over the next two years). Either way, a combination of further spending cuts and above-inflation council tax increases is likely.

3.1. Local government revenue projections to 2027–28

Last year, the Welsh Government published indicative funding allocations for 2023–24 and 2024–25 alongside the local government settlement. Amounting to 3.6% and 2.4% in cash terms, these planned increases to the core settlement were considerably less generous than this year's 9.4% uplift.[22] As we pointed out at the time, this mirrored the overall spending profile outlined at last year's UK Spending Review, with most additional funding front-loaded to 2022–23 to aid with the immediate recovery from the pandemic. As it turns out, this decision has helped cushion the impact of historically high levels of inflation this year. But the modest increases to the settlement expected in future years will make it harder for councils to respond to persistent inflation.

Having adjusted for inflation, the core settlement barely increases at all next year, growing by 0.3% in real terms, followed by a 1.1% increase in 2024–25 (**Figure 3.1**).[23] By the end of the comprehensive spending review period, the total value of Welsh Government funding to

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[21] Cian Siôn, "Local government finance: five key trends for the next five years", *Thinking Wales (Blog)*, 27 April 2022, accessed 09 November 2022. https://blogs.cardiff.ac.uk/thinking-wales/local-government-2022/

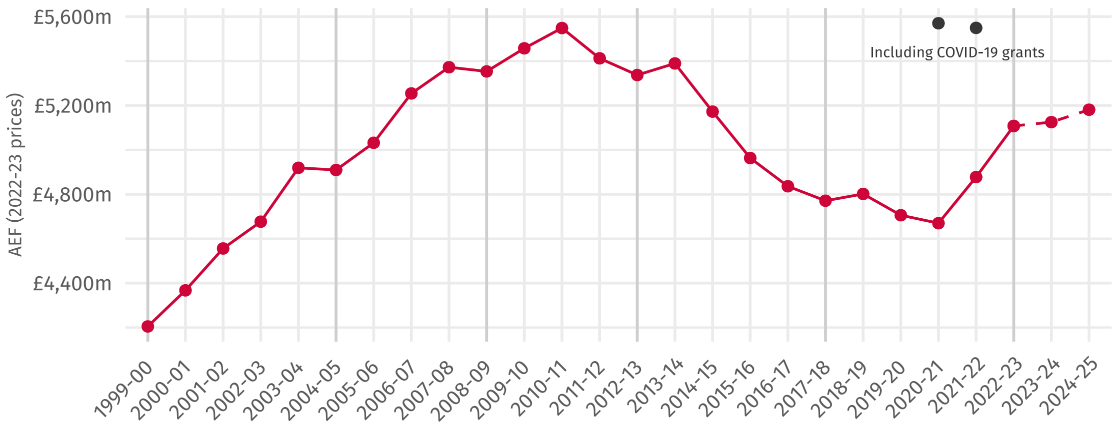
[22] The core settlement comprises the Revenue Support Grant (RSG) and re-distributed Non-domestic rates (NDR) revenue.

[23] As is customary, we use the GDP deflator rather than the CPI inflation rate to deflate public spending totals in our analysis. Further discussion on the rationale behind using this measure of inflation can be found here: https://ifs.org.uk/articles/inflation-squeeze-public-services.

local authorities (excluding specific grants) is still expected to be 6.6% below its 2010–11 high, and 11.1% lower on a per capita basis.

Figure 3.1

Welsh Government funding for local authorities (excluding specific grants), 2022–23 prices



Source: WFA analysis of StatsWales (2021 and previous) Financing of gross revenue expenditure; Welsh Government (2021) Draft Budget and Local Government Settlement 2022–23. • Notes: The CTRS has been added to the RSG in years prior to 2013–14 to ensure consistency with its treatment in subsequent years. 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. COVID grant funding received in 2020–21 and 2021–22 was partially offset by reduced tax revenues and income streams, so the overall increase in local authority spending power was considerably smaller than what is shown on the chart.

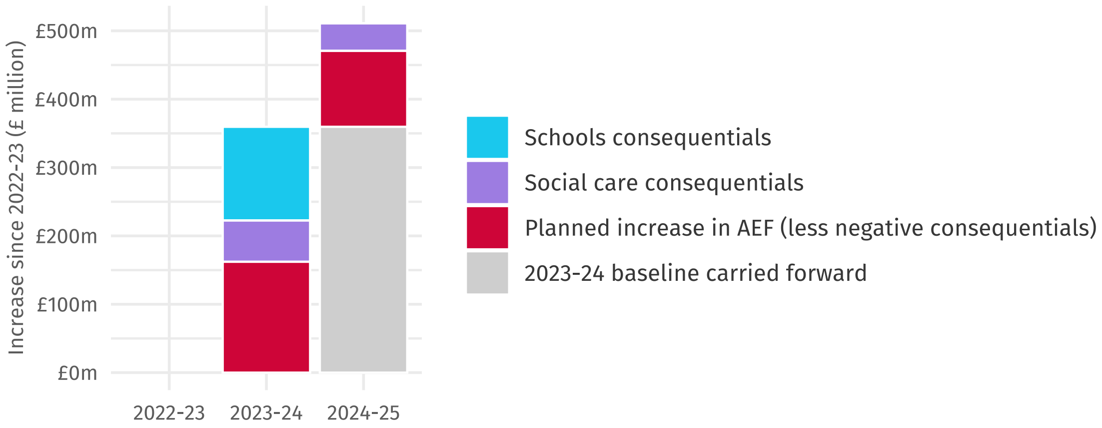
There was some better news for English councils last month. The Chancellor topped up funding for schools and social care; relaxed the council tax referendum requirement (paving the way for larger council tax increases); and delayed implementation of social care charging reform (freeing up additional funding for councils in the near-term at the cost of prolonging the inequity for service users). This additional spending triggered consequentials for the devolved governments. The Welsh Government, of course, has discretion over how to allocate this additional funding. Nevertheless, to offer an illustrative scenario, we assume that the Welsh Government passes on additional funding in 2023–24 and 2024–25 to equivalent devolved services (negative consequentials and the effect of tax forecast changes are allocated proportionately across spending areas).

We estimate that the additional funding announced for schools and social care in England (offset by a proportional share of negative consequentials) could be used to more than double the planned increase to the Welsh local government settlement next year from £175 to £360 million. By 2024–25, this would leave the settlement £221 million above what was set out in last year's plans (**Figure 3.2**).

If rolled into the Revenue Support Grant, passing on these consequentials in full would imply a 7.0% increase to the core revenue settlement in 2023–24 (3.4% in real terms) and 3.0% in 2024–25 (1.7% in real terms).

Figure 3.2

Planned increase to Aggregate External Finance (AEF) in 2023–24 and 2024–25, and consequentials announced at the Autumn Statement



Source: WFA analysis. • Notes: The Welsh Government may choose to allocate consequentials triggered by increased spending on schools and social care in England on other (non-local government) services. Consequentials received in respect of business rates are not shown on this chart since increased spending on reliefs would be offset by reduced tax revenue, leaving local authorities' spending power unchanged.

In future years, we assume the Welsh Government allocates consequentials from additional NHS spending in England (as per OBR assumptions) to the NHS in Wales. We further assume that funding for local government and all other budget areas grow in line with the rest of the spending envelope. Under these assumptions, the Welsh local government settlement grows by a meagre 0.7% a year on average between 2025–26 and 2027–28 (equivalent to an annual reduction of 0.5% in real terms), launching council finances onto an unsustainable trajectory.

Of course, there are good reasons for thinking that the real cuts pencilled in for the final three years of the forecast will not be realised, not least because a new government with a potentially different approach to fiscal policy might be installed after the next General Election (due to be held before the end of 2024). But in the absence of alternative spending plans, the funding outlook for council finances is very challenging – increasing the likelihood that council tax will once again be used to mitigate the impact on council services.

3.2. Projected spending requirements to 2027–28

Building on our previous modelling work for the Institute for Fiscal Studies' Green Budget[24] and our 2021 edition of the Welsh Budget Outlook[25], this section contains updated projections of local authority spending pressures to 2027–28. Our projections have been re-based using the most recent 2021–22 outturn data (less pandemic-related spending), incorporate revised assumptions about future demand for council services using the interim 2020-based population projections, and include further refinements to the way employee costs are modelled.

As expected, the Office for Budget Responsibility (OBR) applied an upward revision to its CPI and GDP deflator forecasts last month. In our model, higher inflation feeds through into faster growth in input costs, particularly in 2022–23 and 2023–24. The OBR also applied an upward revision to its forecast of average earnings in the near-term, reflecting the large cash increases in pay cheques seen this year and more persistent inflation. Data from the Annual Survey of Hours and Earnings suggests that annual Welsh earnings grew by 6.4% in 2021–22 (5.0% in the public sector).

In future years, we assume that pay for most local authority staff tracks the OBR's forecast growth in average earnings. Staff costs for teachers and the adult social care sector are modelled separately. We apply the Teachers' Pay Review Body recommendations for the 2022–23 and 2023–24 academic years, mapping these onto the respective financial years.[26] In the adult social care sector, we assume that all costs (including payments to commissioned providers) follow the Real Living Wage in the near-term, then track average earnings as inflationary pressures subside.

The now defunct Health and Social Care Levy, which we previously estimated would increase local authorities' employee costs by around £30 million this year, reduces councils' future spending requirements.[27] However, since the UK government withdrew the additional funding that it had initially made available to compensate public sector providers for additional costs, the reversal of the levy does not improve councils' overall fiscal position.

A full account of the methodology and assumptions underpinning these projections can be found in **Annex A**.

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[24] Kate Ogden, David Phillips, and Cian Siôn, "What's happened and what's next for councils?" In *The IFS Green Budget 2021 October 2021*, edited by Carl Emmerson, Paul Johnson, and Ben Zaranko, 295-344, (London: Institute for Fiscal Studies, 2021. https://orca.cardiff.ac.uk/id/eprint/145863

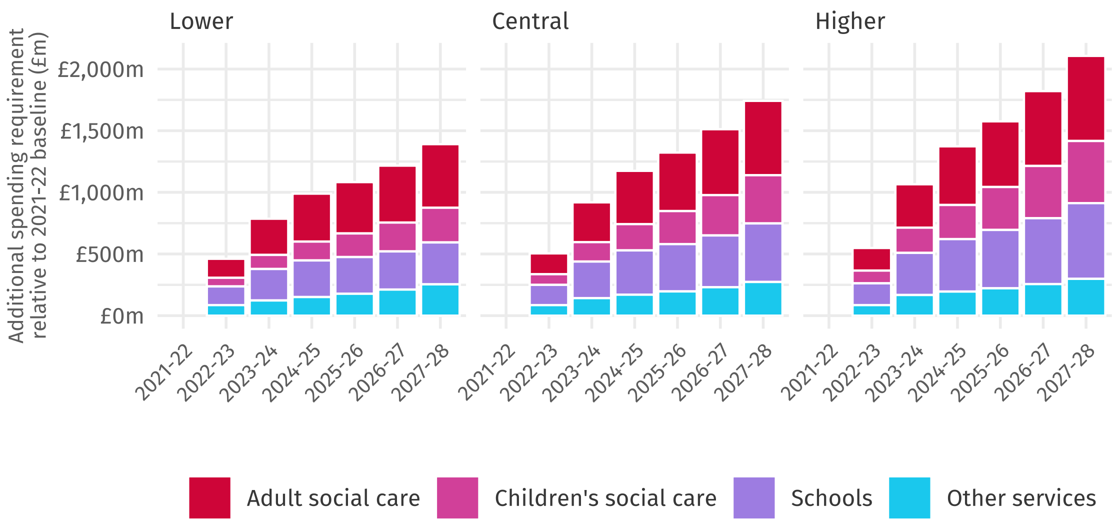
[25] Guto Ifan and Cian Siôn, *Welsh Budget Outlook 2021*, (Cardiff: Wales Fiscal Analysis, 2021). https://orca.cardiff.ac.uk/id/eprint/146082

[26] Independent Welsh Pay Review Body, *Fourth Report – 2022*, (Cardiff: Independent Welsh Pay Review Body, 2022). https://gov.wales/sites/default/files/publications/2022-07/independent-welsh-pay-review-body-fourth-report-2022.pdf

[27] Ifan and Siôn, *Welsh Budget Outlook 2021*, 34.

Figure 3.3

Components of local authorities' projected spending pressures from 2021–22



£ million

Scenario	Pressures	2021–22	2022–23	2023–24	2024–25	2025–26	2026–27	2027–28
Lower costs	Adult social care	0	154	294	389	416	462	516
	Children's social care	0	70	114	153	191	234	281
	Schools	0	151	255	297	298	309	340
	Other services*	0	85	123	151	177	211	254
	Increase on baseline	**0**	**461**	**786**	**989**	**1,083**	**1,217**	**1,391**
	*Spending requirement**	*6,977*	*7,438*	*7,763*	*7,966*	*8,060*	*8,194*	*8,368*
Central	Adult social care	0	169	323	432	474	534	603
	Children's social care	0	87	158	213	268	327	391
	Schools	0	164	297	359	384	420	475
	Other services*	0	85	142	170	197	231	273
	Increase on baseline	**0**	**505**	**919**	**1,174**	**1,323**	**1,512**	**1,742**
	*Spending requirement**	*6,977*	*7,482*	*7,896*	*8,151*	*8,300*	*8,489*	*8,719*
Higher costs	Adult social care	0	183	352	476	533	607	690
	Children's social care	0	103	205	277	348	424	504
	Schools	0	177	342	425	473	534	614
	Other services*	0	85	167	195	222	256	299
	Increase on baseline	**0**	**549**	**1,065**	**1,373**	**1,576**	**1,821**	**2,107**
	*Spending requirement**	*6,977*	*7,526*	*8,031*	*8,445*	*8,700*	*8,848*	*9,038*

Source: WFA analysis. See **Annex A** for full methodology. • Notes: Table and chart show additional funding required to meet councils' spending requirements relative to the 2021–22 (non-Covid) baseline. Lower cost scenario reflects slower growth in demand for adult and children's social services, a cap of 2% on pay awards in 2023–24, and a reduction in schools' input costs due to a declining pupil population. Higher cost scenario reflects faster growth in demand for adult and children's social services, inflation-matching pay awards next year, and the forecast reduction in the pupil population not having any impact on input costs. The "Schools" line includes the estimated cost of the Free School Meals rollout based on the grant funding profile planned between 2022–23 and 2024–25. We assume costs increase in line with the GDP deflator thereafter.

* The "Spending requirement" and "Other services" lines exclude spending financed by Housing Benefit grants.

In total, we estimate that councils' projected spending requirements are £505 million (7.2%) higher this year compared to last year's baseline (with Covid-19 spending removed). We project that £1,174 million will need to be added onto the baseline to meet pressures in 2024−25. This figure grows to £1,742 million by 2027–28 (**Figure 3.3**).

If demand for social care services grows at a slower pace, pay awards are capped at 2% next year, and a forecast reduction in the pupil population feeds through into lower input costs, councils' spending requirement in 2027−28 could be a more modest £1.4 billion higher than the 2021−22 baseline. Conversely, if growth in demand for social services exceeds that assumed in the central scenario, wage growth tracks CPI inflation in the near-term, and the forecast reduction in pupil numbers yields no savings, councils' spending requirement in 2027−28 could be more than £2.0 billion above the baseline.

Taking the central scenario as the most likely outcome, this implies that local authority spending needs to grow by an average of 4.2% a year in cash terms between 2021−22 and 2024−25 to ensure pressures are met by the end of the spending review period. More modest annual increases of 2.3% might be sufficient in the following three years as cost pressures subside and headline CPI inflation turns negative. As it stands, these spending pressures exceed councils' projected increase in revenues, implying significant funding gaps in future years.

3.3. The implied "funding gap"

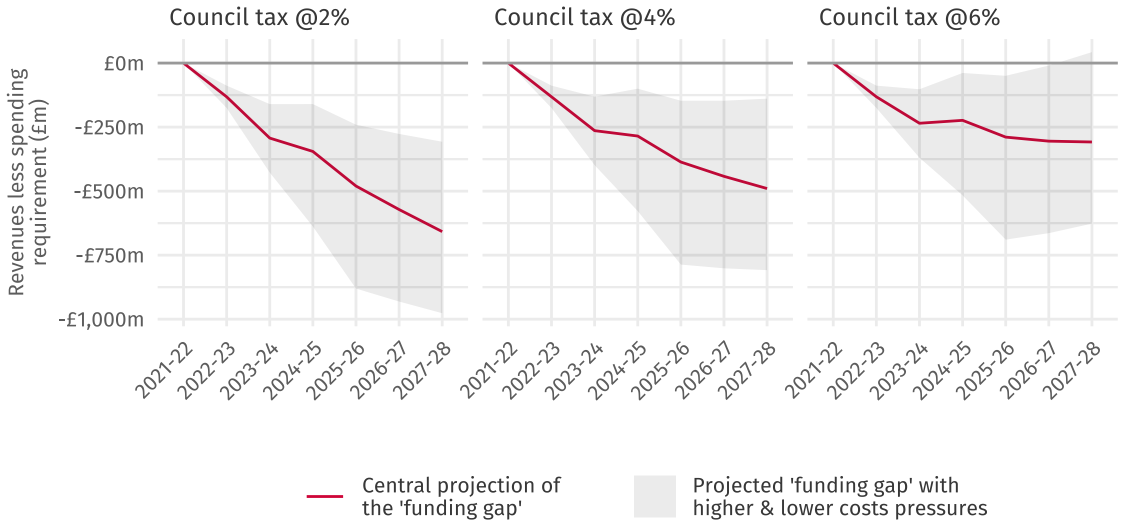
Taking the revenue projections outlined earlier in this chapter (which assume that additional consequentials are passed on to local authorities over the next two years) and subtracting councils' projected spending requirements, we can derive an estimate of the "funding gap". This is the shortfall in funding required to meet pressures and maintain existing service provision.

Figure 3.4 shows the projected size of this funding gap under varying assumptions about future council tax increases. In 2023−24, each additional percentage point on council tax yields an additional £16 million for local authorities (net of the council tax reduction scheme). Assuming annual council tax increases of 2% from 2023−24 onwards, this implies a funding gap of £345 million in 2024−25. This gap grows to £658 million by 2027−28.

In practice, any discussion of funding gaps is purely theoretical. Local authorities are legally obligated to set balanced budgets, and therefore any funding shortfall would need to be met from reserves (which can only be spent once), by cutting back on service provision, or through larger council tax increases. We project that annual council tax increases of more than 6% would be required to stabilise councils' fiscal position by the end of the forecast period (and even this scenario entails significant spending cuts).

Figure 3.4

Local authorities' projected 'funding gap' under varying assumptions about future council tax increases



£ million

Council tax increases	Scenario	2021–22	2022–23	2023–24	2024–25	2025–26	2026–27	2027–28
Council tax @2%	Lower costs	0	-88	-160	-160	-241	-277	-307
	Central scenario	0	-132	-293	-345	-480	-572	-658
	Higher costs	0	-175	-428	-638	-881	-931	-977
Council tax @4%	Lower costs	0	-88	-131	-100	-147	-147	-139
	Central scenario	0	-132	-264	-285	-386	-442	-490
	Higher costs	0	-175	-399	-578	-787	-802	-809
Council tax @6%	Lower costs	0	-88	-102	-38	-50	-10	43
	Central scenario	0	-132	-235	-224	-289	-305	-308
	Higher costs	0	-175	-370	-517	-690	-664	-627

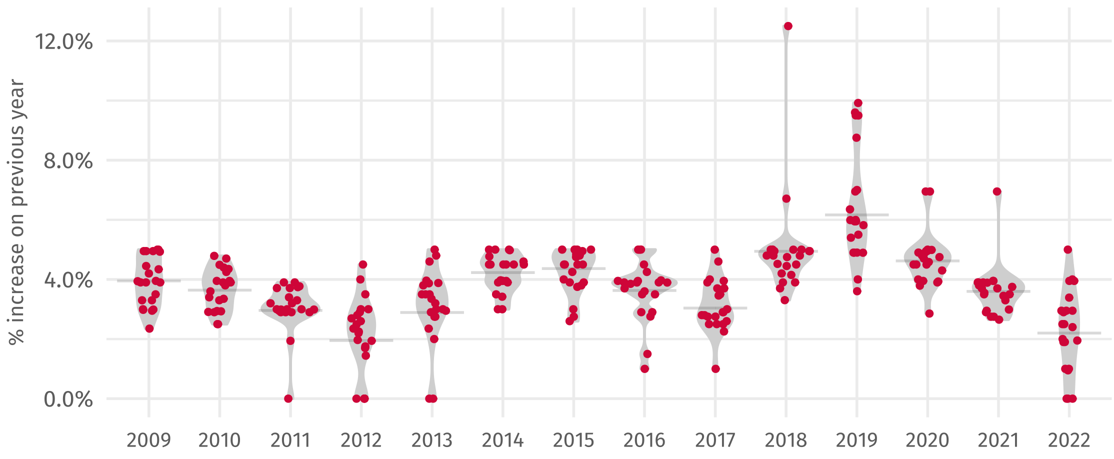
Source: WFA analysis. See **Annex A** for full methodology. • Notes: Table and chart show councils' projected revenues less spending requirements (i.e. the additional funding required to meet councils' spending requirements relative to the 2021–22 (non-Covid) baseline). The lower cost scenario (denoted by the inner edge of the shaded grey band) reflects slower growth in demand for adult and children's social services, a cap of 2% on pay awards in 2023–24, and a reduction in schools' input costs due to a declining pupil population. The higher cost scenario (denoted by the outer edge of the shaded grey band) reflects faster growth in demand for adult and children's social services, inflation-matching pay awards next year, and the forecast reduction in the pupil population not having any impact on input costs.

Local authorities in Wales are relatively more reliant on central government grants and less reliant on council tax revenue than their English counterparts. When public spending grows rapidly, as it did during the first decade of devolution, this compositional difference can ease the burden on council taxpayers. However, in periods of spending retrenchment, larger council tax increases are required in Wales than in England to offset cuts to central government funding. This is particularly problematic given the already bleak outlook for household finances.

Figure 3.5 shows the annual council tax increase for each local authority since 2009. After several years of above-inflation council tax increases, this year's average council tax increase was the lowest in a decade. But it looks increasingly likely that this could be an exception rather than a new rule. Although council tax increases can reduce the need for large cuts to local services, they increase pressures on household budgets in a broadly regressive manner. This arguably strengthens the case for reforming the local tax system to make it fairer, which is a commitment in the Welsh Government's Programme for Government as well as the Co-operation Agreement with Plaid Cymru.[28]

Figure 3.5

Annual council Tax increases, 2009 to 2022



Source: StatsWales (2022 and previous) Composition of average band D council tax. • Notes: Chart shows the percentage increase in the county council element of council tax (excluding police and community precepts) for each local authority in Wales. Horizontal grey lines denote the average increase in each year.

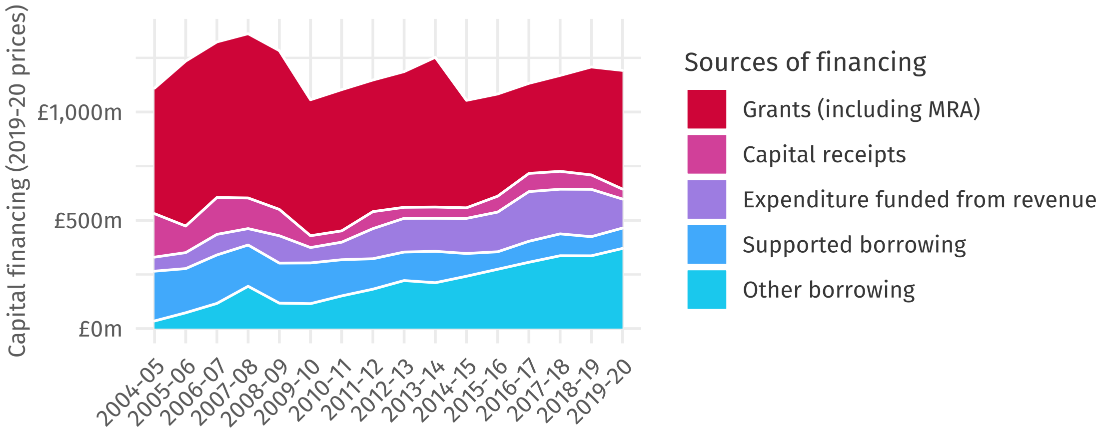
3.4. Financing capital expenditure

Local authorities' capital budgets are not immune to the deteriorating fiscal and economic outlook either. The devolved capital budget was already set to fall in real terms when it was set last year. In the past, local authorities have turned to borrowing arrangements when faced with a decline in the real value of capital grants (**Figure 3.6**). Low interest rates on fixed loans from the Public Works Loan Board (PWLB) made borrowing an attractive way of financing capital expenditure during the 2010s. However, a rise in the cost of borrowing means that finding alternative ways to finance councils' capital outlay will not be as easy going forwards. As of November 22nd, the interest rate on a 1-year loan from the PWLB was 4.2%, up from 1.0% as recently as June 2021 (**Figure 3.7**)

[28] https://gov.wales/sites/default/files/publications/2021-11/cooperation-agreement-2021.pdf

Figure 3.6

Capital financing, by source of funding, 2004–05 to 2019–20 (2019–20 prices)



Source: WFA analysis of DMO (2022) Local Authority Lending – Residual Maturity. • Notes: "Grants" includes all grants from government and public bodies, the Major Repairs Allowance, and contributions from private developers. "Supported borrowing" refers to borrowing that attracts central government support. Between 2014–15 and 2015–16, the amount of "Other Borrowing" increased nearly five-fold due to the one-off housing revenue account subsidy buyout. The 2015–16 value for "Other borrowing" has been removed from this time series to better illustrate the underlying trends.

Figure 3.7

Historic interest rates on a 1-year (maturity) loan using the PWLB lending facility

Source: WFA analysis of DMO (2022) Historic interest rates. • Notes: The last point in the data series is 22nd November 2022.

More than £220 million worth of principal payments on local authority PWLB loans are due in the next two years. Since councils often fix their rates over a 30, 40 or even a 50-year period, most of the loans now maturing were taken out long before the most recent period of low interest rates (the average interest rate on loans maturing in the next two years is 4.4%). This means that higher interest rates are likely to have only a limited impact on the cost of servicing existing local government borrowing. The biggest impact will be felt when financing new capital projects.

4 Devolved taxes

Despite the additional consequentials over the next two years, the Welsh budget outlook remains challenging. Next year, the Welsh Government's spending power will be considerably lower than it might have expected this time last year – a consequence of soaring inflation. Elsewhere, in council chambers up and down the country, the challenge of maintaining public service provision whilst minimising regressive council tax increases looms large. In the face of this demanding budget outlook, there might be a case for reviving the debate around the use of devolved income tax powers. The Welsh Government had previously ruled out increasing tax rates whilst the economic impact of the pandemic endured.[29] However, in the aftermath of the UK government's mini budget, the First Minister Mark Drakeford remarked that he was now "powerfully considering" the idea.[30]

The Welsh Government might also want to revisit non-domestic rates policy. As it stands, most businesses in the retail, leisure, and hospitality sector face a double whammy in April 2023 as the last of the Covid-19 reliefs ends and the inflation-indexed multiplier used to calculate liabilities increases by 10.1%. A typical restaurant faces a 120% increase in their tax bill overnight, just as the UK government's Energy Bill Relief Scheme expires.

The Office for Budget Responsibility applied a downward revision to its Land Transaction Tax forecast, citing a slow-down in the property market and an expected drop in house prices. However, any impact on the Welsh Budget will be contained by the operation of the Fiscal Framework; Wales only bears the risks of asymmetric shocks to tax revenue. As councils deliberate over new powers to impose larger council tax premiums on empty and second homes, and the Welsh Government consults on a visitor levy, expect further debate around the role of taxation – not only as a means of funding public services, but also to nudge behaviour to achieve desired economic and societal outcomes.

4.1. Welsh Rates of Income Tax (WRIT)

The existence of significant budget pressures strengthens the case for making use of the devolved income tax powers. Because it cannot borrow to fund day-to-day spending, the Welsh Government is subject to a hard budget constraint. It must fund its day-to-day spending using the Block Grant, in-year consequentials arising from spending decisions in England, own-sourced revenue, or by making limited drawdowns from its reserves. If the

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[29] Welsh Government, *Tax policy work plan 2021 to 2026* (Cardiff: Welsh Government, 2021), 2. https://gov.wales/tax-policy-work-plan-2021-to-2026-html

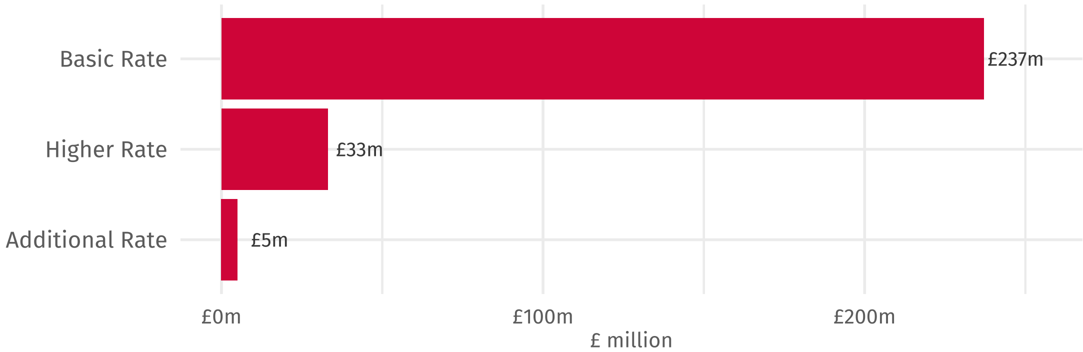
[30] Will Hayward, "How much money Wales could raise by increasing income tax," *Wales Online*, 17 October 2022, accessed 11 November 2022. https://www.walesonline.co.uk/news/politics/how-much-money-wales-could-25266834

Welsh Government wishes to materially increase its spending power, raising tax rates – specifically the basic rate of income tax – is effectively the only way to do so.

Based on the Office for Budget Responsibility's (OBR) latest assessment of the Welsh taxbase, we estimate that putting a penny on the basic rate of Welsh income tax would raise approximately £237 million next year (**Figure 4.1**). Increasing the higher and additional rates by the same amount would raise an estimated £33 and £5 million respectively. We use the Welsh Government's assumptions about potential behavioural and migration responses from their Ready-Reckoner.[31]

Figure 4.1

Estimated additional revenue from levying one pence on each rate of Welsh income tax, 2023–24



Source: WFA analysis of OBR (November 2022) Economic & Fiscal Outlook; Welsh Government (2021) Welsh Rates of Income Tax Ready-Reckoner.

Even if a tax rise applied to the basic rate alone, this would still be a highly progressive way of raising additional revenue, as illustrated in **Figure 4.2**. We estimate that a 1p increase to the devolved basic rate would see the average Welsh household pay just over £100 in additional tax next year. Households in the poorest income quintile would be largely unaffected. The personal allowance – which the UK government has now frozen at £12,570 until April 2028 – means that many low earners are relieved from paying any income tax.

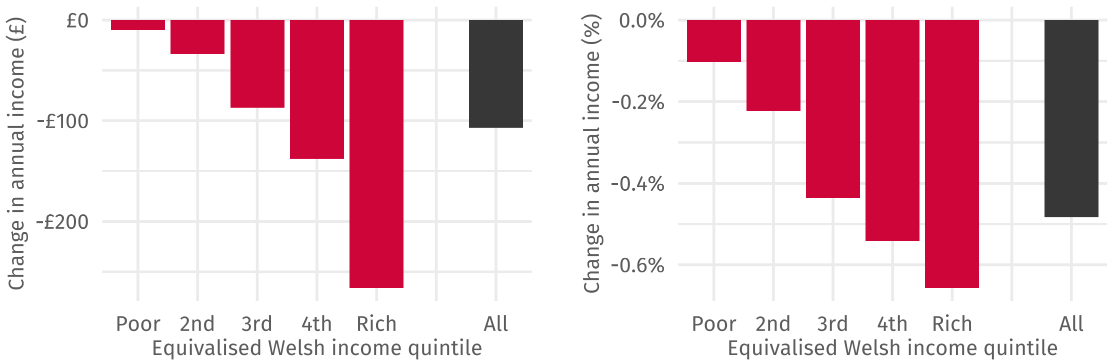
The interaction of WRIT with council tax must also be a key consideration when deciding whether to increase income tax rates. We should not infer that leaving WRIT unchanged will leave households' overall tax burden unchanged. If, as expected, the funding settlement offered to local authorities is insufficient to cover cost pressures, councils could be under pressure to propose large increases to council tax – a tax which places a proportionately greater burden on low-income households (even after accounting for the Council Tax

[31] https://gov.wales/sites/default/files/publications/2021-12/welsh-rates-of-income-tax-ready-reckoner-2022-to-2023.pdf

Reduction Scheme).[32] In anticipation of severe pressures on English councils' budgets, the UK government increased the limit on council tax increases that can be proposed without triggering a local referendum from 3 to 5 per cent next year. No such referendum requirement exists in Wales.

Figure 4.2

Impact of a 1p rise to the basic rate of devolved income tax on Welsh households, by income quintile, 2023–24



Source: WFA analysis using UKMOD A3.23+ and ONS (2018–20) Family & Resources Survey input data. ● Notes: Equivalised income accounts for the size and composition of household units. The results presented here are based on UKMOD version A3.23+. UKMOD is maintained, developed, and managed by the Centre for Microsimulation and Policy Analysis at the University of Essex. The process of extending and updating UKMOD is financially supported by the Nuffield Foundation (2018-2021). The results and their interpretation are the authors' sole responsibility.

4.2. Non-domestic rates (NDR)

A revaluation of non-domestic rates (NDR) will take place in April 2023 for the first time in six years. The planned 2021 revaluation – which had already been brought forward a year to align with the timing in England – was postponed due to the pandemic. This administrative exercise does not typically impact the total amount of revenues collected but rather, it ensures the relative tax liability of premises reflect trends in the commercial real estate market. The UK government – which also plans to go ahead with a revaluation next year – committed £1.7 billion over three years to provide transitional relief to businesses facing a large increase in their bills. This reduces the negative consequential applied to the Welsh Government's block grant, temporarily boosting the Welsh budget by approximately £70 million in 2023–24[33], £30 million in 2024–25 and £15 million in 2025–26. In the long-run, more

[32] 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

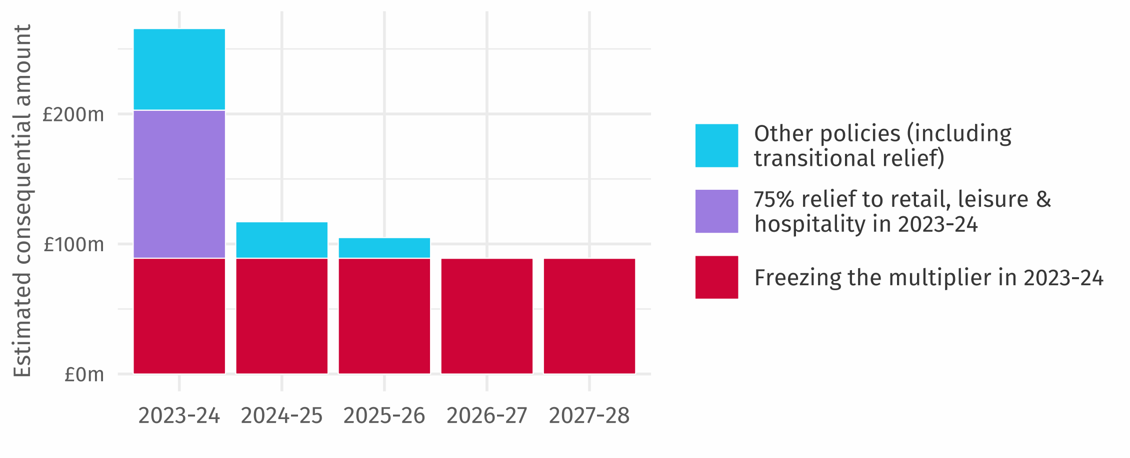
[33] This is partially offset by the decision to delay implementation of the Improvement Relief in England.

frequent revaluations could reduce the need for expensive transitional reliefs by smoothing any increase in rateable values.

As shown in **Figure 4.3**, two further decisions on business rates in England triggered additional consequentials for Wales. First, the multiplier used to uprate business rates liabilities in England has once again been frozen – permanently boosting the Welsh budget by more than £90 million a year. Second, a 75% relief will be provided to retail, leisure, and hospitality premises in England next year (up to a £110,000 cash cap). This is expected to provide a one-off boost to the Welsh budget worth roughly £115 million in 2023–24.

Figure 4.3

Estimated consequentials resulting from business rates policy decisions in England, 2023–24 to 2027–28



Source: WFA analysis of HM Treasury (2022) Autumn statement policy costings. • Notes: The UK Treasury's policy costings document shows the net cost of business rates policies announced in England. This includes the additional Corporation and Income Tax Self-Assessment revenue triggered by the reliefs (business rates are deductible for both Corporation Tax and Income Tax Self-Assessment). We have used these figures to calculate the consequential amounts in this chart. In practice, the consequentials are calculated only on the direct cost of the reliefs (less any additional revenue recouped by HMRC). This breakdown is not provided in the Treasury's documents. Therefore, the figures shown in this chart should be viewed as rough approximations.

The Welsh Government is likely to come under considerable pressure to revisit reliefs and the way NDR bills are uprated before next year. As it stands, the multiplier is set to increase by 10.1% in April 2023. Combined with the sunsetting of the last of the Covid-19 reliefs, a significant cliff-edge looms for many businesses. A typical restaurant faces a 120% increase in their NDR bill overnight, equivalent to an increase of £8,360 a year, just as the UK government's Energy Bill Relief Scheme expires.[34]

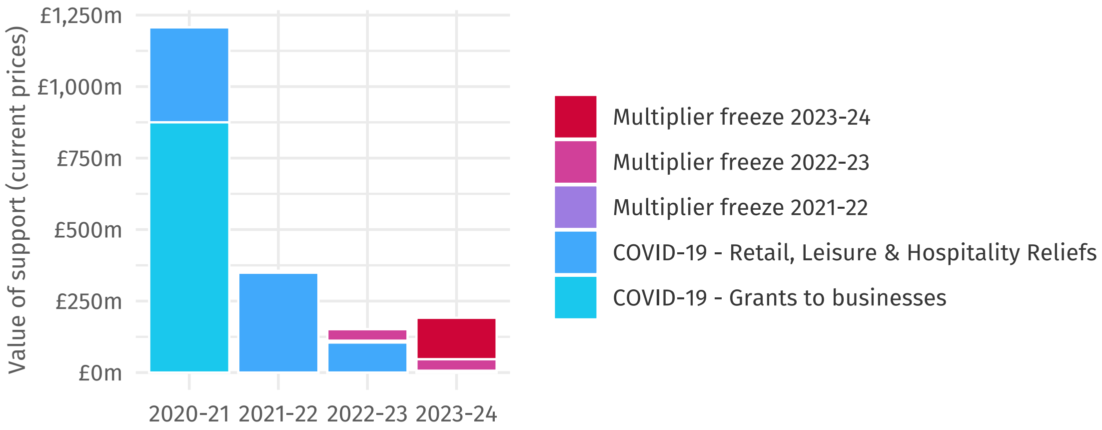
As shown in **Figure 4.4**, the Welsh Government freed most retail, leisure, and hospitality premises from all NDR liabilities in 2020–21 and 2021–22. They tapered this support by

[34] According to the Valuation Office Agency, the average rateable value for a restaurant in Wales is currently £26,000.

offering 50% relief in 2022–23. Businesses have also benefitted from the Welsh Government's decision not to uprate the multiplier in line with inflation – as is customary – for the last two years. This policy came at a cost of £6 million in 2021–22 and an additional £40 million in 2022–23. The Welsh Government rolled additional funding into the local government settlement to compensate local authorities.

Figure 4.4

Covid-19 reliefs and support provided through Non-Domestic Rates (NDR), 2020–21 to 2023–24



Source: WFA analysis of Welsh Government (2022–23) Budget documents and local government settlement.

However, freezing the multiplier again next year would be significantly more costly, potentially exceeding the cost of providing a 50% relief to all retail, leisure, and hospitality premises this year. Unlike the costs of funding temporary reliefs, this cost would be a recurrent one. Moreover, freezing the multiplier would not benefit the more than 70,000 premises that are already eligible for full relief under the permanent Small Business Rates Relief scheme.

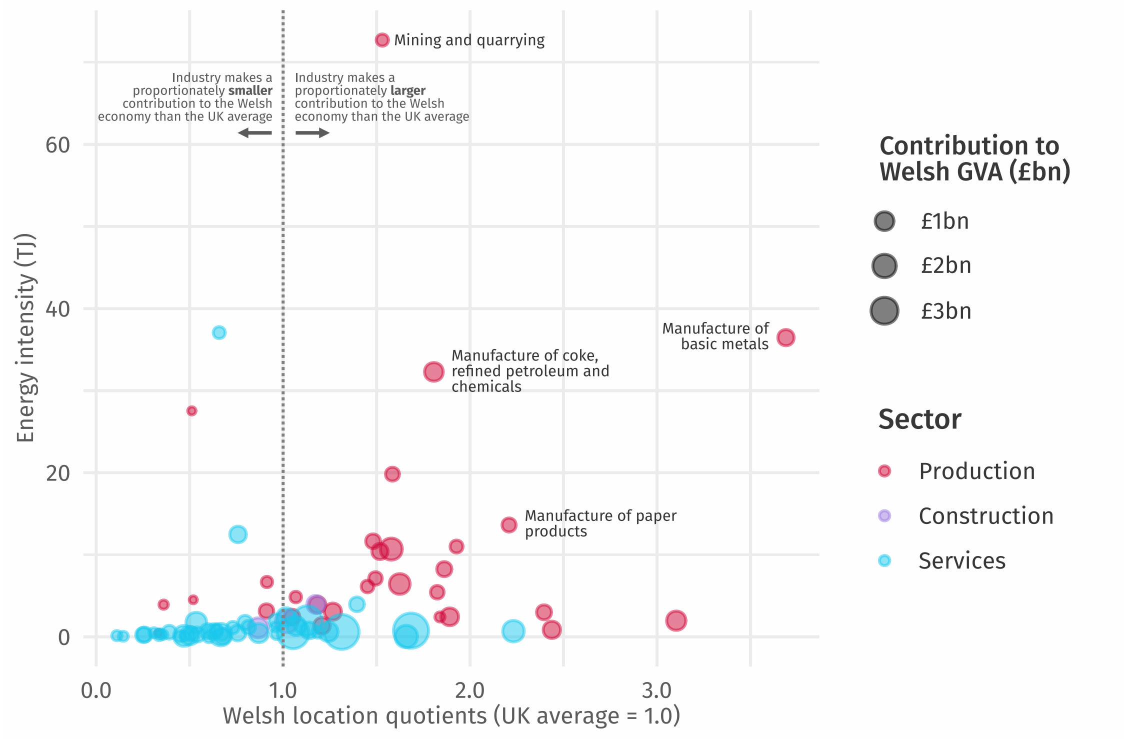
But there might still be a case for providing additional support to the non-domestic sector. So far, most government interventions have aimed to shield households from rising energy prices. Although the Energy Price Guarantee for households has been extended until March 2024 (albeit with a less generous cap from April 2023), the Energy Bill Relief Scheme which caps the bill of non-domestic users – including public, private, and third sector bodies – is set to expire in March 2023. In 2019, the industrial sector alone accounted for 37% of total energy consumption in Wales. The commercial and agriculture sector combined accounted for a further 10%.[35] Not only this, energy-intensive industries (e.g., mining, quarrying, and

[35] Regen, *Energy Use in Wales*, 2nd ed. (Cardiff: Welsh Government, 2022). https://gov.wales/sites/default/files/publications/2022-06/energy-use-wales-report.pdf

metal manufacturing) tend to make a proportionately larger contribution to the Welsh economy than the UK average.

Figure 4.5

Estimated energy intensity of Welsh industries and their contribution to the Welsh economy, 2020



Source: WFA analysis of ONS (2022) Energy intensity in the United Kingdom; ONS (2022) Regional gross value added by industry. • Notes: Energy intensity is calculated by dividing reallocated energy consumption by Gross Value Added (GVA). The energy consumption of Welsh industries is estimated by taking a share of the industry's UK-wide energy consumption equivalent to Wales's contribution to UK GVA for that industry. The location quotient is the ratio of each sector's share of GVA in Wales to that sector's share of UK GVA. A location quotient of more than one signifies that the industry makes a proportionately larger contribution to the Welsh economy than the UK average (specialisation in that sector). A location quotient of less than one signifies that the industry makes a proportionately smaller contribution to the Welsh economy than the UK average (under-representation in that sector).

Figure 4.5 plots the energy intensity of industries on the vertical axis and the industry's location quotient on the horizontal axis.[36] A location quotient of more than one signifies that the industry makes a proportionately larger contribution to the Welsh economy than the UK average (i.e., specialisation in that sector). A location quotient of less than one signifies that the industry makes a proportionately smaller contribution to the Welsh economy than the

[36] This standardised scale to measure industry specialisation features in: Stephen Hill, "Wales in Transition," in *Wales in the 21st Century: An Economic Future*, edited by Jane Bryan and Calvin Jones, (Basingstoke: Macmillan Press, 2000), pp.1-9.

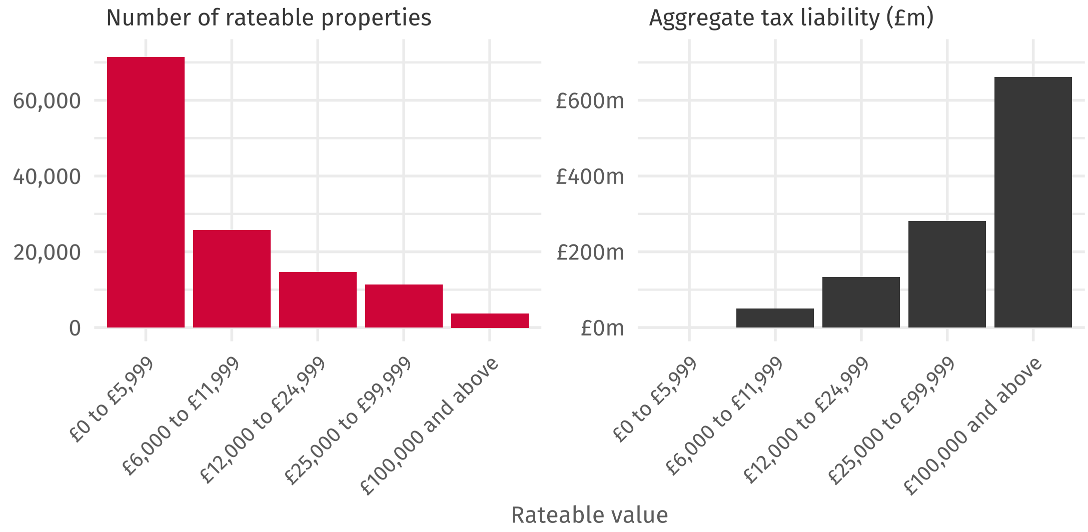
UK average (i.e., under-representation in that sector). Though they make up only 3.5% of UK GVA, Welsh industries account for an estimated 4.6% of UK energy use by industry.

If the Welsh Government opts to use the NDR system to deliver support to businesses and other organisations, there are several important considerations to bear in mind. Given the various reliefs already on offer – including the 100% relief for businesses with a rateable value of less than £6,000, the partial relief for businesses with a rateable value of between £6,000 and £12,000, and the 80% mandatory relief for charitable premises – introducing a blanket relief or making changes to the multiplier might not be the best way to support smaller businesses and charitable premises.

As shown in **Figure 4.6**, although 77% of premises have a rateable value of less than £12,000, they collectively contribute less than 5% of overall tax liabilities. By contrast, premises with a rateable value of £100,000 and over make up less than 3% of the property stock but contribute 59% of all tax liabilities. A blanket relief would see the benefits distributed according to the chart on the right-hand side in **Figure 4.6**.

Figure 4.6

Number of non-domestic premises and estimated NDR liability by rateable value band, 2022–23



Source: WFA analysis of VOA (2022) Non-domestic rating: Stock of properties tables. • Notes: Aggregate tax liability is presented net of Small Business Rates Relief but gross of all other mandatory and discretionary reliefs (including the one-off 50% relief offered to retail, leisure, and hospitality premises in 2022–23).

This could be remedied by imposing an overall cap on the amount of relief that any premises or business can receive and supplementing the scheme with grant payments for premises in vulnerable sectors that have low or zero tax liability. Luckily, the pandemic has shown that the NDR system is highly adaptable and that local authorities are well-placed to administer such schemes.

Given the constraints on funding, the biggest challenge will be deciding which sectors, if any, ought to be prioritised for support. The Welsh Government must balance the real need to disincentivise inefficient energy use in the face of global supply constraints against the potential for job losses and the closure of otherwise viable business and charitable ventures. Any decision about which sectors to target will be highly contentious. Consider the following (non-exhaustive) list of principles that could potentially underpin the policy response:

1. Target support towards energy-intensive consumers (actors that have high energy needs relative to their size and/or turnover);
   e.g., manufacturing, restaurants, hotels?

2. Target support towards sectors where it might be less appropriate / desirable to use price signalling to depress output;
   e.g., hospitals, schools?

3. Target support towards actors that have limited ability to pass on higher costs to the end-consumer.
   e.g., charities, public sector?

On their own, none of these frameworks provide a perfect way of identifying vulnerable industries. The first approach risks disincentivising energy-inefficient industries from investing in more energy efficient processes. If we are convinced by the logic of the second principle, our concerns might be best addressed by using the devolved tax powers to partially compensate public bodies for the reduction in their spending power due to higher inflation. The third principle involves tacitly accepting that households should still bear the indirect cost of high energy prices by paying more for goods and services. This might well exacerbate the expected fall in consumer demand and prolong the looming recession.

The UK government opted to sidestep these difficult questions by singling retail, leisure, and hospitality premises for business rates relief next year. This effective (if somewhat blunt) approach to targeting support could be justified during the pandemic, not least as these industries were more likely to be affected by lockdown restrictions and reduced consumer footfall. However, it is less clear whether this approach suffices now, especially as many other vulnerable sectors (including public and third-sector organisations with fixed incomes) will be left unsupported when the Energy Bill Relief Scheme ends.

4.3. Land Transaction Tax

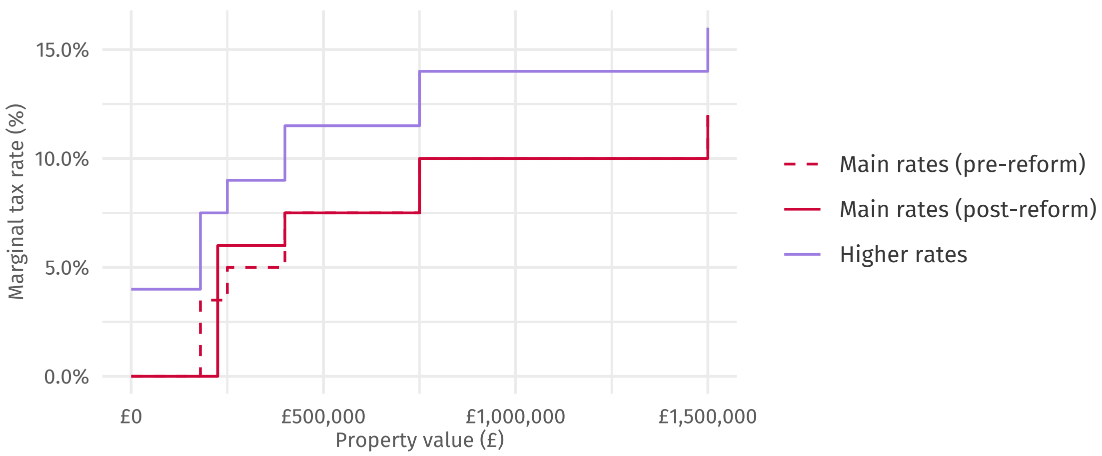
The Welsh Government amended Land Transaction Tax rates on 10th October 2022. This marked the fourth occasion in less than three years when the tax schedule has been adjusted in-year, outside the normal budget-setting timetable. This time, it was in response to an announcement made at September's mini budget, which increased the threshold at which buyers start paying Stamp Duty in England and Northern Ireland to £250,000 (£425,000 for first-time buyers). Since the tax is fully devolved to Wales, the announcement by the UK government triggered a reduction in the Block Grant Adjustment and thus increased the Welsh Government's spending power.[37]

The Welsh Government's subsequent decision to increase the tax-free LTT allowance from £180,000 to £225,000 offsets some of the 'fiscal drag' triggered by house price inflation. As recently as 2019–20, no tax was due on 58% of main rates residential property transactions in Wales. In the first six months of 2022–23, the proportion of tax-free transactions had fallen to just 42% – boosting devolved revenues in the process. In addition to raising the zero-rate threshold, the Welsh Government increased the marginal tax rate for the £225,000 to £400,000 (main) tax bracket from 5% to 6%. This partially offsets the revenue foregone by the more generous nil-rate allowance.

Figure 4.7 displays the marginal tax rate for residential transactions, before and after October's reforms. The tax schedule for transactions subject to the higher rates – paid by owners of multiple properties – was unaffected by the changes to the main rates announced in October. This has introduced a few quirks to the tax schedule. Whereas previously, the marginal tax rate paid on the higher rates was always four percentage points higher than the amount payable on the main rates, this is no longer the case. Between £180,000 and £225,000, a 7.5 percentage point premium is now applied to the marginal tax rate for higher rates transactions. By contrast, between £225,000 and £250,000, the premium paid by higher rate buyers is only 1.5 percentage points. For transactions above £345,000, changes to LTT rates announced in October have reduced the higher rate premium by up to £550.

Figure 4.7

Residential Land Transaction Tax schedule, pre- and post-reforms, October 2022



Source: WFA analysis. • Notes: Chart shows the marginal tax rate for residential property transactions before and after the tax rate changes that came into effect on 10 October 2022.

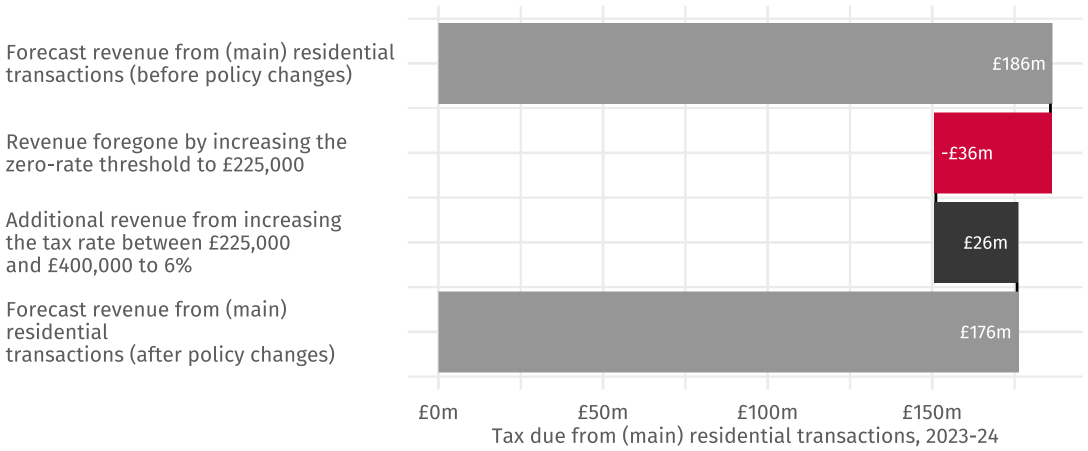
[37] Last month, the Chancellor announced that the Stamp Duty changes in England and Northern Ireland will be time-limited, expiring in March 2025.

Using our in-house Land Transaction Tax model, we estimate that the revenue foregone by the increase to the nil-rate will amount to £36 million next year, relieving an additional 19,000 transactions from all LTT liabilities. Increasing the main tax rate between £225,000 and £400,000 will bring in an additional £26 million. When taken together, the expected net cost of the tax changes announced in October is approximately £10 million in 2023–24.

Recent increases in mortgage rates and the poorer outlook for disposable income caused the Office for Budget Responsibility to revise down its forecast for transaction volumes and house price growth next year, which will impact devolved tax revenues. However, due to the operation of the fiscal framework, Wales is protected from UK-wide shocks to the property market. Put simply, the difference between devolved revenues and the comparable change in English and Northern Irish revenues will determine whether the Welsh budget gains or loses out from falling house prices.[38]

Figure 4.8

Forecast effect of October's Land Transaction Tax policy changes on tax revenue in 2023–24



Source: WFA analysis using WFAMOD-LTT (v1.0.3)[39] and Welsh Revenue Authority (2021–22) input data. ● Notes: Transaction volume and values are uprated using parameters from the OBR's (March 2022) Devolved Tax Forecasts.

The OBR published forecast for the devolved taxes alongside its assessment of the UK economic and fiscal outlook last month. As discussed in **Chapter 2**, trends in England and Northern Ireland – which determine how fast the negative block grant adjustments grow – are just as important as the trajectory of devolved revenues when determining the net effect on the Welsh budget. Nevertheless, **Figure 4.9** shows the OBR's forecasts of devolved revenue through 2027–28, and how this has changed since the last set of forecasts were

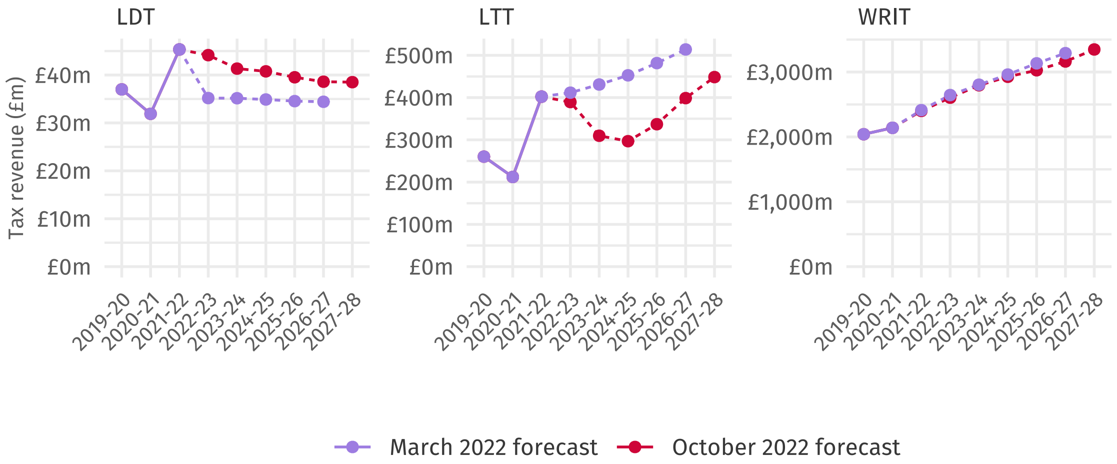
[38] Ed Gareth Poole and Guto Ifan, *The Welsh Tax Base: Risks and Opportunities after Fiscal Devolution* (Cardiff: Wakes Centre for Public Policy, 2018). https://www.wcpp.org.uk/publication/the-welsh-tax-base-risks-and-opportunities-after-fiscal-devolution/

[39] WFAMOD-LTT can be accessed here: https://github.com/ciantudur/wfamod-ltt

published in March 2022. Land Transaction Tax revenues are now forecast to be markedly lower in future years.

Figure 4.9

Forecast revenue from Welsh Rates of Income Tax (WRIT), Land Transaction Tax (LTT), and Landfill Disposals Tax (LDT)



Source: OBR (November 2022) Economic & Fiscal Outlook. • Notes: The impact on the Welsh budget is determined by the growth in devolved revenues relative to the growth in size of the negative Block Grant Adjustments.

4.4. Other local taxes

Since 2017, local authorities have had powers to apply a premium (or discount) to Council Tax bills for second homes and long-term empty homes. The Welsh Government announced new legislative measures earlier this year which will increase the maximum premium that councils may charge. From April 2023, local authorities will be able to impose a premium of up to 300% on non-exempted second homes and long-term empty dwellings, up from the previous ceiling of 100%. Local authorities will confirm the level of premiums and discounts for 2023–24 as part of their normal budget-setting process in the new year, though at least one authority has already launched a public consultation to gauge views on whether to make full use of these new powers.[40]

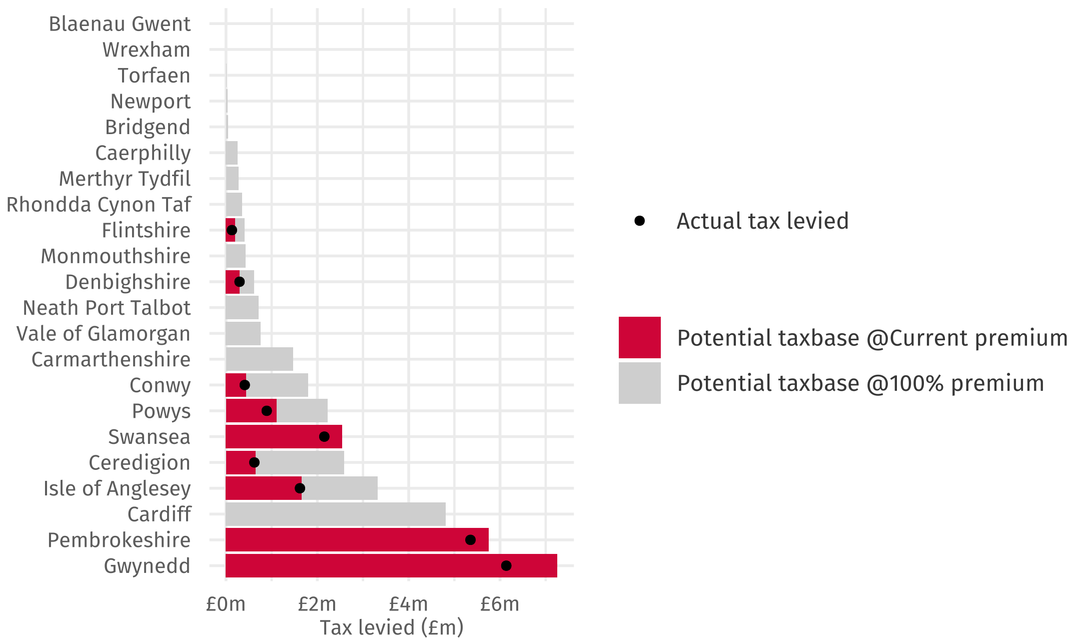
In 2022–23, nine local authorities opted to levy a premium on second homes (**Figure 4.10**). Ceredigion and Conwy both applied a 25% premium. The Isle of Anglesey, Denbighshire,

[40] https://www.gwynedd.llyw.cymru/en/Council/News/Press-releases/Hydref-2022/Public-consultation-on-the-council-tax-premium-on-second-homes-and-long-term-empty-properties.aspx

Flintshire, and Powys each applied a premium of 50%. Pembrokeshire joined Gwynedd and Swansea in levying a 100% premium on second homes.

Figure 4.10

Estimated additional revenue raised from council tax premiums on second homes, 2022–23



Source: WFA analysis of StatsWales (2022) Council tax dwellings, by CT1 row description. • Notes: The actual amount of tax levied is lower than the potential taxbase due to statutory exemptions.

We estimate that the additional council tax paid by owners of second homes will amount to £17.6 million this year, with local authorities netting an additional £5.7 million from owners of long-term empty homes. Taken together, this amounts to less than 1.5% of all Council Tax budgeted for collection across Wales.

Nevertheless, these premiums have become an increasingly important source of revenue for some local authorities – a trend that is likely to continue as the cap rises. Take Gwynedd, for example. If the council decides to increase its premium on second homes three-fold to 300% next year, the authority could net an additional £12 million a year to fund council services. Achieving an equivalent increase in spending power without changing the premiums would require a council tax increase of over 15%.

Of course, we might expect revenues to reduce over time as second homes are sold to buyers intending to use the dwelling as their primary residence. We have previously argued that using a recurrent tax (like the council tax premium) is a more effective way of influencing behaviour and discouraging inefficient use of housing stock than a one-off tax on property transactions.[41] However, the use of premiums does have the potential to introduce a new source of volatility to a tax that has, historically, brought in a steady stream of revenue for councils owing to the relative inertia of local housing stock (the annual addition and attrition rate for residential dwellings is typically low).

Separately, the Welsh Government is consulting on proposals for a visitor levy that would give local authorities discretion to introduce an additional charge for stays in overnight visitor accommodation.[42] Though this tax would only bring in a small amount of revenue on aggregate, it again raises important questions about the role of taxation – not only as a means of funding public services, but also as a tool to influence and curb certain behaviours to achieve desired economic and societal outcomes.

[41] Welsh Parliament Finance Committee, *Scrutiny of the Welsh Government Draft Budget 2022*−23 (Cardiff: Senedd Cymru, 2022), 46. https://senedd.wales/media/nb2i2txi/cr-ld14918-e.pdf
[42] https://gov.wales/a-visitor-levy-for-wales

5 Household income

When **Wales Fiscal Analysis** last published a report on the cost-of-living in the Spring, a combination of inflationary pressures, high energy prices, and trailing income growth threatened households with the biggest squeeze in living standards in decades.[43] The crisis has since intensified. Households face another rise in energy bills in April 2023 as the cap on the typical annual bill increases from £2,500 to £3,000. A repeat of this year's targeted payments will offer some reprieve to pensioners and those in receipt of means-tested and disability benefits. Most other households will still be paying nearly three times as much on energy as they did three years ago.

Changes to the underlying drivers of inflation are also altering how households experience price rises. The rate of inflation for food items is now at its highest level since 1977, with prices for 36 of the 49 food and non-alcoholic drink items tracked by the Office for National Statistics (ONS) increasing at a faster pace than the headline CPIH inflation rate of 9.6% in the 12 months to October. This largely reflects higher costs for distribution, the energy used in food production, and the war in Ukraine. It is a reminder that government policy to protect households cannot be decoupled from measures to help businesses absorb higher input costs (discussed in **Chapter 4**).

In addition to the immediate challenges, the longer-term outlook for households is equally bleak. By 2027, real disposable incomes in Wales will be over £10,000 lower than had the pre-financial crisis trend been sustained. Even after the immediate pressures on income subside, this ought to raise serious questions about the future trajectory of UK economic and fiscal policy.

5.1. Cost-of-living interventions in 2022–23

Throughout the spring of 2022, the UK and Welsh governments announced several schemes to assist households with rising costs as energy price forecasts were repeatedly revised upwards. Taken together, we estimate that the measures announced by both governments between February and May 2022 provided £1,300 of support for the average household in Wales. The subsequent £2,500 price cap announcement increased total support for the average Welsh household in 2022-23 to over £2,000.

[43] Cian Siôn and Guto Ifan, *When ends don't meet: a cost-of-living update,* (Cardiff: Wales Fiscal Analysis, 2022). https://orca.cardiff.ac.uk/id/eprint/148317/

The first major policy intervention came in February 2022, when the UK government announced a £200 energy bill rebate for all households in Great Britain and a £150 cost-of-living payment for English households in Council Tax bands A to D (the Welsh and Scottish governments followed suit). In Wales, targeted payments to individuals in receipt of qualifying benefits (through the Winter Fuel Support Scheme and local authority-run discretionary funds) supplemented these near-universal measures.

One way of gauging the distributional impact of policies is to group households into ten roughly evenly sized "income deciles" based on their equivalised, after-housing-cost income and examine how the policy affects income across the income distribution.[44] As shown by the red bars in **Figure 5.1**, the addition of these targeted measures by the Welsh Government increased the progressivity of the overall support package. However, since the payments are not automatic, this introduced a separate challenge of encouraging take-up.[45]

In March 2022, then-Chancellor Rishi Sunak announced a significant increase to the National Insurance Primary Threshold and Lower Profit Limits, aligning them with the personal allowance for income tax, and a 5p per litre cut to fuel duty. Higher-income households benefitted the most from these policies. Only a quarter of the benefit from the increased National Insurance thresholds went to the bottom half of the income distribution in Wales.[46] Similarly, the fuel duty cut delivered nearly three times more support for UK households in the most affluent income quintile than those in the poorest income quintile.

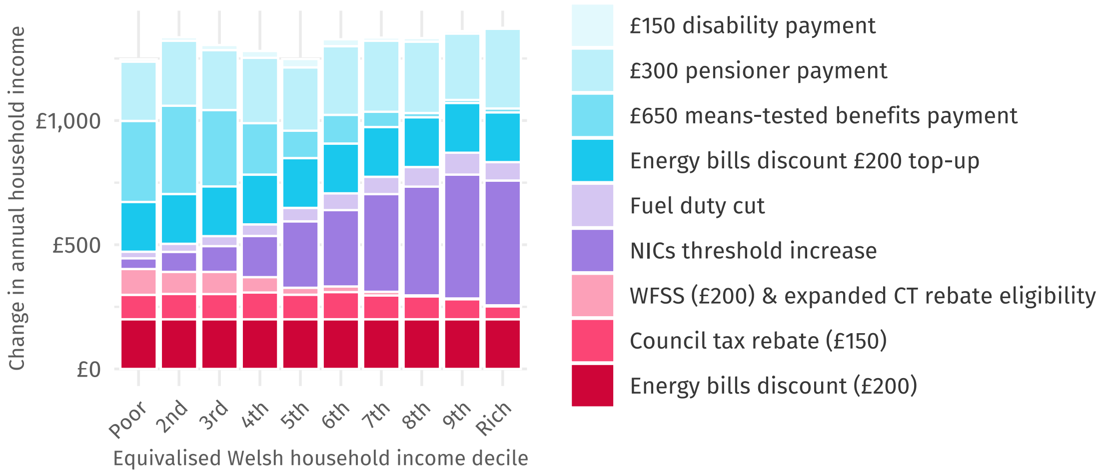
In May 2022, the UK government announced its largest intervention yet, consisting of a further £200 rebate for all households and several means-tested payments targeting low-income working-age households, pensioners, and recipients of Carer's Allowance. These measures stood in sharp contrast to the announcements made in March, which had mostly benefitted more affluent households. We estimate the measures announced in May 2022 alone more than doubled support for Welsh households in the poorest income decile from £470 to £1,250, in line with the support to higher income households.

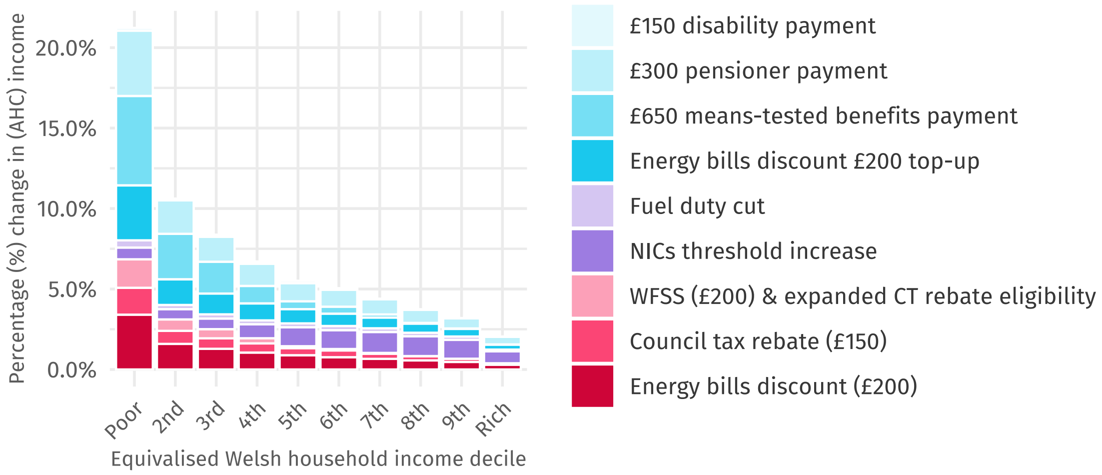
The overall benefit from these support measures was roughly evenly distributed across the income distribution in Wales – equivalent to 21.2% and 2.0% of disposable income (after housing costs) for households in the poorest and richest income decile, respectively (**Figure 5.1**).

[44] Equivalised household income accounts for differences in a household's size and composition.
[45] In a letter to the Senedd Equality and Social Justice Committee, the Minister for Social Justice Jane Hutt confirmed that 166,780 payments were made during the first round of the Winter Fuel Payment Scheme. Officials estimated the total number of eligible households to be 220,000 (implying a take-up rate of 76%).
[46] Guto Ifan and Cian Siôn, *Spring Statement 2022: Implications for Wales,* (Cardiff: Wales Fiscal Analysis, 2022). https://orca.cardiff.ac.uk/id/eprint/148637/

Figure 5.1

Distributional impact of cost-of-living interventions announced between February and May 2022 on Welsh households





Source: WFA analysis using UKMOD A2.51+ & ONS (2016–18) Family and Resources Survey input data. • Notes: Assumes full take-up of all policy measures. The results presented here are based on UKMOD version A2.51+. UKMOD is maintained, developed, and managed by the Centre for Microsimulation and Policy Analysis (CeMPA) at the University of Essex. The process of extending and updating UKMOD is financially supported by the Nuffield Foundation (2018-2021). The results and their interpretation are the authors' sole responsibility.

By late August, Cornwall Insight were projecting that Ofgem's standard price cap – now updated quarterly – would eclipse £5,000 in the second quarter of 2023.[47] In response, then-Prime Minister Liz Truss announced an Energy Price Guarantee on the 8th of September, superseding Ofgem's price cap with a new £2,500 cap on households' energy bills for 24 months – later revised to six months. This cap operates in the same way as its predecessor, with unit rates and standing charges capped rather than total bill amounts, thereby

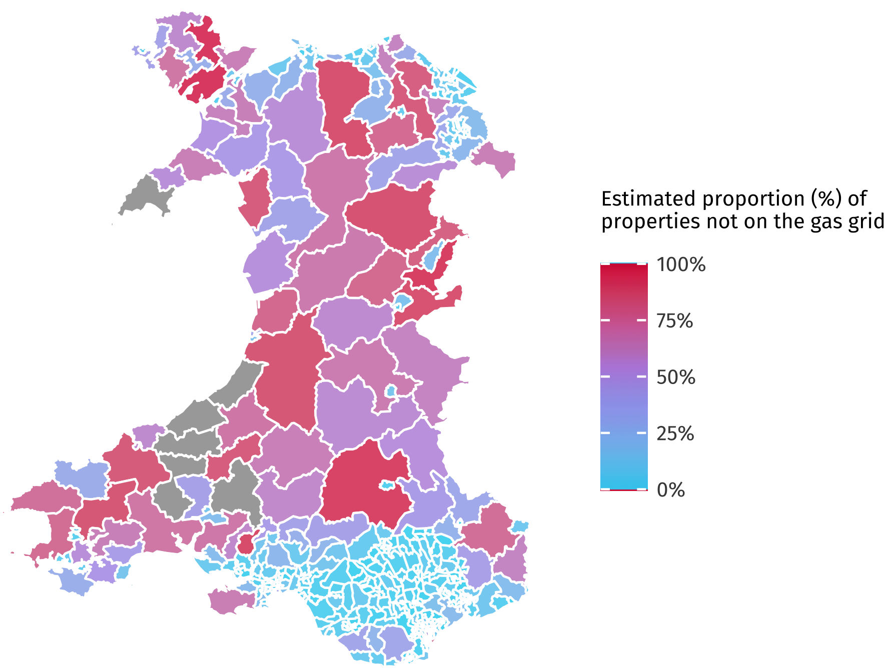
[47] https://www.cornwall-insight.com/cornwall-insight-release-final-predictions-for-octobers-price-cap/

preserving an incentive to reduce usage. Taking Cornwall Insight's late-August price cap projections, a typical household on a variable tariff might expect to save £800 between 1st October 2022 and 31st March 2023 compared to how much they would have paid under the legacy arrangements.

Together with the measures announced in the Spring, we estimate that the UK government's interventions will fully offset the rise in energy bills faced by the average household in 2022–23. However, this statement needs caveating. First, many households with higher-than-typical energy consumption will still be out of pocket. Second, the support measures do not offset the rising cost of other essential goods, and real disposable income is projected to fall by 7% over the next two years. Third, homes not connected to the gas grid will not benefit from the Energy Price Guarantee; instead, they will be eligible for a (recently doubled) £200 payment from the UK government – still considerably less than the value of support provided to mains-connected households.

Figure 5.2

Estimated proportion of households not on the gas grid by Middle Layer Super Output Area (MSOA), 2020



Source: BEIS (2022) Domestic properties not on the gas grid by Middle Layer Super Output Area (MSOA). • Notes: These estimates are derived by subtracting the number of domestic gas meters (including non-consuming meters) from the estimated number of domestic properties. Where no data are provided (grey-shaded areas), this is because the number of gas meters has been supressed for disclosure control reasons.

The Department for Business, Energy, and Industrial Strategy estimates the number of Welsh households not connected to a mains gas supply to be 275,000 (or 19% of all households). Because of the way this estimate is derived – subtracting the number of registered gas meters from the number of properties – this is likely to be an overestimate. Survey-based estimates from the Welsh Housing Conditions Survey point to a much lower figure of 5%. We make no attempt to reconcile the two figures here, but the geographic concentration of off-grid households is likely to mirror the patterns shown in **Figure 5.2**, with Ceredigion and Powys recording the largest proportion of households not connected to the gas grid.

In the absence of further changes to UK government support, these areas, and Wales as a whole, stand to lose out relative to the rest of the UK. Some additional support has been made available through the separate Discretionary Assistance Fund administered by local authorities, but as of August 11th, only 677 off-grid fuel payments had been made this year.[48]

5.2. Cost-of-living interventions from April 2023

The decision to use one-off, non-recurring payments to deliver support in Spring 2022 meant that, by default, the targeted elements of the UK government's support package were set to expire this year. However, the Chancellor has since confirmed that these targeted cost-of-living payments will be repeated next year. At the same time, the cap on a typical domestic energy bill will be raised to £3,000 from April 2023, up from its current level of £2,500. Taken together, these measures signal a shift in the UK government's approach to protecting households, reducing the value of universal support, whilst doubling down on the use of targeted payments to vulnerable groups.

As shown in **Figure 5.3**, the £900 payment to households in receipt of means tested benefits, and, to a lesser extent, the £150 payment to individuals receiving qualifying disability benefits, are progressive with respect to income. Along with the £300 payment to households with pensioners, these three measures will boost the average income (after housing costs) of Welsh households in the poorest income decile by 10% next year. This is in addition to the 10.1% uplift planned for most benefits (including the state pension) in April 2023.

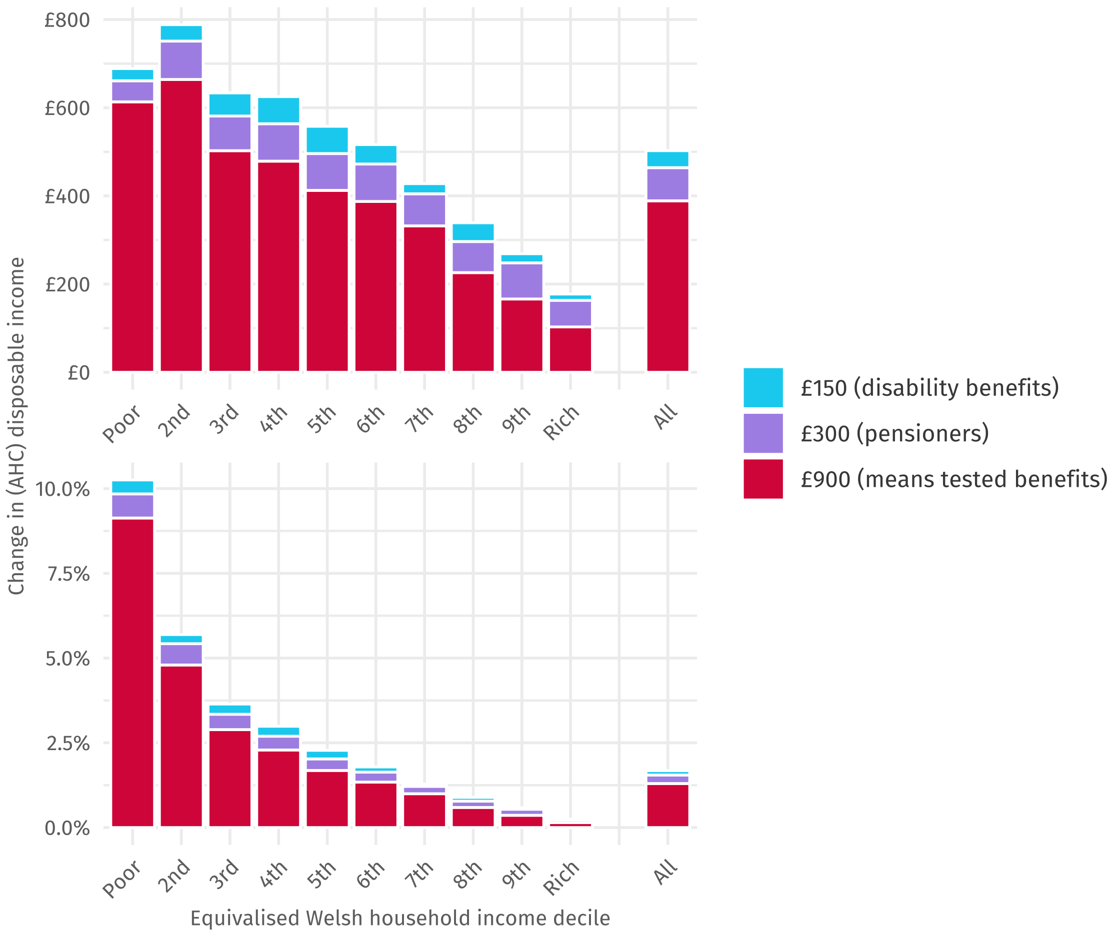
Despite these interventions, next year will prove even more challenging for households. The absence of other support measures, including the council tax and energy bill rebates, as well as the decision to increase the government price cap to £3,000 from April 2023, means that most households will receive less support than they did this year. A household in receipt of the £900 means tested payment will still be paying more than twice as much on energy as they did three years ago. A typical household which does not meet the eligibility criteria for

[48] https://business.senedd.wales/documents/s128931/Letter%20from%20the%20Minister%20for%20Social%20Justice%20-%2018%20August%202022.pdf

any of the three additional payments will be paying three times as much for energy as they did three years ago.

Figure 5.3

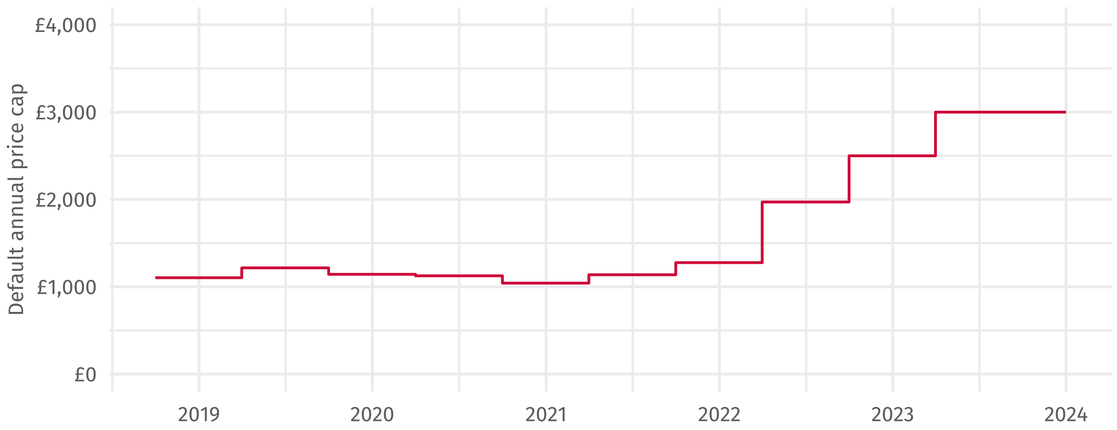
Distributional impact of the UK government's targeted cost-of-living payments in 2023–24



Source: WFA analysis using UKMOD A3.23+ & ONS (2018–20) Family and Resources Survey input data. • Notes: Assumes full take-up of all policy measures. The results presented here are based on UKMOD version A3.23+. UKMOD is maintained, developed, and managed by the Centre for Microsimulation and Policy Analysis (CeMPA) at the University of Essex. The process of extending and updating UKMOD is financially supported by the Nuffield Foundation (2018-2021). The results and their interpretation are the authors' sole responsibility.

Figure 5.4

Annual price cap for a typical household paying by direct debit



Source: WFA analysis of Ofgem (2022) Default price cap level; UK government announcements.

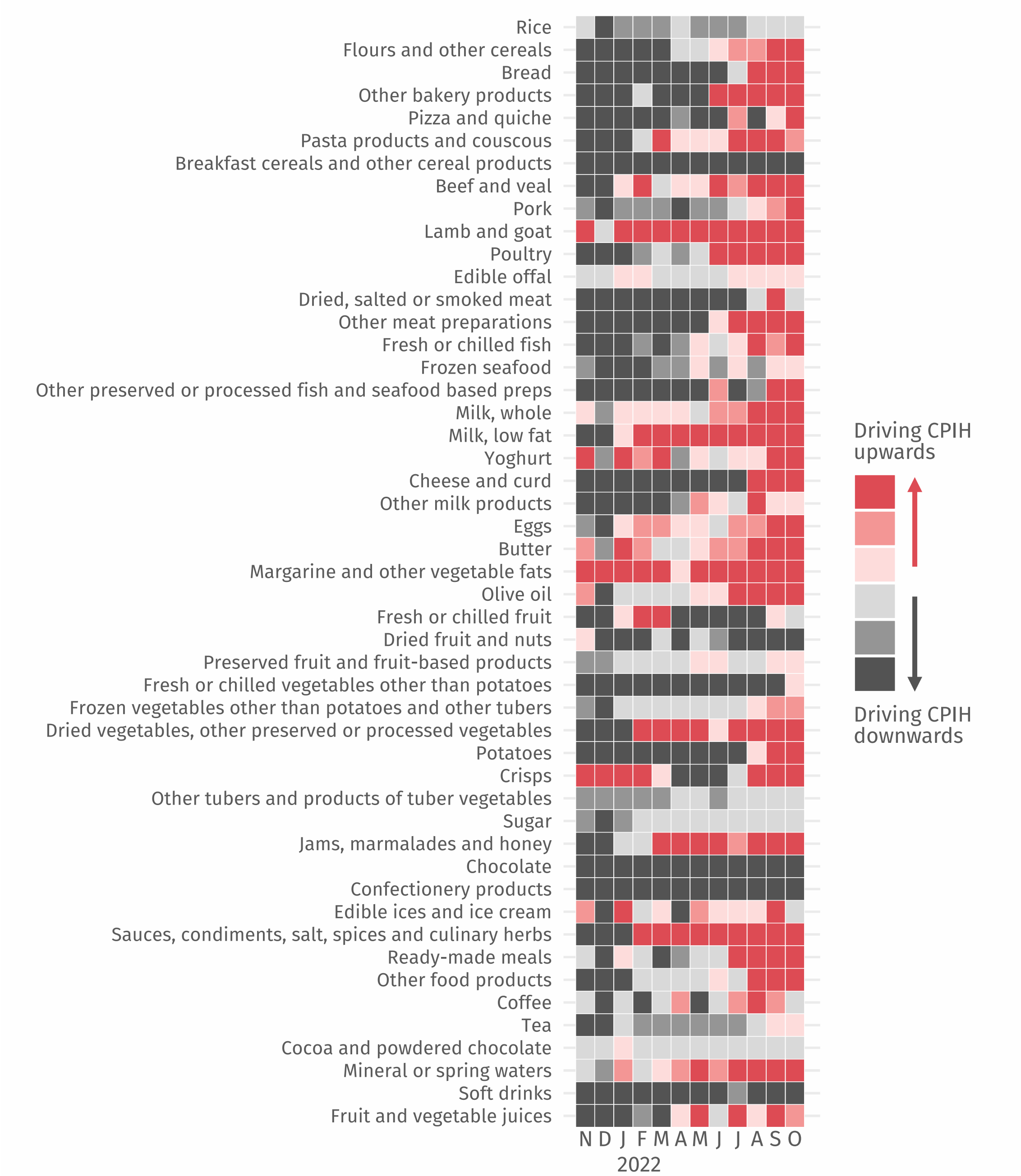
The Consumer Price Index (CPI) and the Consumer Price Index (including owner occupiers' housing costs) (CPIH) both track change in prices for goods and services included in the representative consumer's basket. In October 2022, the 12-month CPI rate stood at 11.1%, up from 10.1% in the 12 months to September 2022 (the CPIH rate stood at 9.6%, up from 8.8% in the year to September).

Looking beyond changes to the headline rate, the underlying drivers of inflation have become considerably more diverse over the past year. Although housing and household services remain the biggest factor driving the headline rate, other expenditure categories are also making larger upward contribution to the index. These include transport and food items. Data from the Living Costs and Food Survey shows that, even pre-pandemic, UK households in the poorest income quintile were spending more than twice as much on food and non-alcoholic beverages (as a proportion of their disposable income) compared to households in the top income quintile.

Figure 5.5 shows the contribution of various food and beverage items to the annual rate of inflation over the past 12 months. Grey shaded blocks indicate that the annual inflation rate for the respective item trailed the headline CPI index (thus applying downward pressure to the inflation rate). In November 2021, three-quarters of the items recorded slower price growth than the headline CPI rate. By October 2022, three-quarters of the items are red, indicating that they apply upward pressure on the inflation rate.

Figure 5.5

Contribution of food items and non-alcoholic beverages to the headline 12-month CPIH rate, November 2021 to October 2022



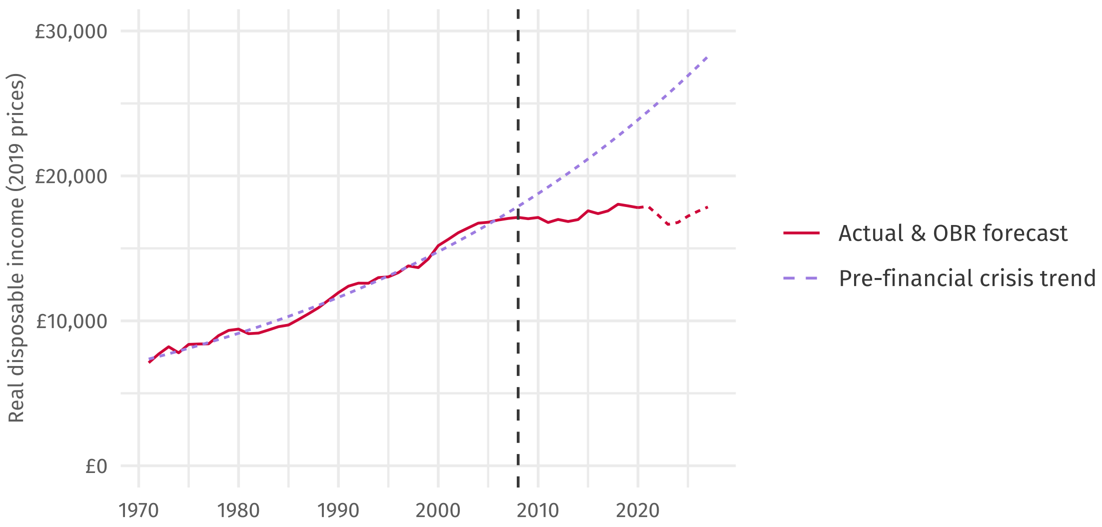
Source: WFA analysis using of ONS (October 2022) CPIH tables. • Notes: Notes: Shaded cells represent the contribution of each item to the 12-month CPIH rate based on the deviation from the headline rate and the weight of the item in the consumer basket.

5.3. Longer-term trends in household income

While the recent focus has understandably been on the immediate challenges posed by price rises, the longer-term outlook for household income remains bleak. The latest iteration of the OBR's forecast implies real disposable income – which measures how much households have available to spend or save after adjusting for the impact of inflation – will fall by 7% over the next two years. This is after accounting for the various government support schemes to boost incomes in response to the cost-of-living crisis. Applying these projections to a historic data series for Wales, we estimate that by 2027, real incomes in Wales will be over £10,000 lower than had the pre-financial crisis trend been sustained. This effectively amounts to two decades of zero growth in earnings and living standards. Even after the immediate pressures on income subside, there ought to be a serious discussion about the future trajectory of UK economic and fiscal policy, with the aim of arresting the long-term decline in living standards.

Figure 5.6

Estimated real disposable income per person in Wales



Source: WFA analysis of ONS (2022) UK Economic Accounts; OBR (November 2022) Economic and Fiscal Outlook.

A Local government projections

The approach used to project local authority spending pressures builds on that used in our previous reports.[49] The key assumptions and methods used are outlined below.

Base year

Our projections have been rebased using the most recent 2021–22 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 establish the 2021–22 (non-Covid) baseline for our model.

Demand

A growing population is likely to increase demand for services. Our baseline assumption is that demand pressures grow in line with the interim 2020-based projections of population growth. We amend these demand projections for the two largest areas of spending – social care services and schools.

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).[50] 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 2027–28. This is adjusted by +/- 1 percentage point in our higher and lower cost scenarios, respectively. Additionally, we assume that some pandemic-related pressures persist adding 3.0% to the adult social care spending baseline in 2022–23, 1.5% in 2023–24 and 0.75% in 2024–25. Pandemic-related pressures are not simulated beyond 2024–25.

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

[49] Kate Ogden, David Phillips, and Cian Siôn, "What's happened and what's next for councils?" In *The IFS Green Budget 2021 October 2021*, edited by Carl Emmerson, Paul Johnson, and Ben Zaranko, 295-344, (London: Institute for Fiscal Studies, 2021). https://orca.cardiff.ac.uk/id/eprint/145863

[50] 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/

authorities. In our central scenario, we assume demand pressures in this area grow by 5.1% a year – the average rate of growth in the number of children looked after over the past five years. This is adjusted by +/- 2 percentage points to simulate different demand scenarios.

We use the 2020-based pupil population projection to simulate future demand for school places. By default, a forecast reduction in pupil numbers puts a slight downward pressure on schools' future spending requirements in our model. In our lower cost scenario, we assume the effects of this reduction in pupil numbers feed through into lower input costs in full. In our higher cost scenario, we assume that this implied reduction in demand has no impact on future input costs. The central projection uses the mid-point of the higher and lower cost 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 November 2022. We estimate the additional impact of planned increases to the Real Living Wage (RLW) on care workers by growing adult social care costs in line with the RLW in 2023–24 and then by average earnings or CPI (whichever is higher). We do not incorporate the impact of National Living Wage (NLW) increases on other council workers (the lowest point on the national pay spine is still above the NLW).

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.[51] In following years, teachers' pay is grown in line with observed pay awards and the pay review body recommendations for the 2023–24 academic year. From 2024–25, we assume that each point on the pay spine, including pay for teachers on the upper pay range, leadership scales, and unqualified teachers, grow in line with average earnings. Our projections are also adjusted to account for the split of each academic year across multiple financial years.

We also incorporate the effects of the Health and Social Care Levy – which has since been withdrawn – on employer staff costs between April and November 2022.

Local authority funding

We start with the Welsh Government's indicative RSG and specific grant allocation in 2023–24 and 2024–25. We then assume the Welsh Government pass on the consequentials

[51] 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

announced at the Autumn Statement to equivalent devolved services in full. In future years, we assume the Welsh Government allocates consequentials from additional NHS spending in England (as per OBR assumptions) to the NHS in Wales. We further assume that funding for local government and all other budget areas grow in line with the rest of the spending envelope. Housing benefit and the associated administration grants paid by the Department for Work and Pensions are excluded from this analysis.

Our measure of council tax revenues equals the council tax requirement up to 2022–23, excluding any precepts for police, fire and rescue authorities, and community councils. In future years, we assume that the council tax base grows by 0.8% annually – in line with the 4-year average, and we vary our assumptions about council tax increases. 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 2022–23 budgeted level of 15.5% in future years.

We make no assumption about payments to or drawdowns from council reserves beyond what was budgeted to be drawn down in 2022–23.

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