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Welsh Budget 2018: Chief Economist's Report

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Chief Economist's Report 2018

Recent economic performance and shorter-term prospects

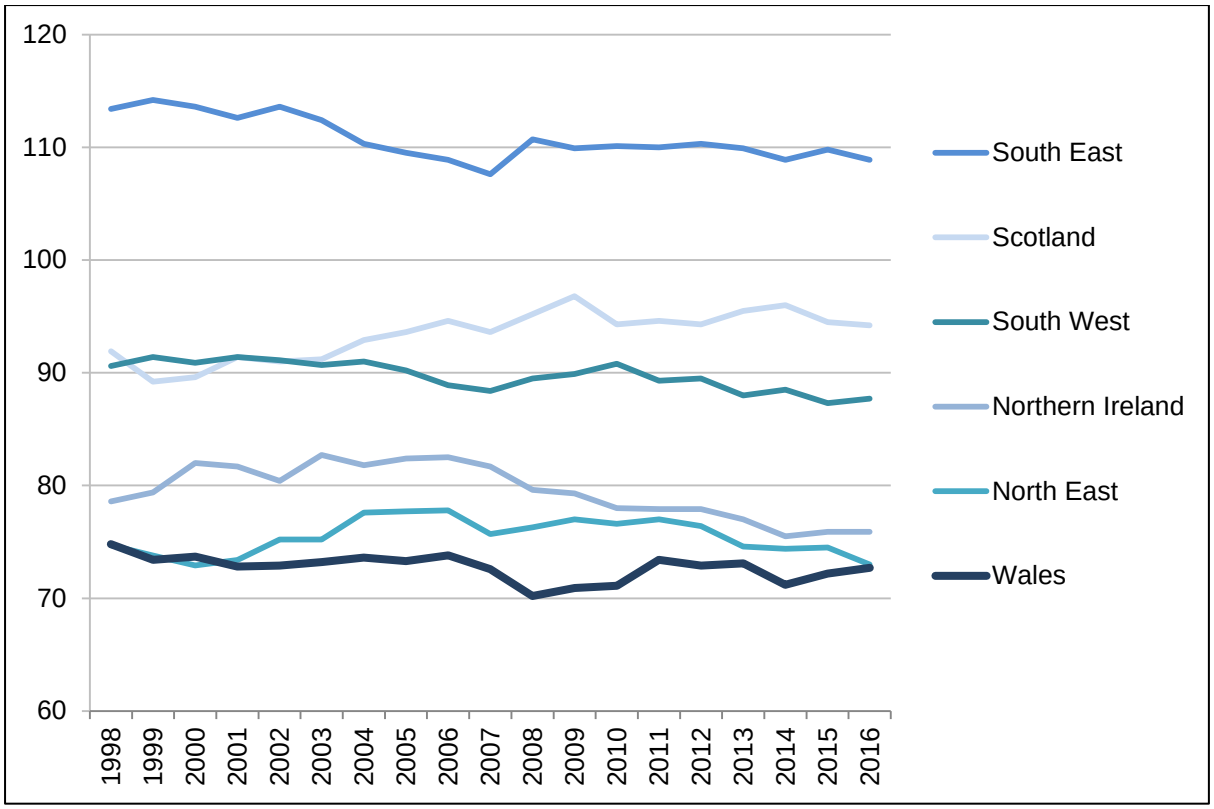
Brexit continues to weigh on growth prospects for Wales and the UK as a whole; the severity of the impact will depend on the form that Brexit takes and the dislocation associated with the process of leaving. It is likely that Wales will be hit disproportionately by a "hard" Brexit.

Drivers of Welsh short to medium-term economic performance

Over the short to medium term, the performance of the economy in Wales generally tracks quite closely to that of the wider UK, albeit with some fluctuation (which may reflect statistical variability as well as real effects related to the speed of transmission of economic shocks across the UK).

Figure one shows Gross Value Added (GVA) per head for Wales and selected other UK countries and regions, relative to the UK as a whole. GVA is the total value of goods and services produced in an area; it also represents the total value of income generated in an area (but not necessarily received by residents).

Figure one: GVA per head (UK = 100)



Source: ONS

For Wales, as for most regions, there has been little trend movement relative to the UK as a whole over recent years. (GVA per head has a number of limitations as an indicator, discussed below, and is used here for illustrative purposes.) The reasons for Wales's relatively weak performance in terms of *levels* of GVA per head are also discussed below.

This close association between the performance of the economy in Wales and the wider UK over the short to medium term is unsurprising.

First, for reasons of geography and history, the economy in Wales is deeply embedded within that of the wider UK, with particularly close links to adjacent areas of England. And while the structure of the economy in Wales differs from that in England as a whole (with, for example financial and business services playing a less important role, and manufacturing a more important role) such differences are minor when Wales is compared with English regions outside the south east.

Second, the key macro-economic policy levers – over monetary and fiscal policy – are held by the UK Government. The policy levers held by the Welsh Government – particularly those covering education, skills and infrastructure – are critically important for economic outcomes, but operate mainly over the longer term.

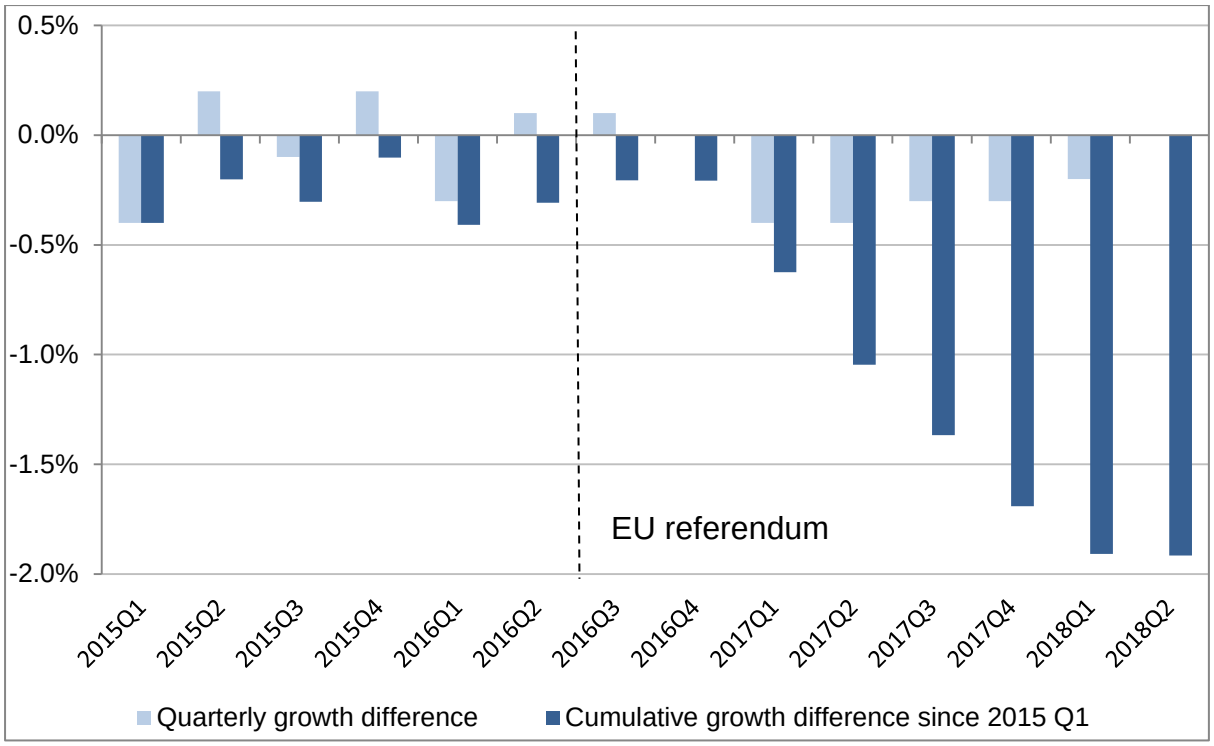
Recent UK economic performance

Over the last year, economic growth across the UK has continued the weak path seen since the Brexit vote. In the first quarter of 2018, growth was 0.2% and in the second quarter 0.4%, both below the long-run average of more than 0.5%. Taking the whole period since the referendum, the UK has grown more slowly than other developed economies.

Figure two compares quarterly growth for the UK and the EU as a whole. The UK has grown more slowly than the EU in almost every quarter since the referendum, with cumulative difference approaching 2%. If only half of this shortfall were due to the Brexit vote, it would amount to around £200 per head in Wales for each full year this gap persists.

Attribution of (much of) the shortfall to the Brexit vote is made plausible by the causal channels identified by the Bank of England as key sources of slower growth: the erosion of people's real incomes as a result of the depreciation of sterling following the vote (in anticipation of longer-run negative economic effects) and the impact of Brexit related uncertainty on business investment decisions. A short to medium-term impact of 1% to 2% per cent of GDP is consistent with many mainstream assessments made prior to the referendum – in magnitude if not in timing (where many expected a more immediate hit).

Figure two: Quarterly GDP growth – UK relative to EU 28



Source: Eurostat

Some analysis of the expected short-run impacts of Brexit, conducted prior to the referendum, noted the potential for an even larger negative impact (an example would be that undertaken by HM Treasury). However, it should be noted that in the event, the triggering of Article 50 was delayed; there was little short-term political instability; offsetting monetary policy interventions were implemented by the Bank of England and the context for the aftermath of the vote was strong global economic performance.

Shorter-term economic prospects

Prospects for the next few years depend crucially on the form of any final Brexit deal, including transition arrangements. There is a strong consensus among independent mainstream economists that the eventual impact on the UK economy will be directly proportional to the degree of access retained to the EU single market, with estimates ranging up to 10% of annual income under the “harder” versions of Brexit. In addition, a “cliff edge” transition, as a result of no deal, would be expected to result in a very high level of immediate disruption.

In this respect, economic expectations are almost entirely dependent on developments in the political arena.

A number of studies have considered how different parts of the UK may fare under Brexit. Again, much depends on the form Brexit may take, but as a higher proportion of Welsh exports are sent to the EU than is the case for the UK as a whole, it is

reasonable to expect that the impact on Wales would be more than averagely negative.

Longer-term economic prospects: UK context

Slow productivity growth over the last decade has resulted in very little growth in people's real incomes and contributed to the challenges faced in funding public services. The reasons for this trend, which is unprecedented in modern economic history – and which has affected the UK particularly badly – are not completely understood. If the trend continues, it may result in profound social and political challenges.

The economic drivers of living standards

Over the long term, the driver of higher material living standards is economic growth. Economic growth delivers increases in real wages and provides the potential sources of tax revenues to protect the vulnerable, to deliver high-quality public services.

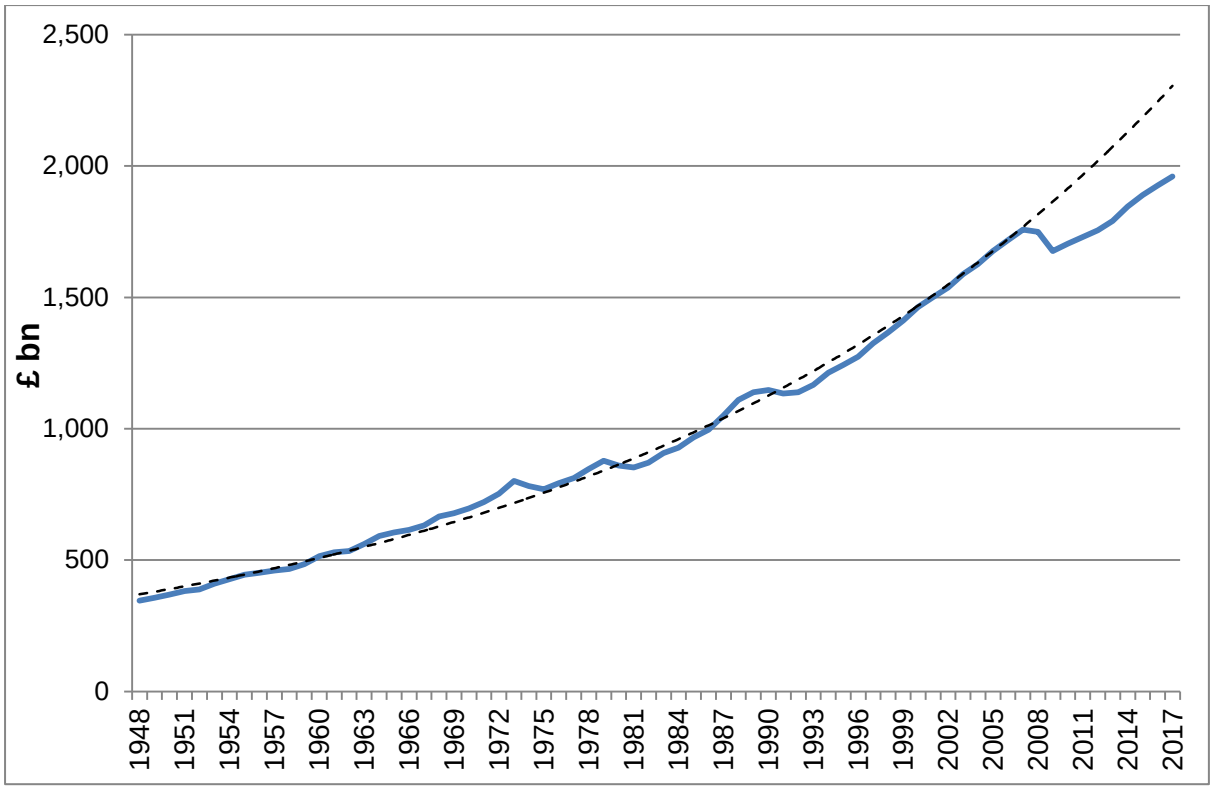
In turn, long-term economic growth depends on improvements in productivity – the efficiency with which outputs are produced from inputs. Productivity improvements derive from innovation in the broad sense – from new or better ways of producing existing goods and services and from the production of new or better goods and services. However, not all countries and regions are, or could be, leaders at the earliest stages of innovation. Indeed, research indicates that for most countries and regions, having the capacity to effectively "absorb" and apply innovations developed elsewhere is the key to promoting economic growth.

The UK growth slowdown

At least since around the time of the great recession that started in 2008, the rate of economic growth across developed countries has slowed sharply.

This slowdown has been particularly marked in the UK, with the result that the level of output is now around 15% lower than it would have been had previous trends continued (see figure three). In the UK context, the slowdown in productivity growth has been offset to some extent by increases in employment rates – to record levels. If this had not happened, the growth shortfall would have been around 20%, rather than the 15% illustrated in figure three. Of course, employment rates cannot increase indefinitely, and with employment rates at, or close, to historic highs, this source of growth is probably close to exhaustion.

Figure three: UK real GDP, actual and pre-recession trend



Source: ONS, Welsh Government

This prolonged slowdown in growth is unprecedented in modern economic history – annual productivity growth has averaged around 2% per year over at least the last century and probably since the industrial revolution.

The slowdown in growth has resulted in little average growth in people's real incomes for a decade or so. This is again unprecedented in modern economic history. The slowdown has also been a major factor in the failure of tax revenues to grow in line with past trends, thereby contributing to the challenges faced in funding public services – although of course the UK Government's political choices about taxation levels and the distribution of public spending have also been crucial.

It should be noted that there has been little change in income inequality across the UK over the last decade (with the big increase in income inequality across the UK occurring over the 1980s) – the defining feature of the last decade has been the sluggish growth in real incomes, not an increase in inequality (although analysis by the IFS and the Resolution Foundation indicates that this is likely to change if the further welfare cuts planned by the UK Government go ahead).

The reasons for the slowdown in productivity growth, and particularly the explanation for the UK's particularly poor performance since the recession remain unclear and open to dispute. In part, the UK's unusually poor performance may be the

counterpart to its strong labour market performance, with high employment reflecting a flexible labour market and consequently reduced pressure on firms to invest and innovate.

Of course, in addition to the worse-than-average slowdown in productivity performance in the UK, the UK has a long-standing problem of lower levels of labour productivity when compared with many other developed countries. Research indicates this problem is linked to a greater prevalence in the UK of “lagging” businesses with very low productivity levels but also to weakness in the fundamental drivers of productivity, education and skills training particularly at the “lower end”, and low investment in both infrastructure and businesses.

As the OECD has argued, a focus on education and skills at the lower end also has the merit of helping to promote inclusive growth.

Prospects for a recovery in productivity growth

While there is far from a complete consensus about the causes of the international slowdown in productivity growth, a range of research has indicated that contributory factors may include:

- The fading of a boost to productivity from ICT which occurred in the 1990s
- The continuing legacy of the great recession, which has had “scarring” effects on the willingness of firms to invest and the capacity of financial institutions to lend to support investment.

At the same time as developed countries have witnessed a prolonged productivity slowdown there has been much discussion about the implications of automation in general (and digital technologies in particular) for employment. There is a paradox here – employment rates are currently at, or close to, record levels, and slow productivity growth is, in principle, more likely to reflect slow, rather than fast, innovation.

In addition, of course, automation in the past has *not* led to a reduction in job numbers, as increased demand (driven in part by higher incomes) has led to the creation of new jobs which have more than offset the jobs that have been lost. However, this may not be true in the future and the more general implications of new technologies merit much careful study, such as is being undertaken as part of the Welsh Government’s digital innovation review.

One possibility is that new technologies introduced in recent years are bringing about very fundamental changes across the economy, which will take many years to play out, and that the “growth pause” seen in recent years reflects a temporary phase as the disruptive effects of change mask the potential gains that the new technologies will bring.

A number of commentators have argued that if productivity growth does not resume at a rate somewhere close to its long term trends, supporting an increase in living standards over time, there could be the most profound social and political implications as result of disappointed expectations, particularly amongst those on low incomes.

Welsh economic performance over the longer term

The performance of the economy in Wales since devolution has been mixed; a significant relative improvement in employment rates – driven by reduced inactivity, and concentrated in West Wales and the South Wales Valleys – has been offset by a relative deterioration in productivity and in pay, which are closely related.

Overall, the limited change in relative GVA per head in Wales has reflected these largely offsetting effects. However, in the two most recent years of data (2015 and 2016), GVA per head has grown faster in Wales than across the UK as a whole.

Future improvements in Wales' relative economic performance will depend crucially, but not exclusively, on the success of policies to improve education and skill levels and on better transport and communication links.

Welsh economic performance since devolution

Over the short to medium term, by far the single most important influence on Welsh economic outcomes is the performance of the UK economy.

Over the longer term, Welsh Government policies – particularly education, skills and infrastructure – are critical, but even here the UK context is important, particularly in respect of any meaningful recovery in productivity.

Compared to many other countries, the UK is more spatially unbalanced, with London and greater South East dominant to a greater extent than leading regions in many other countries. This reflects a complex mix of historical and geographical factors, but UK Government policies, for example on infrastructure investment and on the structure of taxation and the distribution of spending, are also likely to have important effects.

Given the close integration of the economy in Wales with the rest of the UK, it is natural to assess Welsh economic performance in the UK context. In these terms, and taking the period since devolution in 1999, the relative performance of the economy in Wales has been mixed.

As indicated in figure one, in respect of the indicator GVA per head, Wales has remained at the bottom of the league table of UK countries and regions. However, this indicator has a number of limitations which means that, taken in isolation, it does not fully reflect economic performance.

Firstly, owing to its demographic structure, Wales has a relatively large dependent population, which contributes relatively little to GVA. Secondly, Wales experiences net out-commuting. Out-commuters contribute to Welsh incomes but not (directly) to Welsh GVA. Thirdly, there is a wide body of evidence which shows that, holding other things equal, productivity (GVA per hour worked) and pay tend to be higher in large centres and lower in more sparsely populated areas.

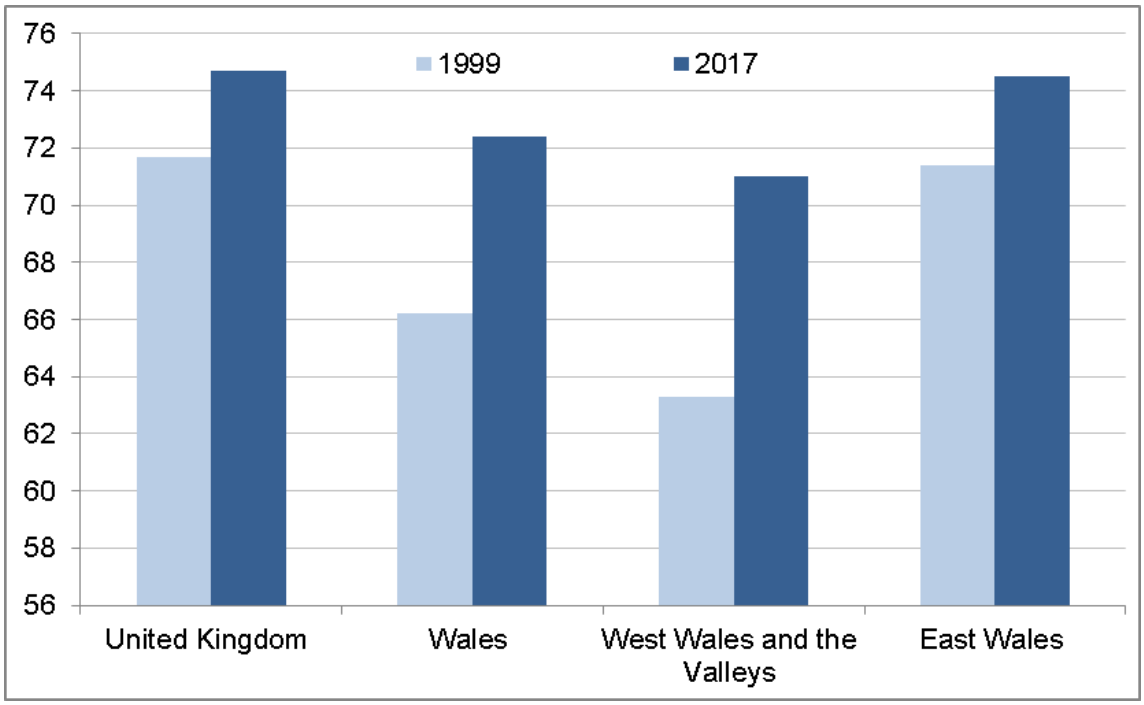
For these reasons, it is important to consider a set of economic indicators, rather than a single measure like GVA per head. The Welsh Government publishes, and regularly updates, a set of economic indicators, available here:

https://gov.wales/statistics-and-research/economic-indicators/?lang=en

Over the period since devolution, Wales has demonstrated a relatively strong performance on employment, unemployment and inactivity, but less so on productivity and pay (which are closely related). This has resulted in a situation where, on the latest data, Wales ranks bottom out of the 12 UK countries and regions on productivity and pay but does rather better on employment rates and on household income (the single best measure of economic wellbeing), ranking above the North East of England and Northern Ireland on each.

The marked improvements in employment rates across Wales since devolution are shown in figure four.

Figure four: Employment rate, Wales and UK 1999 and 2017



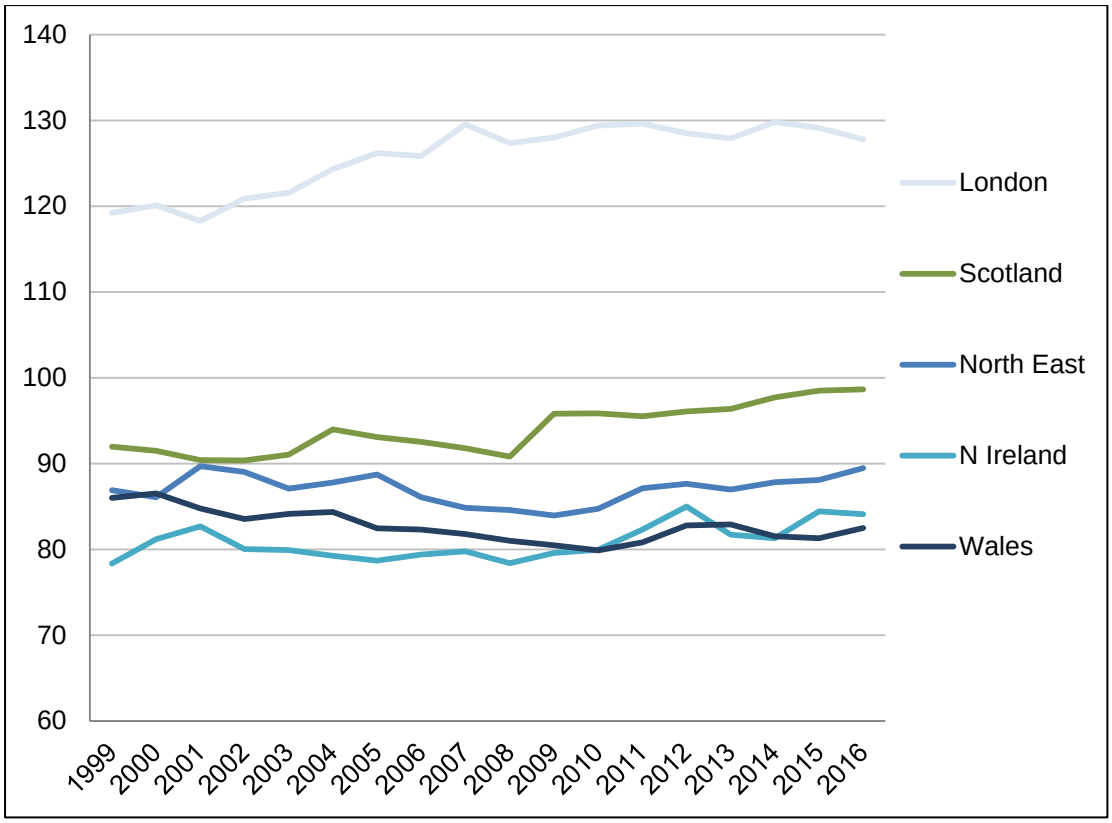
Source: ONS

Figure four shows that the gap in employment rates between Wales and the UK as a whole has narrowed significantly since devolution, with the greatest improvement in West Wales and the South Wales Valleys. The improvement has been mainly driven by a reduction in inactivity. The improvement in the employment rate has been especially pronounced for women.

Wales has moved from a position in the 1990s where its labour market performance was anomalous in the UK context, and markedly worse than that across Northern England, to a position where this is no longer the case, although there is further progress to be made if the gap with rest of the UK is to be completely closed.

As previously noted, and as figure five shows, similar progress has not been made on productivity (and there has been a similar lack of progress on pay, which is closely linked to productivity).

Figure five: GVA per hour worked (UK=100)



Source: ONS

Figure five shows productivity (GVA per hour worked) for Wales and a selection of UK countries and regions, all expressed relative to the average for the UK as whole.

After a period of decline, Welsh relative productivity has stabilised since around 2010 and may have improved modestly. The reasons for this trend are not fully understood but it may be that improvements in the labour market, concentrated in the earlier part of the period, were associated with the entry into employment of people (particularly women) with lower than average skill levels who would previously have been inactive.

Taking the whole period since devolution, the change in relative GVA per head in Wales has reflected the largely-offsetting effects of the improvement in the employment rate and the deterioration in relative productivity. However, over the most recent two years, GVA per head has grown faster in Wales than across the UK as a whole.

<u>Prospects for Welsh relative economic performance over the long term</u>

Going forward, Welsh relative economic performance will be shaped by the extent to which:

- Productivity and pay increase;

- Labour market performance can be further improved, eliminating the gap in employment rates between Wales and the UK as a whole.

As considered further below, following tax devolution, progress in these areas would also have important implications for the Welsh tax base and hence for the revenues available to the Welsh Government to fund public services.

Analysis by the ONS and the Welsh Government indicates that relative productivity differences across the UK are *not* strongly influenced by variations in industry mix – productivity differences within industries are much more important.

Research also suggests a strong link between productivity across the UK and qualification levels, and, having allowed for this, with "economic mass" – that is, with having larger and more densely-populated centres of economic activity.

The association of productivity (and pay) with economic mass is much stronger in service industries than in manufacturing, and is driven by a range of factors, including, for example, the better matching of people and jobs that can take place in large centres.

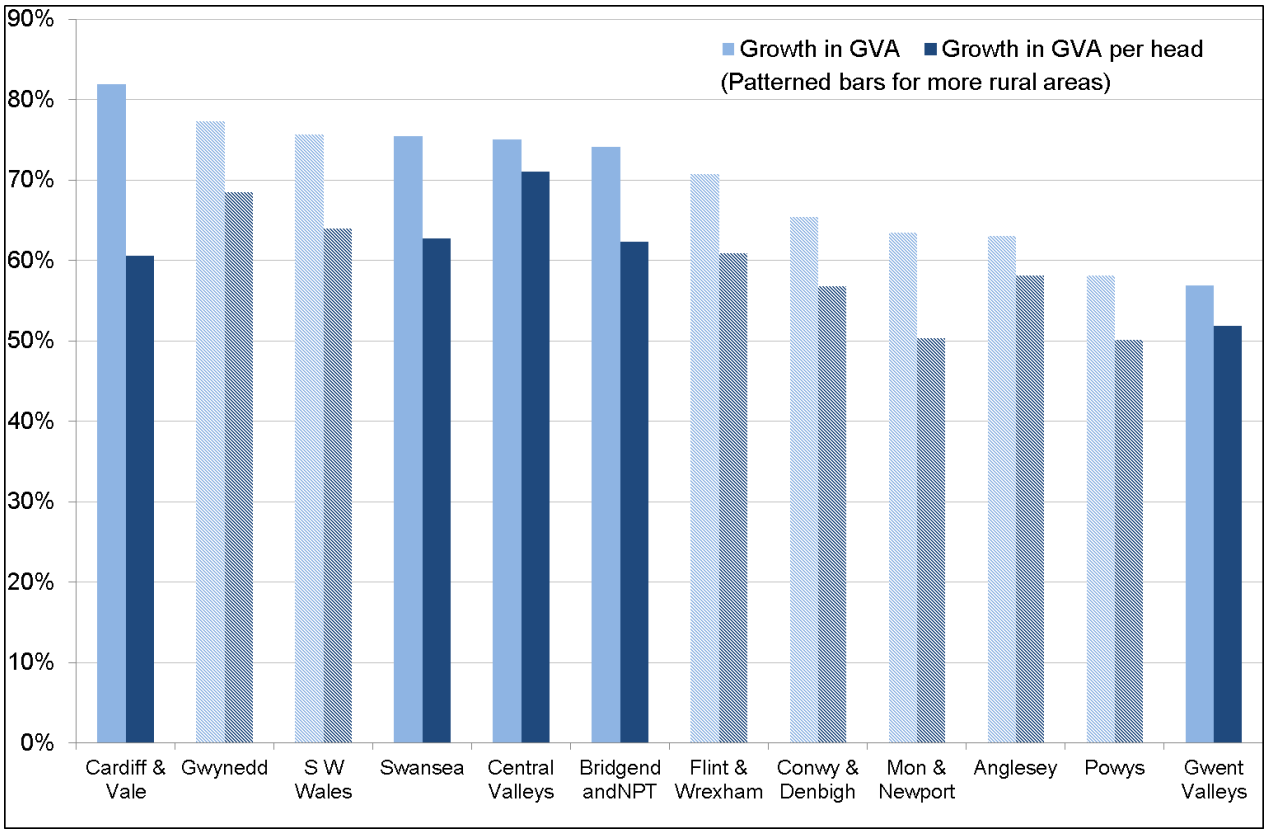
At the highest level, therefore, the success of policies to improve levels of education and skills, and to help to increase effective economic mass by improving transport and communication links, will be crucial to improving Wales' relative productivity performance.

While productivity *levels* are related positively to economic mass (and hence negatively to population sparsity), there is no simple relationship between economic mass and *growth*. Figure six shows the growth in total GVA and in GVA per head for statistical sub-regions of Wales over the period since just before devolution (averages are used to reduce volatility in the data, which should in any case be seen as illustrative of broad patterns rather than definitive of the position in individual sub-regions). These figures are not adjusted for inflation, so illustrate the *relative* performance of sub-regions, rather than real increases in GVA[1].

Predominantly urban sub-regions are shown in red, rural sub-regions in green. Cardiff and the Vale of Glamorgan has experienced the largest increase in total GVA. But it also had a large increase in population, so GVA per head has risen less than in many other sub-regions.

[1] It should be stressed that Chart 6 shows *changes* in GVA. *Levels* of GVA, particularly for sub-regions, are strongly affected by commuting patters and should be interpreted with great care

Figure six: GVA and GVA per head, 2014-16 and 1996-98



Source: Welsh Government

Figure six does not demonstrate any clear geographic pattern. Contrary to some commentary, GVA growth in rural areas has not been systematically lower than in urban areas.

It follows from this that, while Wales' relative performance in terms of *levels* of productivity and pay is disadvantaged by a lack of economic mass, these factors do not imply that prospective *growth* in productivity and pay need be lower in Wales than elsewhere for this reason.

Last year's report contained further information about geographic differences in economic performance within Wales. Geographical factors are important but typically have their effects over the long term and often indirectly. As last year's report showed, people with similar characteristics – most importantly qualifications, but also health status and other factors – have broadly similar chances of being in employment wherever they live in Wales, or indeed across the UK.

UK fiscal context

Analysis by the Office for Budget Responsibility (OBR) indicates that, following an unprecedented decade of real reductions in spending on public

services, UK Government policies imply a further five years of constrained spending. The extent of this constraint will depend on how far the recently-announced additional spending for the NHS in England is offset by reductions elsewhere.

The OBR's longer-term fiscal projections indicate the UK's public finances are fiscally unsustainable in the sense that, meeting their central projections for the demand for public services without tax increases, would result in ever-increasing public debt.

UK's short-term fiscal prospects

The UK fiscal context is, and will remain, critically important for the public finances in Wales, as Wales receives a large proportion of its public funding in the form of a block grant from the UK government. Even after tax devolution, more than 70% of devolved spending will be sourced from the block grant

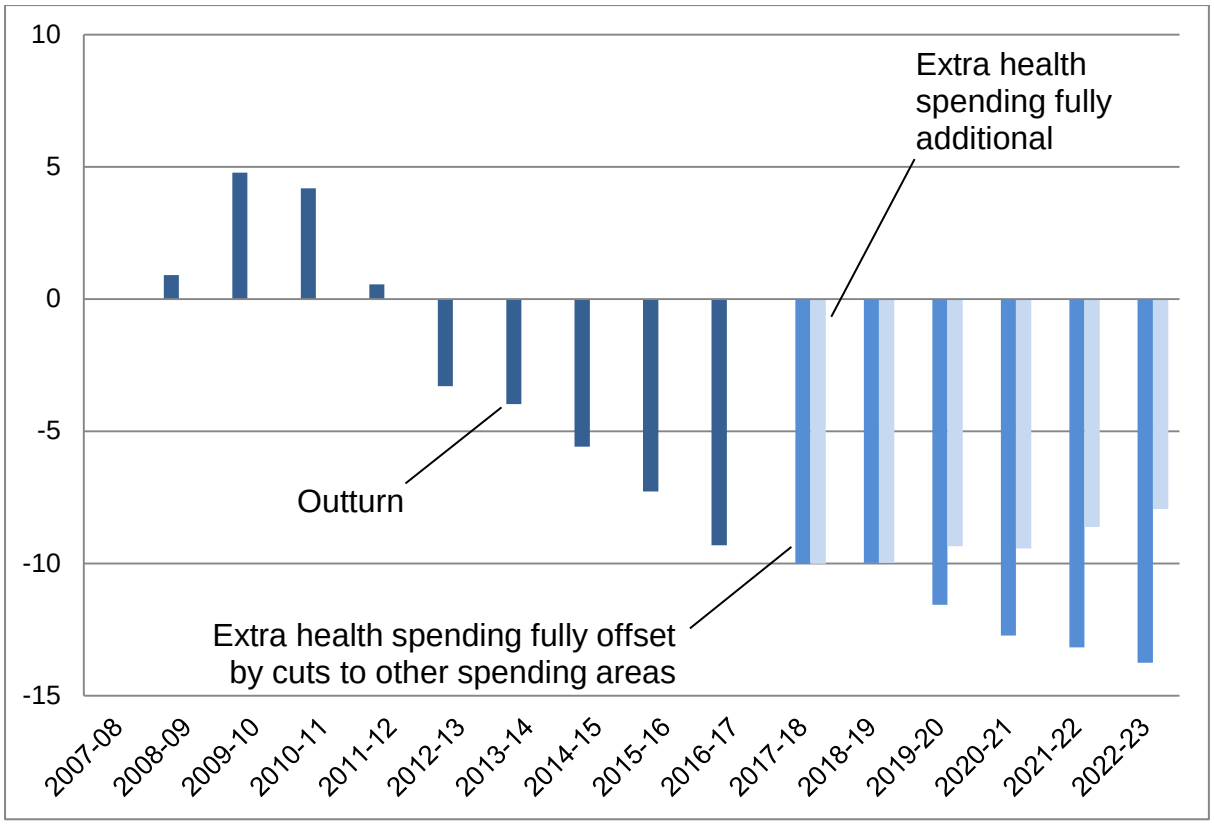
The UK is in a process of unprecedented fiscal retrenchment. In part, this reflects the legacy of the recession, and in particular the failure of the economy to resume historic rates of growth as described above[2]. It also reflects the choices on spending and taxation made by recent UK governments.

The Office for Budget Responsibility (OBR) has shown that, despite austerity, the slow rate of economic growth has resulted in the share of public spending in UK GVA being close to historic averages. Within this context, the UK Government has made specific choices, particularly on taxation, which have resulted in day-to-day spending on public services (termed RDEL) being cut severely in real terms.

Figure seven shows the cumulative percentage reduction in real spending on day-to-day public services across the UK as a whole. It shows outturn figures and two spending forecast scenarios following the extra health spending announced in June 2018. The first spending forecast assumes the extra spending on health announced in June 2018 is fully offset by cuts to other areas of government spending. The second forecast assumes the extra spending is fully additional. The UK Government has yet to clarify how far, if at all, the extra spending will be additional.

[2] It may also be that the very process of cutting public spending has contributed to the growth slowdown.

Figure seven: Cumulative change in real RDEL per head (%)



Source: OBR

It can be seen that even if the extra health spending is fully additional, it will only offset the real cuts already made, leaving real day-to-day spending on public services around 8% below where it was in 2007-08.

In addition, of course, there have been large real cuts to welfare spending, with more planned by the UK Government. These cuts will impact particularly severely in Wales due to its lower-than-average income levels and higher levels of sickness and disadvantage.

UK's longer-term fiscal prospects

The OBR has recently reviewed the UK's long-run fiscal prospects in its *Fiscal Sustainability Report*, in which it projects UK public spending and tax revenues over the period to the 2060s. Spending is projected on the basis of expected demand and is, in this sense, unconstrained by tax revenues, which are projected broadly on the basis of maintaining their historic average share of national income.

Key drivers of demand are demographic change (affecting particularly pensions, health and social care) and the tendency of the costs of providing health and social care to rise faster than other goods and services. (In fact, under the baseline projections, the impact on health expenditure from cost pressures is greater than that from demographic change.)

The OBR's baseline projection is shown in figure eight. The primary balance is the extent to which public spending exceeds tax revenues before paying the interest on public sector debt. A negative primary balance adds to debt (or more fully, public sector net debt (PSND)). The figure shows that, on the baseline projection, the primary balance is increasingly negative over the period, with public sector debt increasing towards 300% of GDP.

The OBR regards this as fiscally unsustainable, implying it is likely that a future government will respond by implementing some combination of reductions to public spending and/or increases in revenue.

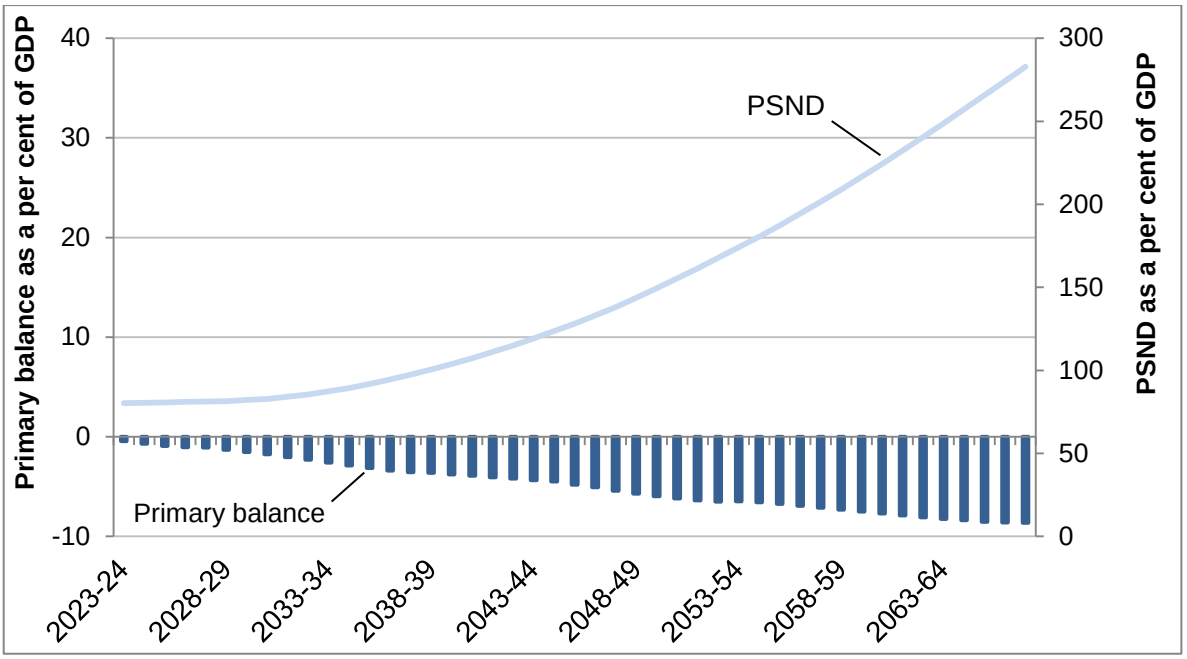
In respect of the former, this would imply that public spending would be constrained below the level needed to meet demand pressures. In respect of the latter, it should be noted that tax revenues, as a share of national income, are currently broadly in line with the historic average. The OBR's latest forecasts (March 2018) indicate that current receipts (mainly tax revenues) are expected to peak at 36.8% of GDP in 2020-21 – this would be the highest level since 1986-87[3].

The OBR notes that projections of future spending needs are highly uncertain and a variety of scenarios are possible. However, a combination of very favourable assumptions would be needed to deliver fiscal sustainability over the long-run on the assumption that the share of tax is kept close to its historical average.

Recent demographic statistics from the ONS suggests the historic increase in life expectancy across the UK may have stalled in recent years. A similar slowdown has been seen in many other developed countries, although to a lesser degree. It is too soon to determine whether this slowdown represents a "blip" or a change in trend. But it should also be noted that the ageing of the population is driven by a change over time in population "mix", reflecting a birth rate for the indigenous population that lies below the "replacement rate", and not just by increased longevity.

[3] However, there are many developed countries with higher taxation shares in GDP.

Figure eight: Baseline projections of the primary balance and PSND



Source: OBR

Welsh fiscal prospects

Welsh fiscal prospects depend heavily on the UK Government's fiscal position and policies as these determine the size of the block grant, and to a lesser but still significant extent, on the revenues raised from devolved taxes.

The position over the medium term – to 2022-23 – will depend in part on the approach taken by the UK Government to funding the recently-announced increase in spending for the NHS in England.

The long-term UK Government fiscal position and policies are uncertain and several scenarios are presented. However, the analysis undertaken by the OBR implies that the assumption of a prolonged period of fiscal restraint should remain at the core of the central scenario.

Devolved Welsh taxes will account for around 30% of spending on devolved public services in Wales. The devolved tax base faces certain risks but it also presents opportunities for the Welsh Government to design policies to develop the tax base and thereby increase tax revenues.

Welsh fiscal context

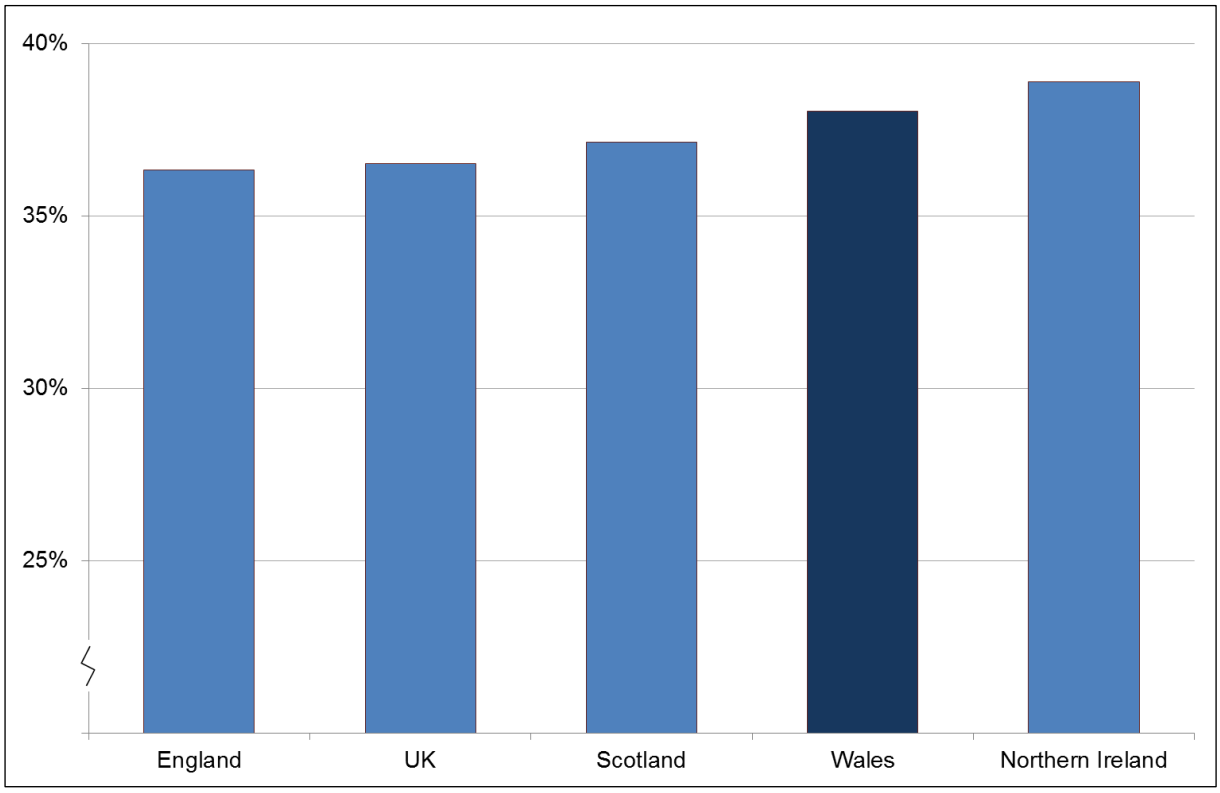
In common with all parts of the UK outside London, public spending in Wales is higher than tax revenue. This is unsurprising in a fiscal union in which some taxes

are progressive and there is some redistribution in favour of people with lower levels of income.

In the most recent year for which data are available – 2016-17 – ONS figures shows that total receipts (overwhelmingly taxes) derived from Wales were around £26bn. Total public expenditure undertaken either in Wales or on behalf of Welsh citizens exceeded this by around £13bn.

Similar imbalances are seen in other UK countries and regions with higher levels of need and lower levels of income. Total receipts as a percentage of GDP, a measure of tax effort, was higher in Wales than across the UK as a whole (figure nine).

Figure nine: Tax revenues as a percentage of GDP in 2016-17



Source: ONS and Welsh Government

Out of total public expenditure in Wales in 2016-17, around 90% was “identifiable” – that is, directly benefiting the residents or enterprises in Wales. Around 10% was non-identifiable – that is, spent on behalf of the UK as a whole, such as interest payments on public debt, international aid and military spending.

Spending in devolved areas accounted for nearly half of public expenditure in Wales.

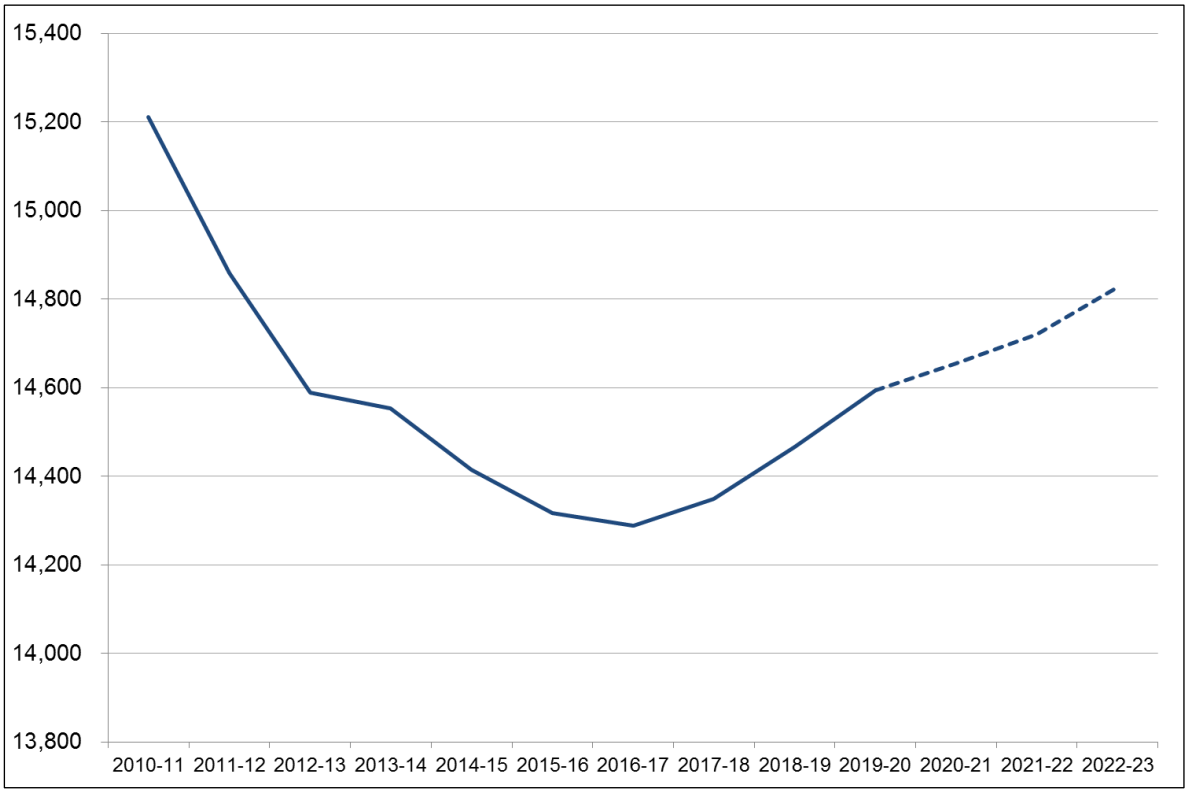
Welsh medium-term fiscal prospects – 2019-20 to 2022-23

In assessing fiscal prospects for Wales over the medium term, the continuing importance of the block grant, even after tax devolution, means the analysis set out by the OBR in its March *Economic and Fiscal Outlook* and in July in its *Fiscal Sustainability Report* should form the starting point.

The medium term projection assumes that all of the announced NHS increase in 2019-20 feeds through to increase the overall Wales Resource DEL. Beyond that, it is assumed that the NHS announcement is increasingly funded by spending cuts in "non-protected" departments – up to 50% by 2022-23.

In this scenario, the overall Wales resource budget would grow by around 2% in real terms between 2019-20 and 2022-23 (see figure 10). The annual growth rate of 0.5% a year from 2020-21 onwards is similar to the average over recent years. Within the overall budget, if growth in the Welsh NHS budget is maintained at the same rate as that announced by the UK Government for England, the rest of the budget would decline in real terms by 2% a year after 2019-20.

Figure 10: Medium-term projection for Welsh Government resource budget in real terms (£m, 2017-18 prices)



Source: Welsh Government

Welsh longer-term fiscal prospects – 2023-24 to 2029-30

The longer-term projections use the medium-term scenario set out above as a starting point. We then apply one of three scenarios up to 2029-30 (see figure 11).

Scenario one: OBR “demand-based” spending projections

- Based on the OBR’s headline projections for relevant non-interest, non-benefit spending from the 2018 *Fiscal Sustainability Report*. UK Government spending relevant to block grant funding grows around 1% a year faster than GDP, reflecting increased demand from factors, such as an ageing population and increases in the real costs of providing health and care.
- The OBR states that spending under this scenario would be unsustainable under current taxation policies.

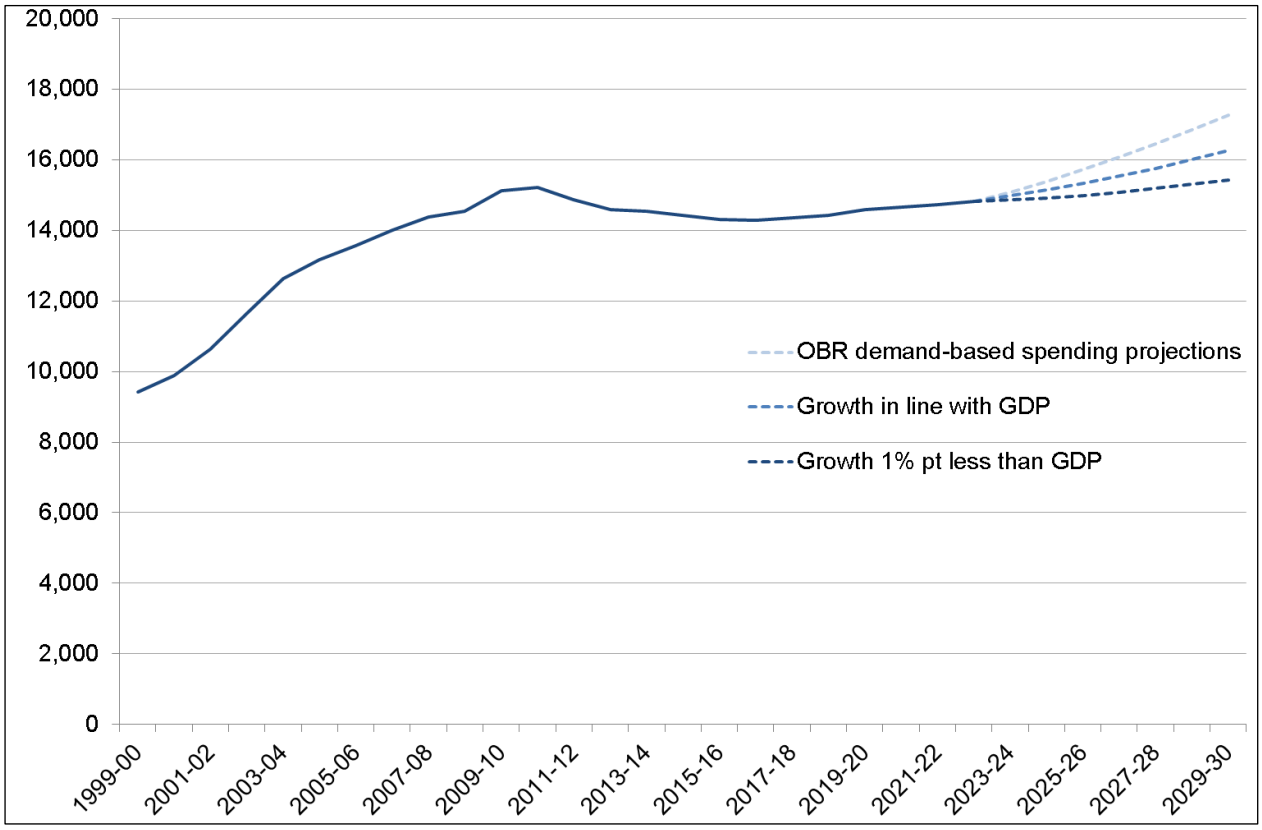
Scenario two: Growth in line with GDP

- UK Government spending relevant to Welsh Government block grant funding for day-to-day spending grows at the same pace as the UK economy. This level of spending might be considered more affordable than that implied by the first scenario by a UK Government unwilling to increase the share of national income taken in taxation.

Scenario three: Growth one percentage point less than GDP

- Relevant UK Government spending grows one percentage point slower than the UK economy, reflecting a scenario where the UK Government adopts a policy to reduce public sector net debt, currently at a level which may be regarded as excessive.

Figure 11: Long-term projections for Welsh Government day to day spending (resource budget) in real terms, under three scenarios, £m



Source: Welsh Government

In broad terms, the key conclusion here is that even a demand-led scenario only takes Welsh Government funding back to pre-recession rates of growth and does nothing to restore the lost growth over the last decade.

Crucially, this scenario may well be regarded as implausibly optimistic, unless it is envisaged either that the UK Government is prepared to raise UK taxes to a point where they represent a share of national income which is significantly higher than the historic average or see public sector debt rise to unprecedented levels.

The lower scenario, in which the UK Government reduces public sector debt, would see the Welsh Government budget growing at the same subdued rate as in recent years and only recover to its 2010-11 level by the end of the next decade.

This scenario, combined with an NHS budget which continues to grow at the same rate as announced for England for the next few years would mean funding for the rest of devolved public services falling by more than 20% in real terms over the next decade. Even if relevant UK Government spending grows in line with GDP (the second scenario), those increases in the NHS budget would mean the rest of the Welsh Government budget would see a 10% real terms reduction over the next decade.

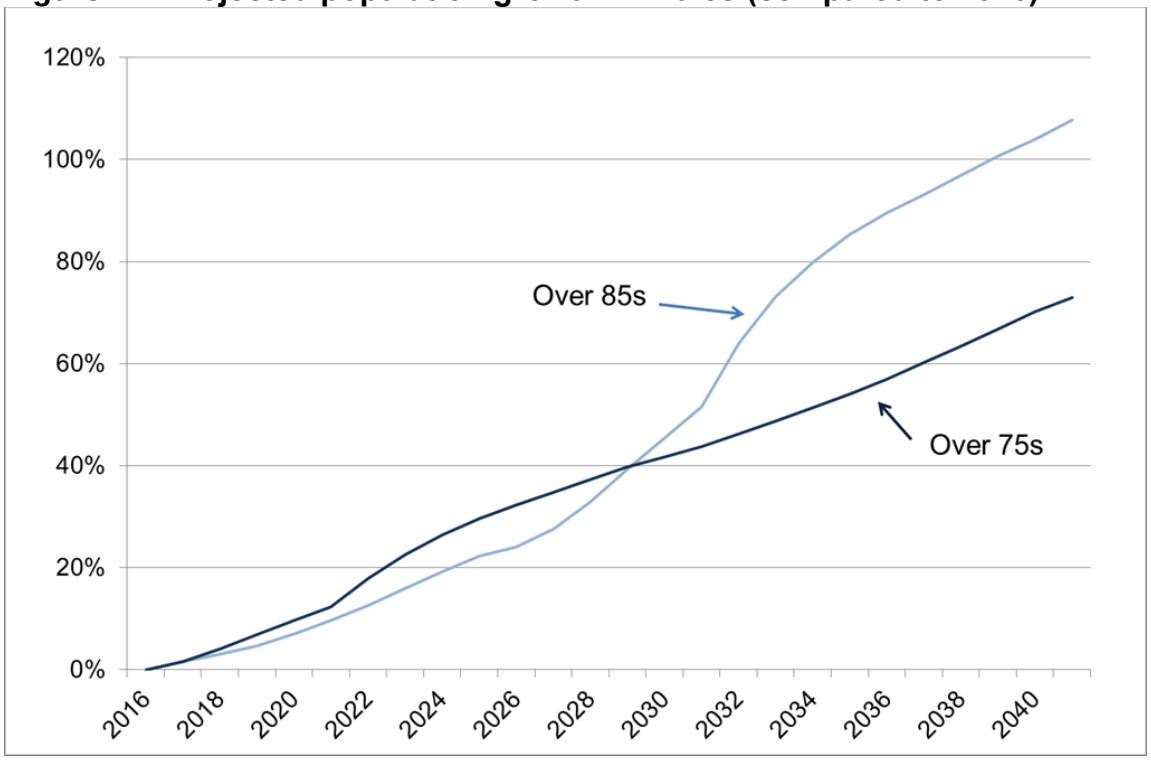
“Demand” for public services in Wales

The OBR *Fiscal Sustainability Report* systematically explores longer-run demand pressures on public spending across the UK resulting from *changes* in the factors that drive demand and in the factors that increase costs.

In many respects, the *changes* projected in Wales are very similar to those across the UK as a whole.

This is because the key factors driving these changes are similar. These factors include similar demographic changes, with an ageing population increasing demands on health and social care, partly through the increasing prevalence of complex conditions and co-morbidities (see figure 12).

Figure 12: Projected population growth in Wales (compared to 2016)



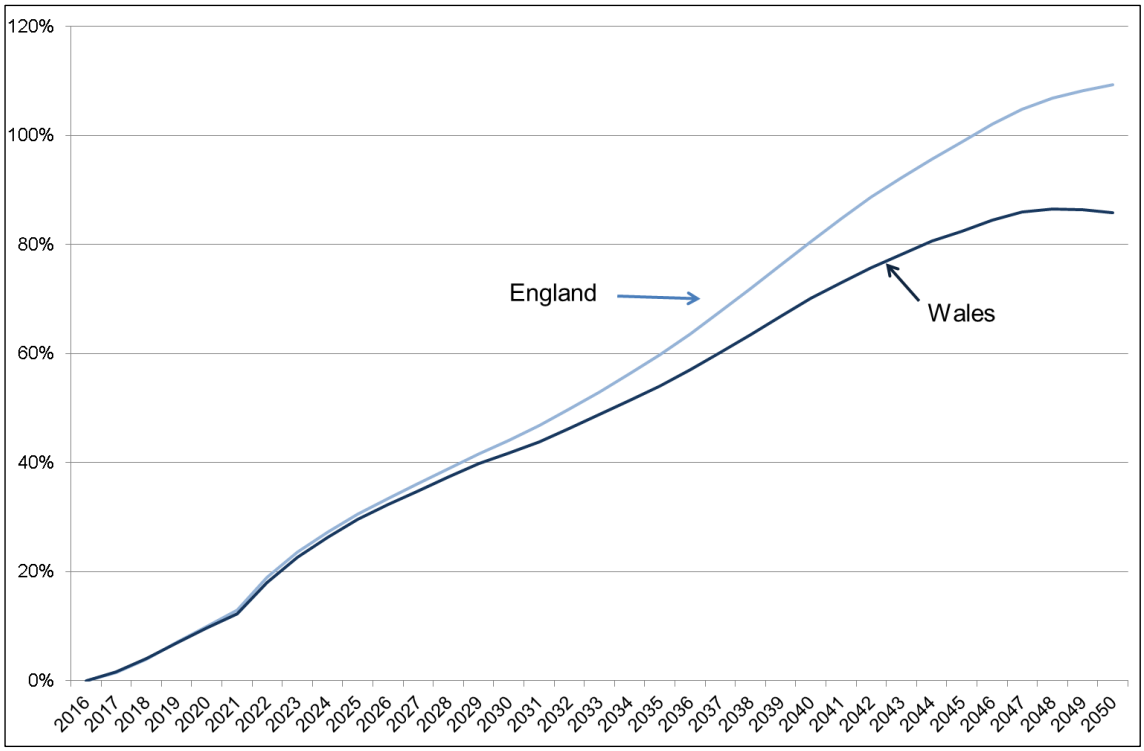
Source: ONS 2016-based principal projections

Common factors also include changes in the relative cost of the provision of health and social care (reflecting the labour-intensive nature of these services and the limited scope for productivity improvements) and the provision of new, and often expensive, medical treatments.

Wales also faces some critical uncertainties, which are similar to those seen across the UK as whole. New medical treatments (for example to prevent or treat dementia) could greatly reduce old-age dependency. Changes in international migration could have a major impact on future population size and structure. For Wales, population projections are crucially dependent on assumptions about UK “internal” migration, which is highly uncertain, and potentially open to policy action.

One consequence of the fact that demographic change is common to Wales and the UK as a whole is that, while Wales currently has a higher share of older people in its population, the projected *growth* in the share of older people in Wales is quite similar to that in England (see figure 13). So, other things equal, the *change* in demand should also be similar. It follows the extent that increased pressures are funded in England, Wales will receive its population-based share through the block grant. Of course, the UK and Welsh governments may well have differing views about the extent to which pressures should be funded.

Figure 13: Over-75 population growth (compared to 2016)



Source: ONS 2016-based principal projections

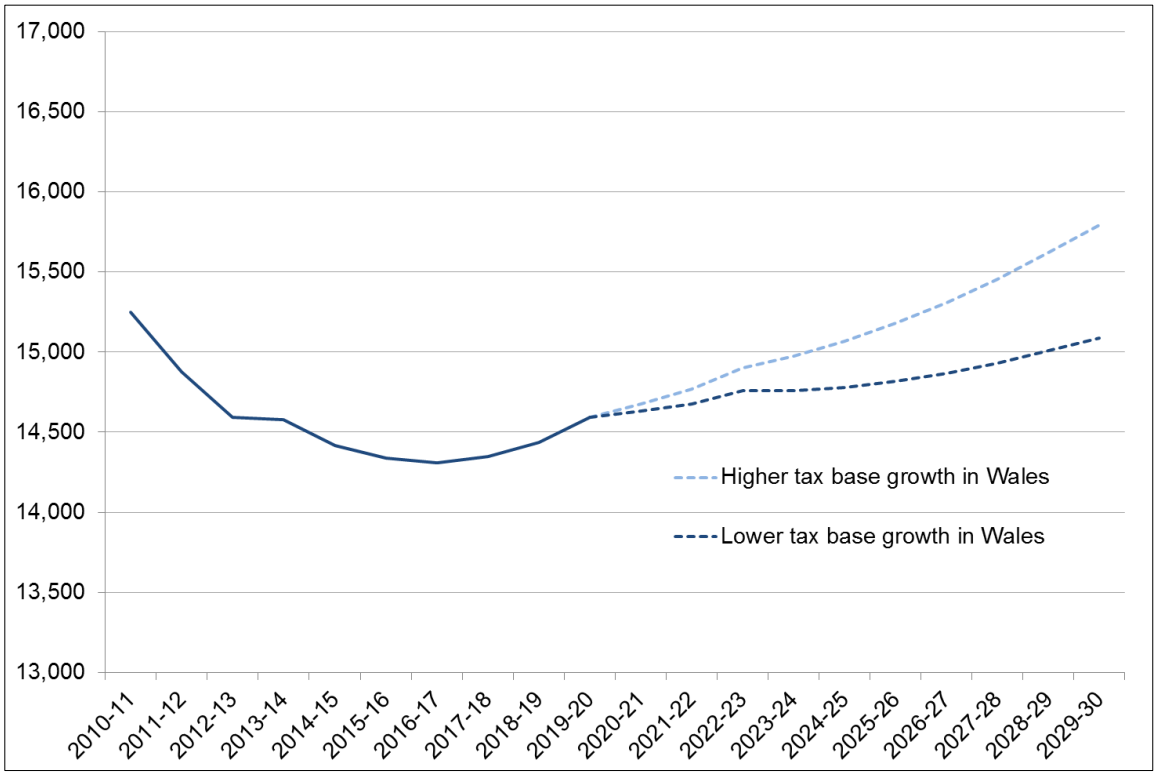
Following income tax devolution in Wales, as noted above, devolved and local taxes will account for almost 30% of spending in devolved areas. The level of Welsh Government spending will therefore be determined in part by the level of devolved and local taxes and the growth of the tax base in Wales.

The Welsh tax base

In respect of the growth of the tax base, the funding agreement between the Welsh and UK governments – the fiscal framework – offers some protection to the Welsh Government finances should there be lower rates of growth in the Welsh tax base (most importantly by insulating the Welsh Government from changes in the composition of income taxpayers across tax bands). The agreement also provides additional funding in the short to medium term and a long-term guarantee to stop convergence in relative funding caused by the Barnett formula.

These protections do not alter the fact that the Welsh Government's spending power will be affected by the performance of the tax base in Wales relative to the rest of the UK. This is illustrated in figure 14, showing what would happen to the Welsh Government's resource budget if devolved taxes in Wales grew 1% faster or slower each year than counterparts in England and Northern Ireland. By 2029-30, that could mean an increase or reduction of £400m in the Welsh Government's spending power.

Figure 14: Welsh Government resource budget with varying performance of devolved taxes (£m) 2017-18 prices



Source: Welsh Goverment

The Wales Centre for Public Policy (WCPP) report *Tax Risks and Opportunities in Wales* highlights some of the risks associated with the current Welsh tax base[4]:

- Proportionately fewer high earners (for a range of reasons, including the level and quality of jobs, related to qualification levels in the workforce);
- Lower property prices and rental values;
- Proportionately fewer high-value properties (and a lesser dependency on more valuable properties for tax revenue);

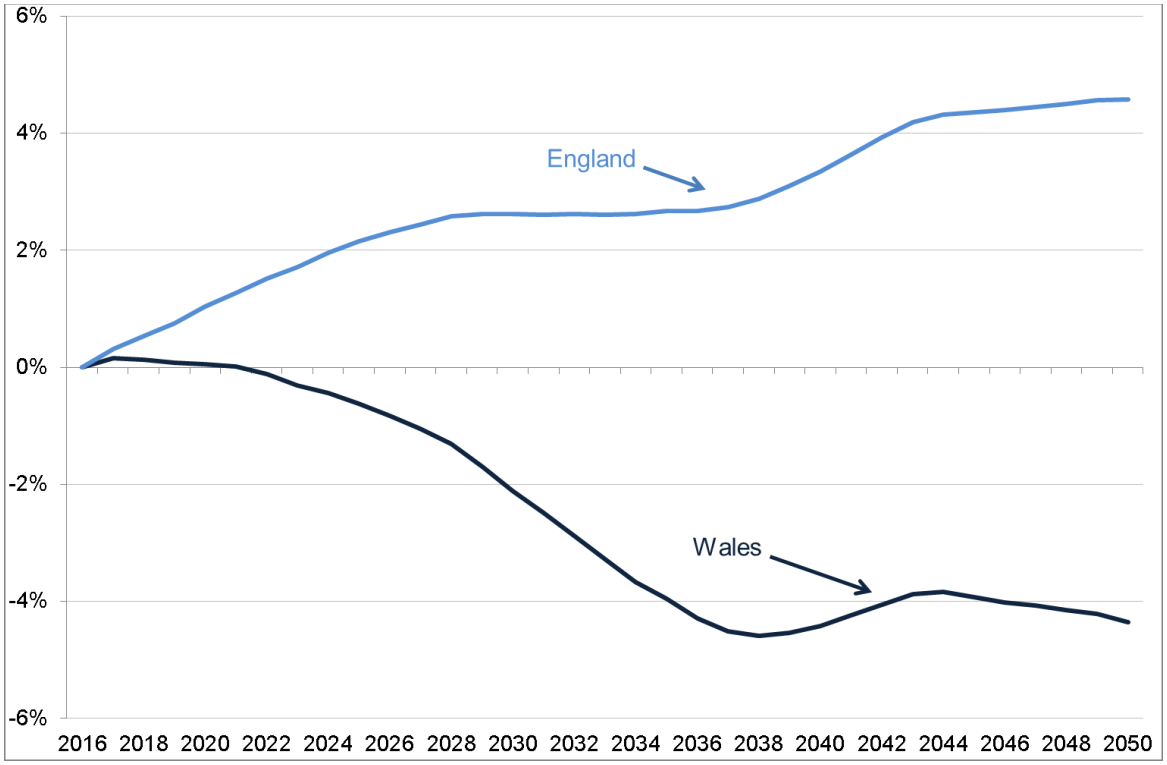
[4] In addition to the scale of the tax base, the efficiency of taxes and the rates at which they are set are obviously crucial and complex issues but are not discussed further in this report.

- A larger proportion of the population outside the workforce (relatively more older people and, despite improvements over the period since devolution, higher levels of inactivity in the working age population).

It should again be stressed that in all of these areas it is differential future growth between Wales and England, not levels, that matters. Nevertheless, some current trends represent real risks to tax revenue in Wales and in areas where Wales currently underperforms, such as employment rates and average pay (reflecting productivity); policies which close these gaps would generate additional tax revenues for the Welsh Government.

ONS population projections[5] point to a specific risk to the future Welsh tax base, with working age population forecast to grow more slowly than in England – see figure 15. Of course, and perhaps even more importantly, this also has broader implications for future Welsh relative economic performance and for social outcomes.

Figure 15: Growth in 16-64 population from 2016

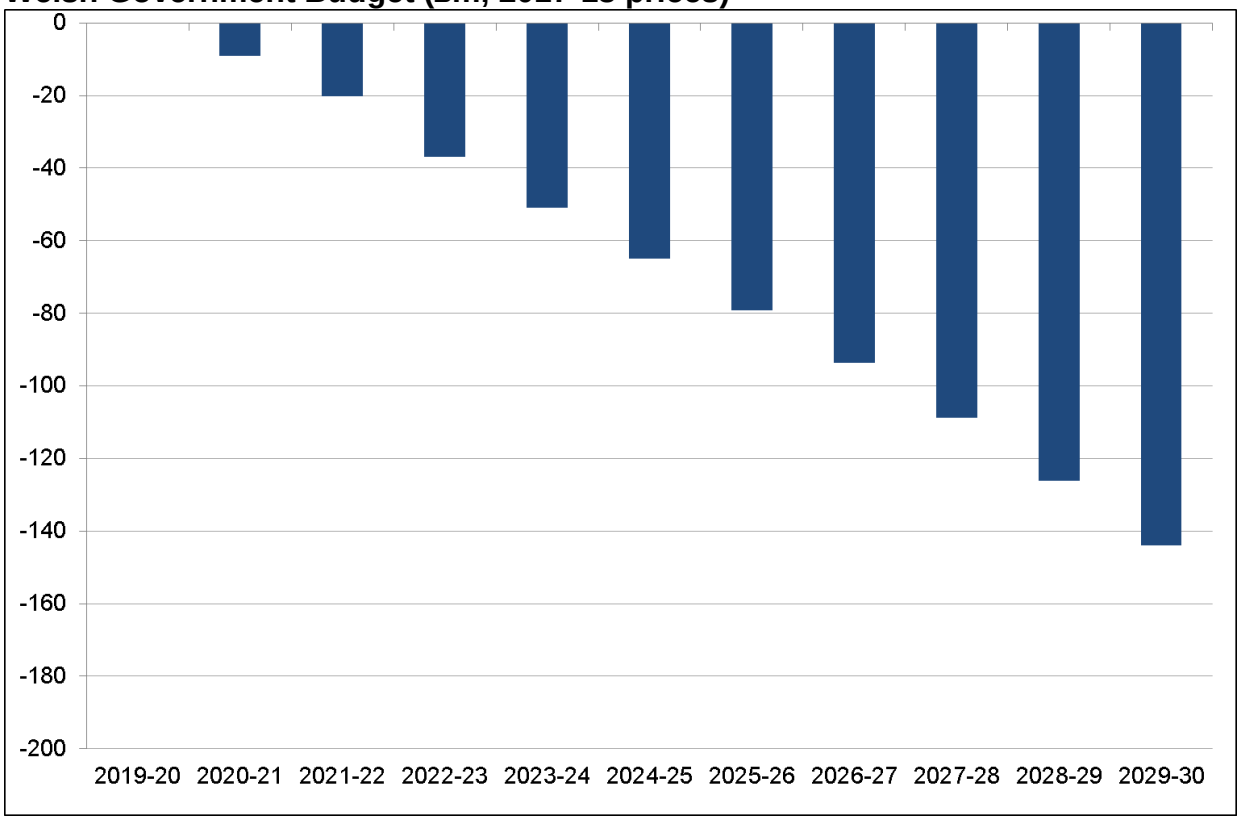


Source: ONS 2016 based principal projections

If slower growth in the working-age population in Wales feeds directly through to slower growth in devolved revenues, the impact on the Welsh Government budget could be nearly £150m a year by the end of the next decade (see figure 16).

[5] Which are however highly uncertain, not least due to their sensitivity to migration – and particularly migration that is internal to the UK.

Figure 16: Potential impact of slower working age population growth on the Welsh Government Budget (£m, 2017-18 prices)



Source: Welsh Government

If population trends in the following decade also reflect the latest population projections, this gap would continue to grow.

Of course, differential growth in working-age populations between Wales and England would have much wider economic and social consequences, but the focus here is more narrowly on the fiscal implications.

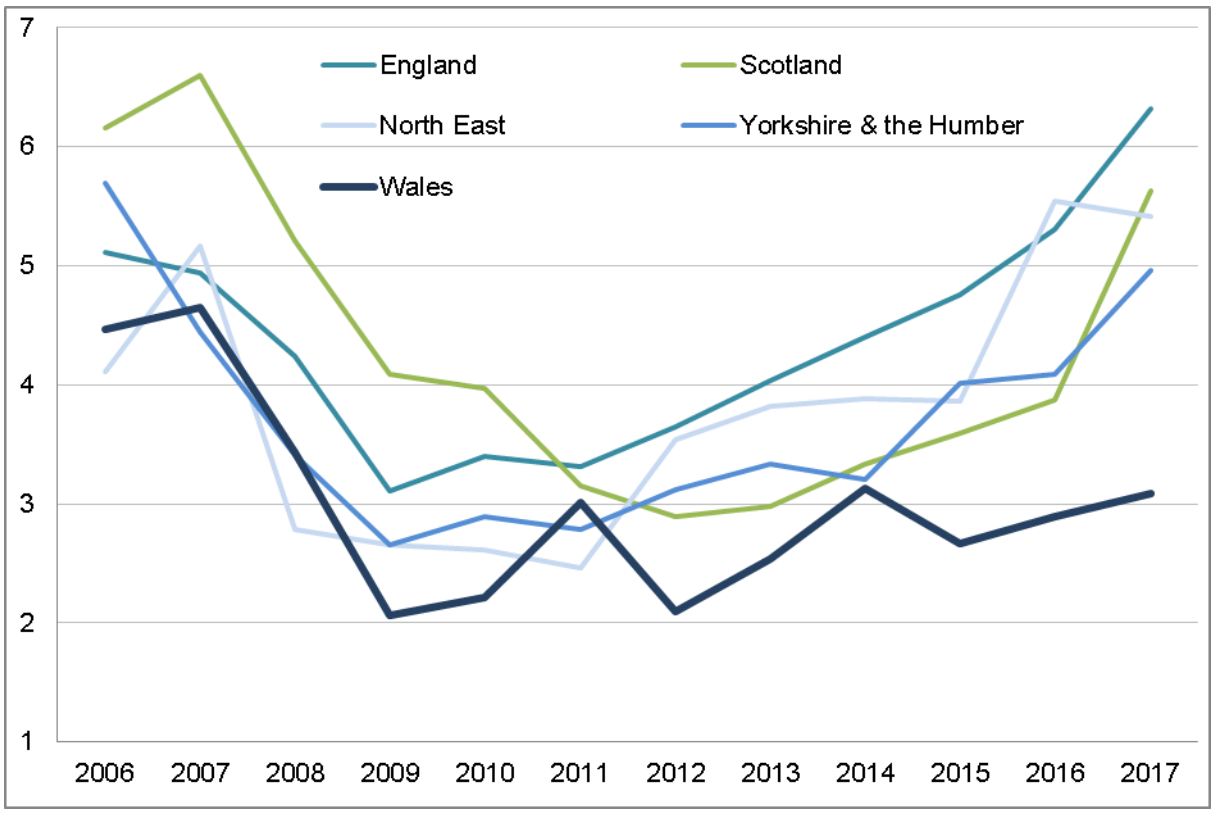
This report does not consider the potential policy responses which would raise a host of issues. However, in principle, there could be a range of options to address differential growth in the working-age population, particularly as many areas of Wales are potentially very attractive places for people to live and work.

Also relevant in this context is the WCPP's finding that out-commuters from Wales earn higher incomes and contribute more income tax than average workers.

The future supply of appropriate housing is one factor, which will influence the potential of Wales to retain, and attract, people of working age. Apart from the link to future population levels, housing supply also has direct implications for property tax revenues in Wales.

It is notable that data indicates the “pipeline” of housing units gaining planning approval in Wales is below what might be expected in comparison with other parts of the UK (see figure 17)[6].

Figure 17: Housing unit approvals per 1,000 population



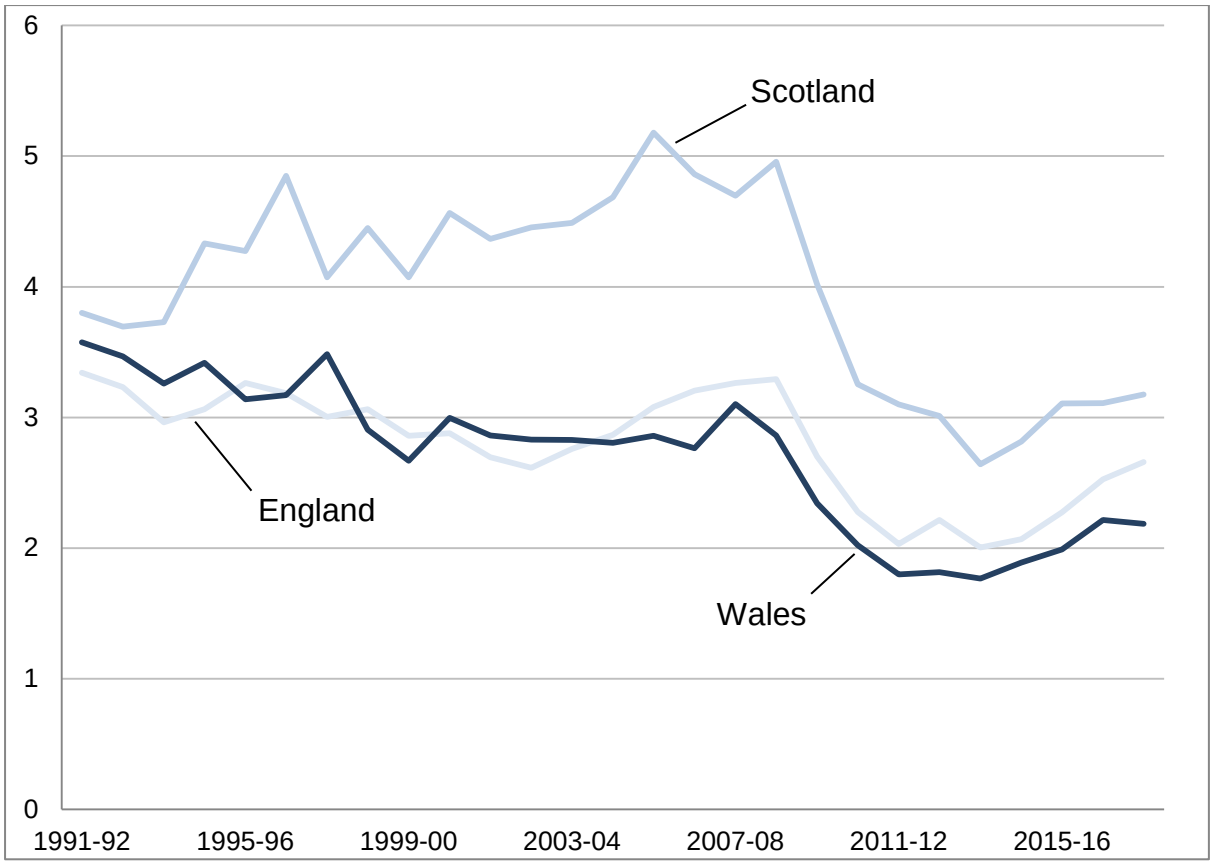
Source: Housebuilders’ Federation

The existence of undeveloped sites with planning permission in place may mean that that data on planning approvals is not a good guide to future levels of development. However, the available data on new dwelling completions also suggest that housing supply in Wales may have fallen behind other parts of the UK in recent years - see figure 18.

While the data in figures 17 and 18 include dwellings of all types, they do not include dwellings which are planned and/or funded but which have not yet been built or received planning permission. Some social and affordable housing funded by the Welsh Government and local authorities will fall into this category, and will add to supply in future years.

[6] The data in this figure, and that in figure 18, refer to all new dwelling, including owner-occupied, privately rented or socially provided.

Figure 18: New dwellings, completions per 1,000 population



Source: Ministry of Housing, Communities and Local Government and Welsh Government