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Scenarios for the Welsh Government Budget to 2025-26

IFS Report R83

Benjamin Deaner
David Phillips

Scenarios for the Welsh Government Budget to 2025–26¹

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Executive Summary

The UK government is part-way through significant cuts in spending on public services as it attempts to deal with the large hole in the UK's public finances. As part of this, grants from the UK Treasury to the Welsh Government have been reduced in real terms each year since 2009–10, and the spending plans set out by the Treasury have confirmed further cuts in 2014–15 and 2015–16. Furthermore, with further fiscal tightening planned in the two years after that, grants to the Welsh Government look set to continue to fall in real terms in 2016–17 and 2017–18. If delivered, this would mean an unprecedented seven years of retrenchment in public service spending in Wales, in stark contrast to the first ten years of devolution, when the Welsh Government enjoyed substantial year-on-year real-terms spending increases.

This report sets out the current UK economic fiscal context and explores the implications for Wales. In particular, it examines the changes in Welsh Government spending in recent years, and sets out a number of scenarios for the Welsh Government's budget for the period to 2025. It also explores the trade-offs facing the Welsh Government when setting its departmental budgets, and relates these to the spending pressures that will be faced in the coming decade as the impact of demographic change begins to make itself felt.

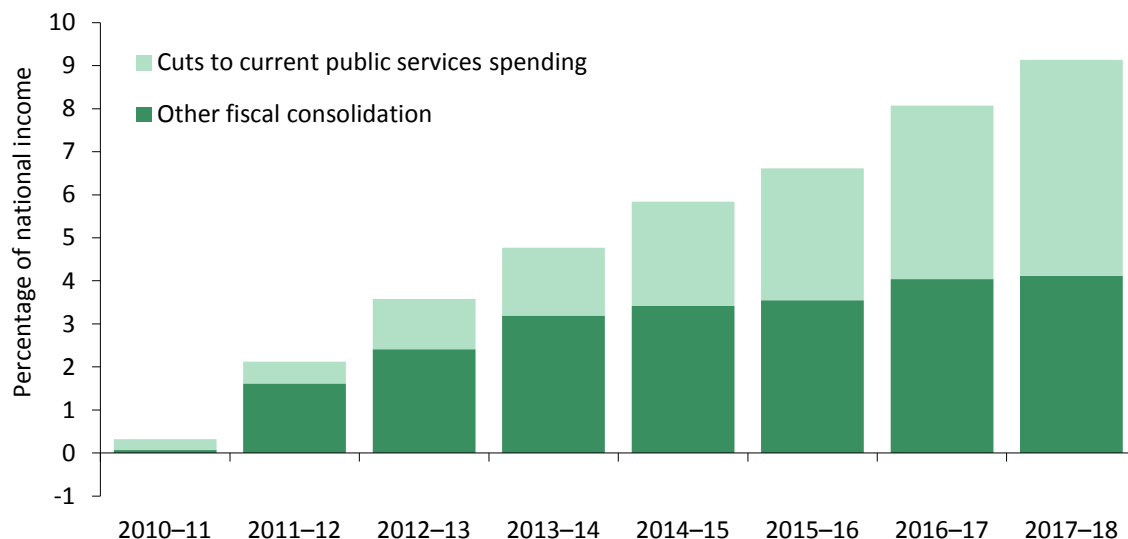
The key findings of the analysis are:

The economic and fiscal situation

- The financial crisis and associated deep recession has been followed by only a modest economic recovery. Indeed, the economic output did not grow at all in 2012. This poor performance is indicative of a more permanent problem: the trend level of output is now estimated to be over 13% lower in 2016–17 than was projected by the Treasury back in 2008, before the severity of the crisis became apparent. This means that despite a deep recession and weak recovery, there is thought to be little spare capacity in the economy and therefore only limited scope for above-trend rates of economic growth in the coming years.
- During the recession, government spending increased rapidly as a share of national income as spending rose (for instance, due to more claims for Job seeker's allowance) and national income fell. At the same time, there was a modest fall in tax receipts as a proportion of national income as tax-rich activities (such as property transactions and financial services) declined. The significant reduction in the long-term productive potential of the economy implies a large permanent underlying gap between spending and taxes: in the absence of any policy action after March 2008, the UK government would have been borrowing an estimated 9.2% more of national income (£134 billion in today's prices), on top of any borrowing from temporary weakness in the economy, every year going forward, than previously planned.
- The UK government has responded by setting out plans for significant increases in taxes and reductions in spending, designed to eliminate the increase in borrowing by 2017-18. Most of the increases in taxes and reductions in investment spending are due to have

happened by the end of the current financial year (2013–14), but the majority of the reduction in current spending on public services pencilled in – over two thirds – is still to come. In other words, the planned cuts to current spending on public services have been back-loaded as shown in Figure 1.

Figure 1. The fiscal consolidation over seven years



Notes: Other fiscal consolidation includes cuts to investment spending, benefits spending and debt interest payments as well as tax rises. Figures for 2016–17 and 2017–18 are based on the Office for Budget Responsibility's public finance baseline, which assumes further consolidation in these years is delivered by cuts to current public services spending: whether this is the case has not yet been confirmed, however. Figures include realised underspends by government departments and the latest estimate of Exchequer savings from changing to CPI indexation.

Source: Tetlow (2013).

- The October 2010 Spending Review set out plans for spending on public services from 2011–12 to 2014–15. The June 2013 Spending Round set out plans for spending in 2015–16. The plans imply that the departmental spending limits for the UK as a whole in 2015–16 will be 10.9% lower in real terms than the amount spent in 2010–11. The resource departmental expenditure limit (excluding depreciation) is set to be 10.8% lower, and the capital departmental expenditure limit 11.8% lower. Note that a large cut to capital spending took place between 2009–10 and 2010–11, before the period covered by the 2010 Spending Review.
- How the additional fiscal consolidation planned for 2016–17 and 2017–18 will be delivered has not yet been decided. The default assumption in the Office for Budget Responsibility's (OBR's) fiscal forecasts is that it will be delivered by further cuts in current spending on public services, but further cuts to benefits spending or increases in taxes are also possible while keeping to the Government's plan for reducing the deficit without further cuts to investment spending. An additional £10 billion of tax increases or benefit cuts by 2017–18 would be required to allow the pace of cuts to current public service spending between 2010–11 and 2015–16 to be maintained for the final two years of the fiscal consolidation.
- It is important to note that the apparent strengthening of the economy since the spring of 2013 does not mean that this planned austerity can be abandoned, or even scaled back.

The plans outlined are predicated on growth returning in line with the OBR's forecasts and it is not clear that the economy will outperform the OBR's forecasts in the longer term.

- The OBR's July 2013 Fiscal Sustainability Report suggests that the demographic pressure of an ageing population will put further strain on the UK's finances in the longer term. The proportion of GDP to be spent on services such as long-term health care and the state pension are predicted to rise steadily in the coming decades. This will just be starting to make its impact felt by the early 2020s, as the late 1950s and 1960s baby-boomers approach retirement.

Welsh Government spending and spending plans: 2000–01 to 2015–16

- The Welsh Government is funded nearly entirely by a block grant provided by the UK Treasury. The change in this block grant is calculated using the Barnett formula, based upon changes in the budgets of Whitehall departments that deliver services for which the Welsh Government are deemed to have responsibility in Wales. Large increases in spending on the NHS and education in England therefore fed through to substantial increases in the amount of grant paid to the Welsh Government in the first decade following devolution.
- But cuts to government spending as part of the fiscal consolidation mean that the Welsh block grant has been cut substantially since 2010–11. The total block grant allocated by the UK government to Wales in 2013–14 is set to be 9.4% lower in real terms than that in 2010–11 (after adjusting for the transfer of funding for council tax benefit to the Welsh Government). Further cuts have been announced for 2014–15 and 2015–16, which, if implemented, would take the cut to 12.2%.
- The Welsh Government decides how to allocate the cut in its overall budget among the different service areas it funds. It has chosen to cut the health budget by 8.6% in real terms; the budget of the Department for Economy, Science and Transport by 20.8% and of Education and Skills by 10.1% between 2010–11 and 2013–14. The Department for Local Government has seen a relatively smaller reduction, amounting to a real-terms reduction between 2010–11 and 2013–14 of 4.5%. This figure excludes the transfer of funding for council tax benefit to the Welsh Government (where it appears as part of the Local Government budget) but exclude transfers into the local government settlement from other budget areas.
- These choices contrast with the decisions taken by the Scottish Government, and those taken by the UK government with respect to public services in England. Both the Scottish and UK governments chose to ring-fence NHS spending: between 2010–11 and 2013–14 real-terms spending on the NHS is to fall by just 0.4% in Scotland and rise by 3.1% in England. On the flip-side, the departmental budgets for local government fell substantially more rapidly than in Wales, by 7.6% and 9.5% in real terms in Scotland and England respectively.

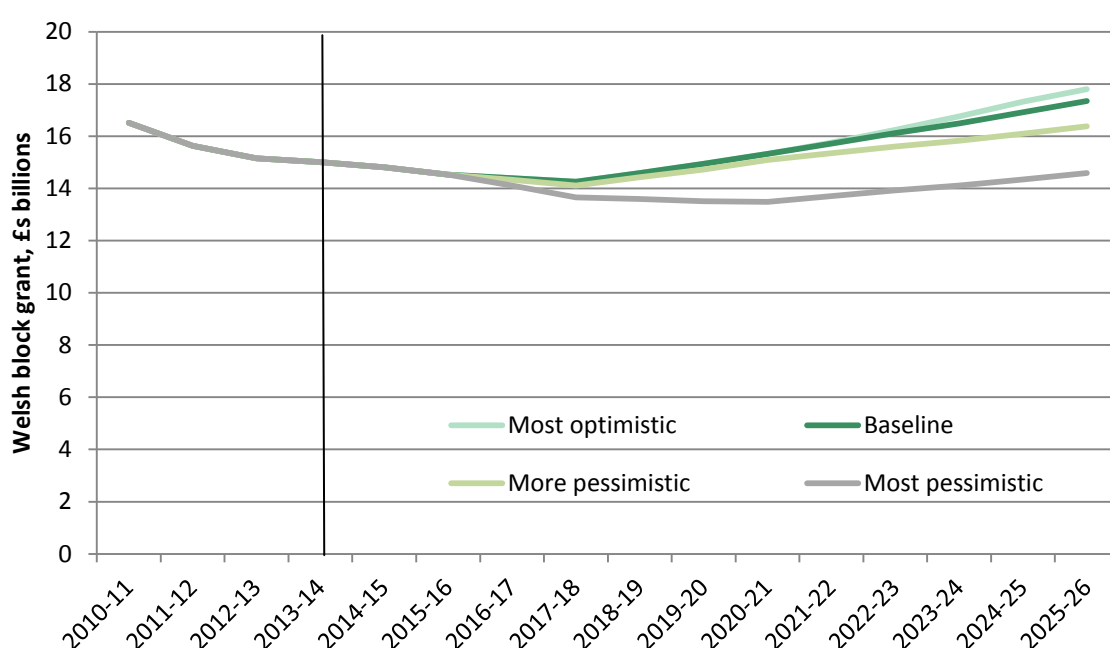
The public spending outlook to 2025–26

- The Government's plans imply the fiscal consolidation will be complete in 2017–18. This implies that spending could then begin to grow again in 2018–19 and beyond. However, it is possible that further fiscal consolidation is required beyond 2017–18, which might take the form of additional spending cuts. Because of this, and because the long-term rate of economic growth in the years ahead is unclear, the path for total UK government spending between 2017–18 and 2025–26 is uncertain. Therefore, in this report we consider four scenarios for total UK government spending over this period.
- The block grant for Wales will depend upon not only the overall level of government spending, but also how the UK government decides to allocate that spending between benefits and tax credits and various Whitehall departmental budgets. If, as in our most pessimistic scenario yet-to-be-allocated cuts in 2016–17 and 2017–18 fall entirely on departmental spending, and Whitehall offers no protection to English health and education spending, the Welsh block grant is set to fall by 9% in real terms to £13.7 billion in today's prices in 2017–18. Under our most optimistic scenario, where there are a further £10 billion of benefit cuts or tax increases by 2017–18, and where health and education spending are protected, the Welsh block grant would instead be 5% lower than today (at £14.3 billion).
- There is a wide range of plausible outcomes for the Welsh block grant in 2025–26: it not possible to give an upper or lower bound on what could be expected. Instead we are able to set out a range of scenarios, based on different paths for overall UK government spending and different options for how to allocate that between different areas.
- In the most optimistic scenario we consider, total UK government spending grows in line with the OBR's high productivity growth variant projection for GDP after 2017–18; English education and health spending are protected from further cuts in 2016–17 and 2017–18, with the latter increases in line with the OBR's '1% health productivity growth' scenario after 2017–18, and; £10 billion of additional benefit cuts or tax credits are made by 2017–18. Under this scenario, the Welsh block grant will be 19% higher than today by 2025–26, and 8% higher than in 2010–11 on a like-for-like basis. This may seem like a significant increase but a growing and ageing population, and likely cost pressures mean even this scenario would still be challenging.
- Our baseline scenario is the same as our most optimistic except that UK government spending grows in line with the OBR's baseline projection for GDP after 2017–18. Under this scenario, the Welsh block grant will be 16% higher than today by 2025–26, and 5% higher than in 2010–11. Accounting for the projected population increase that would make the block grant per person roughly 10% higher than today, but slightly lower than the level in 2010–11 (1% lower).
- In the most pessimistic scenario we consider, total UK government spending is held fixed in real terms between 2017–18 and 2020–21 and then grows in line with the OBR's low productivity growth variant projection for GDP; no protection is offered to education and health spending from further cuts, with the latter increases in line with the OBR's baseline projections for health spending; and no further benefit cuts or tax increases are made by 2017–18. Under this scenario, the Welsh block grant would be £14.6 billion in 2025–26,

3% lower than today (or 9% lower per person). And given the cuts already made, the block grant would be 12% lower than in 2010–11, 15 years after the fiscal consolidation began in earnest. As shown in Chapter 5, a block grant of £14.6 billion in 2025–26 would involve a set of trade-offs that are difficult to comprehend.

Figure 2 shows the path for the Welsh block grant between 2010–11 and 2025–26 under the four scenarios set out above. This illustrates the substantial uncertainty about just how much the Welsh Government will have to spend over the next 12 years. It also shows that even on our most optimistic scenario, the Welsh block grant will only be around 8% higher in real terms in 2025–26 than in 2010–11: an annual average growth rate of just 0.5%. Given population growth, the block grant available per person would be just 1% higher per person than 15 years earlier, even under this optimistic scenario.

Figure 2. Scenarios for the Welsh block grant to 2025–26, £ billions, 2013–14 prices



Notes: Figures for 2010–11 to 2013–14 include an adjustment for council tax benefit, funding for which is included in the Welsh Government's DEL from 2013–14, but which was previously funded from the UK government's Department for Work and Pensions' AME. In order to make figures comparable before and after this change in responsibility, £222 million has been added to the reported Welsh DEL for each year between 2010–11 and 2012–13: this is the amount transferred from AME to Welsh DEL in 2013–14.

Source: Tetlow (2013).

The trade-offs facing the Welsh Government when setting departmental budgets

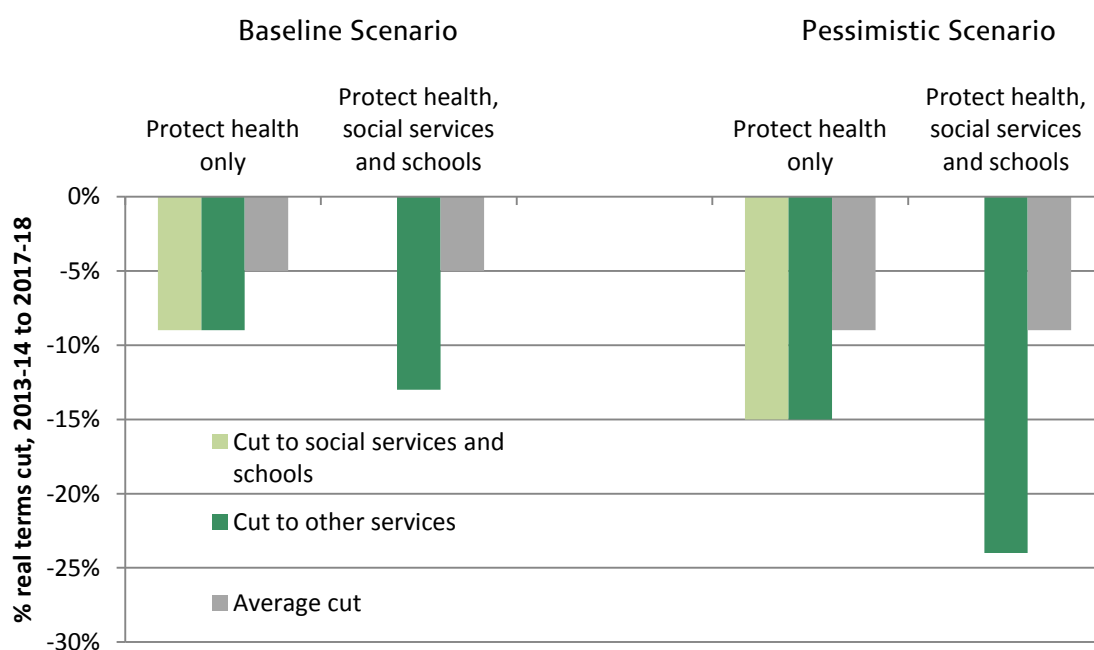
- It is not possible to determine upper or lower bounds on the amounts available to different service areas funded by the Welsh Government. Instead, we set out the implications of a number of choices the Welsh Government *could* make to allocate its budget, the total amount of which is determined by the scenarios set out in Chapter 4 of this report.
- Under our baseline scenario for the Welsh block grant, further cuts of 5% in real-terms will be required by 2017–18. If the Welsh Government were to protect health spending, that would require cuts to its funding for other service areas – including things such as

schools and social services – that averaged 9%. If the Welsh Government were to extend the protection to its funding to local government for schools and social services, the cuts to unprotected areas would have to average 13% to balance the budget. Coming on top of existing cuts, such a cut could take the amount spent on the Department for the Economy, Science and Transport, for instance, to almost one-third below its 2010–11 level.

- Under our most pessimistic scenario for the Welsh block grant, further cuts of 9% in real terms will be required by 2017–18. In this case, protecting health, schools and social services would require cuts averaging 24% across all other service areas. Coming on top of the cuts already delivered, this could take the amount spent on the Department for the Economy, Science and Transport, for instance, to 40% below its 2010–11 level.

Figure 3 shows the cuts that may be required of different service areas funded by the Welsh Government between now (2013–14) and 2017–18. It does this under our baseline and most pessimistic scenarios for the Welsh Government’s block grant, separately by whether only health is protected from further cuts, or whether health, social services and schools are protected from further cuts. It shows that protecting even health spending means difficult cuts elsewhere, and that protecting social services and schools too could require additional average cuts of 24% to other services under our pessimistic scenario.

Figure 3 The trade-offs facing the Welsh Government between now and 2017–18



Source: PESA 2013 Budget tables, OBR Economic and Fiscal Outlook, OBR Fiscal Sustainability Report, Welsh Government First Supplementary Budget 2013–14, Welsh Local Government Budget Estimates 2013–14 and authors’ calculations.

- Under our baseline scenario for the Welsh block grant in 2025–26, if the Welsh Government were to protect its funding health, social services and schools from any further cuts, and once its budget starts growing again, increase spending on all services area at the same rate, spending on unprotected areas in 12 years’ time would be 6% higher in real terms than now: after accounting for population growth, that would equate to just 1% more per person. If, in addition to protecting them from cuts, relatively large

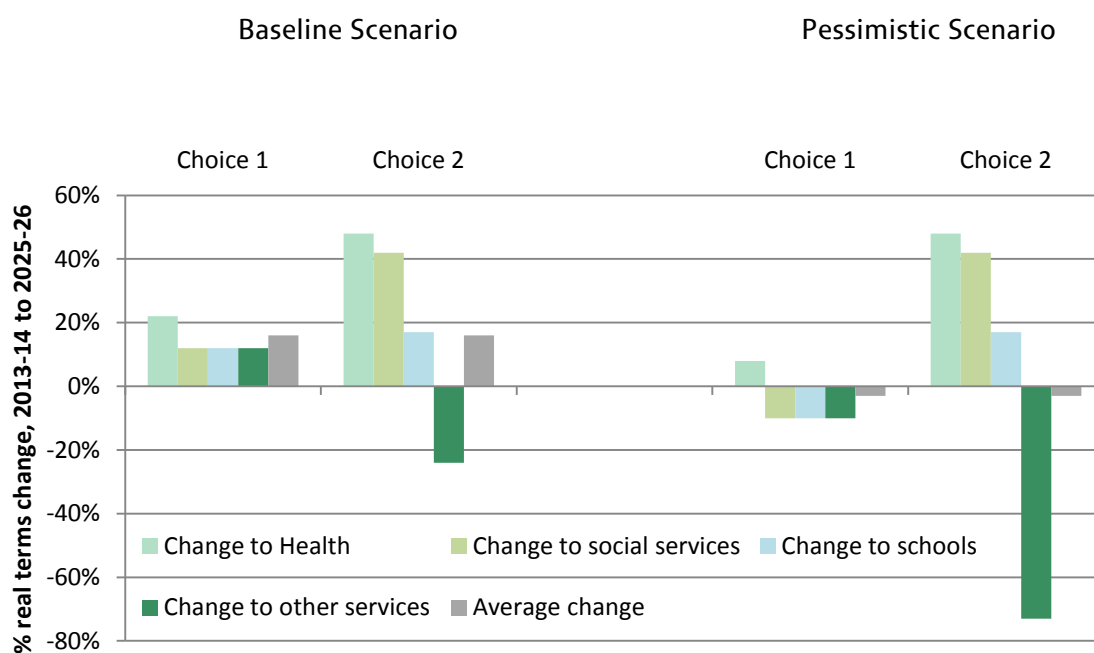
increases in spending on health (5% per year), social services (4.5%) and schools (2%) were felt needed after 2017–18 to cope with rising demands and costs and to undo some of the earlier cuts, spending on other services would need to be 24% lower than today, which equates to a fall of 28% per person. And, spending on these services would still be falling: with the rate of cut averaging 1.7% per year between 2017–18 and 2025–26.

- Things look little easier under our most optimistic scenario for the Welsh block grant in 2025–26. But in our more pessimistic scenario things would be substantially worse. Even if all that was done was to protect health, social services and schools spending from further cuts, spending on other areas would be 2% lower now, equivalent to a 7% fall per person. Providing relatively large increases in health, social service, and schools after 2017–18 would require very large cuts elsewhere. Under one option, spending across other services would need to be 41% lower than today and still falling at a rate of 7% a year in 2025–26.
- Under our most pessimistic scenario for the Welsh block grant, the difficulties the Welsh Government would face in trading off spending on different services are difficult to comprehend. Protecting just health from further cuts and then sharing spending increases equally across departments would leave health spending only 8% higher than now – just 3% higher per person – and would require spending 10% less on other areas, including schools and social services, in 2025–26. Providing relatively large increases in health, social services and schools after 2017–18 would decimate the rest of the budget, with one option requiring spending 73% less than today on areas such as transport, culture, and housing. Such large cuts seem implausible.

Figure 4 shows the changes in funding that different service areas would face between now (2013–14) and 2025–26 under our baseline and most pessimistic scenarios for the Welsh Government's block grant, and the options discussed above. Choice 1 is for the Welsh Government to protect health spending from further cuts, and, once spending starts growing again, to increase spending on all services at the same annual rate. But rising demand for health and social care may make funding these services under such a scenario difficult. Choice 2 is for the Welsh Government to protect health, social services and schools spending from any further cuts, and after 2017–18 increase spending on these by 5%, 4.5% and 2% in real terms per year, respectively, in order to cope with rising demands and costs and to undo some of the earlier cuts. Under such a choice, spending on other services would have to be substantially, and, in the case of our most pessimistic scenario, probably implausibly, lower than now in 2025–26.

The scale of the challenge implied by our more pessimistic – but not implausible – scenarios means advanced planning by the Welsh Government for the trade-offs that it would make between different public services over the next decade (and beyond) would be sensible. It will also be important to understand the demand and cost pressures facing public services, and to develop policies to try to reduce those pressures.

Figure 4 The trade-offs facing the Welsh Government between now and 2025–26



Source: PESA 2013 Budget tables, OBR Economic and Fiscal Outlook, OBR Fiscal Sustainability Report, Welsh Government First Supplementary Budget 2013–14, Welsh Local Government Budget Estimates 2013–14 and authors' calculations.

The spending pressures facing Wales in the coming decades

- Wales, like the rest of the UK, has both a growing and ageing population. The latest projections are for the number of individuals aged 65 and over in Wales to increase by 22% by mid-2025, and by 43% by mid-2035, by when they will make up over one quarter of the Welsh population. The increase in the number aged 80 or over is set to be even more dramatic: rising by 40% over the next 12 years, and 90% over the next 22. The number of school-aged children is also expected to increase, albeit much more modestly. On the other hand, the number of people aged between 16 and 64 is expected to decline slightly over the next 22 years.
- Demographic trends vary substantially across Wales. For instance, whereas the number of 4- to 16-year olds is expected to increase by 7% across Wales by 2025–26, in Cardiff the increase is expected to be 26%, whilst in Powys the numbers are expected to decline by 6%. Conversely, parts of the country like Powys that already have a higher proportion of older people are expected to age most rapidly in the coming decades, whilst Cardiff will see only a small increase in the fraction of its population that are aged 65 and over and aged 80 and over. These differences in demographic trends will mean some areas are likely to experience a much greater increase in demand for certain public services than other areas.
- Increases in the number of older people are likely to lead to increases in the amount required to fund health care and social care. In its baseline projections, the OBR projects an increase in the proportion of national income spent on health care and social care of 0.8 percentage points by 2025–26. The costs are projected to continue rising until at least

2062–63, by which time costs are projected to rise by 3.0 percentage points of national income.

- However, the projections are subject to wide margins of error, reflecting uncertainty about future demands for health and social care, and the future costs of providing these services. Whilst the past is not necessarily a guide to the future, recent experience suggests that baseline projections may overstate demand by assuming no reduction in the demand for services at a given age as life expectancy increases, but may understate the costs by assuming health and social care productivity growth matches economy-wide productivity growth. There is also uncertainty around the underlying population projections. Thus, the amount needed to be spent on health and social care implied under current policies and the projected ageing of the population could be significantly more or less than in the OBR's baseline and variant projections.
- In using the existing projections for spending needs, it is important to realise that most relate to England only, or the UK as a whole. Differences in economic and demographic factors, and substantial differences in health and social care policies between Wales and the rest of the UK mean these analyses can only offer a rough guide to the spending pressures facing Wales in the coming decades: this is an area where more Wales-specific research would be beneficial.
- Demographic change will also put upwards pressure on the cost of providing free bus passes for those aged 60 and over, and the cost of education in Wales. In particular, differences in the projected change in the number of school-aged children mean that whilst some parts of Wales may see shortages of school places and require investment in new schools, others may see existing problems of surplus school places worsen.

1. Introduction

The UK government is part-way through significant real-terms reductions in government expenditure as it attempts to deal with the large hole in the public finances. As part of this, grants from the UK Treasury to the Welsh Government have been reduced in real terms each year since 2009–10, and the spending plans set out by the Treasury have confirmed further cuts in 2014–15 and 2015–16. Furthermore, with further fiscal tightening planned in the two years after that, grants to the Welsh Government look set to continue to fall in real terms in 2016–17 and 2017–18. This would mean an unprecedented seven years of retrenchment in public service spending in Wales, and stands in stark contrast to the first ten years of devolution, when the Welsh Government enjoyed substantial year-on-year real-terms spending increases.

This report sets out the current UK economic fiscal context and explores the implications for Wales. In particular, it examines the changes in Welsh Government spending in recent years, and sets out a number of scenarios for the Welsh Government's budget for the period to 2025. It also explores the trade-offs facing the Welsh Government when setting its departmental budgets, and relates these to the spending pressures that will be faced in the coming decade as the impact of demographic change begins to make itself felt.

The rest of this report proceeds as follows. Chapter 2 describes how the recent financial crisis and subsequent recession caused long-term damage to the UK public finances and sets out the planned fiscal consolidation the UK government is currently undertaking. This provides the context to Chapters 3 to 5, which focus on the impact of this on Wales to date and a number of scenarios for government spending in Wales both during the remaining period of planned austerity, and as far as 2025–26.

Chapter 3 examines how the Welsh Government budget has changed between 2000–01 and the present, a period during which there were substantial increases until 2009–10, and subsequently cuts. It then examines how the cuts made since 2010–11 have been spread across service areas, and compares these to the cuts made by the UK government (for spending largely in England) and the Scottish Government. Chapter 4 looks to the future and examines a number of potential scenarios for the Welsh Government's total budget in the period to 2025–26, which will depend upon the path for total UK government expenditure, and how the UK government decides to allocate that spending across different parts of its budget. Chapter 5 then explores the trade-offs facing the Welsh Government when deciding how much to spend in different service areas over the same period. These decisions of how much to spend on different services will take place in the environment of spending pressures associated with demographic change, which are discussed qualitatively in Chapter 6.

The report also includes two appendices. Appendix A contains additional tables on the Welsh Government's budgets for 2010–11 to 2013–14. Appendix B sets out the methodology used in the quantitative analysis of the Welsh Budget in Chapters 3 to 5. Lastly, a set of spreadsheets to accompany the quantitative analysis in Chapters 3 to 5 has been provided to Wales Public Services 2025; these allow stakeholders to examine further scenarios for the Welsh Government budget and the trade-offs between allocations to different public service areas.

2. The UK economic and fiscal context

Summary

- The financial crisis and associated deep recession has been followed by only a modest economic recovery. Indeed, the economic output did not grow at all in 2012. This poor performance is indicative of a more permanent problem: the trend level of output is now estimated to be over 13% lower in 2016–17 than was projected by the Treasury back in 2008, before the severity of the crisis became apparent. This means that despite a deep recession and weak recovery, there is thought to be little spare capacity in the economy and therefore only limited scope for above-trend rates of economic growth in the coming years.
- During the recession, government spending increased rapidly as a share of national income as spending rose (for instance, due to more claims for Job seeker's allowance) and national income fell. At the same time, there was a modest fall in tax receipts as a proportion of national income as tax-rich activities (such as property transactions and financial services) declined. The significant reduction in the long-term productive potential of the economy implies a large permanent underlying gap between spending and taxes: in the absence of any policy action after March 2008, the UK government would have been borrowing an estimated 9.2% more of national income (£134 billion in today's prices), on top of any borrowing from temporary weakness in the economy, every year going forward, than previously planned.
- The UK government has responded by setting out plans for significant increases in taxes and reductions in spending, designed to eliminate the increase in borrowing by 2017–18. Most of the increases in taxes and reductions in investment spending are due to have happened by the end of the current financial year (2013–14), but the majority of the reduction in current spending on public services pencilled in – over two thirds – is still to come. In other words, the planned cuts to current spending on public services have been back-loaded.
- The October 2010 Spending Review set out plans for spending on public services from 2011–12 to 2014–15. The June 2013 Spending Round set out plans for spending in 2015–16. The plans imply that the departmental spending limits for the UK as a whole in 2015–16 will be 10.9% lower in real terms than the amount spent in 2010–11. The resource departmental expenditure limit (excluding depreciation) is set to be 10.8% lower, and the capital departmental expenditure limit 11.8% lower. Note that a large cut to capital spending took place between 2009–10 and 2010–11, before the period covered by the 2010 Spending Review.

- How the additional fiscal consolidation planned for 2016–17 and 2017–18 will be delivered has not yet been decided. The default assumption in the Office for Budget Responsibility's (OBR's) fiscal forecasts is that it will be delivered by further cuts in current spending on public services, but further cuts to benefits spending or increases in taxes are also possible while keeping to the Government's plan for reducing the deficit without further cuts to investment spending. An additional £10 billion of tax increases or benefit cuts by 2017–18 would be required to allow the pace of cuts to current public service spending between 2010–11 and 2015–16 to be maintained for the final two years of the fiscal consolidation.
- It is important to note that the apparent strengthening of the economy since the spring of 2013 does not mean that this planned austerity can be abandoned, or even scaled back. The plans outlined are predicated on growth returning in line with the OBR's forecasts and it is not clear that the economy will outperform the OBR's forecasts in the longer term.
- The OBR's July 2013 Fiscal Sustainability Report suggests that the demographic pressure of an ageing population will put further strain on the UK's finances in the longer term. The proportion of GDP to be spent on services such as long-term health care and the state pension are predicted to rise steadily in the coming decades. This will just be starting to make its impact felt by the early 2020s, as the late 1950s and 1960s baby-boomers approach retirement.

The UK government is currently undertaking a planned seven-year fiscal consolidation, composed of tax increases and significant spending cuts, aimed at reducing borrowing from its 2009–10 peak of 11.1% of national income back to sustainable levels by 2017–18. This chapter of the report aims to provide a brief summary of the scale of the fiscal consolidation, why such a fiscal consolidation is required, in terms of both what has happened to the outlook for the economy and why this has had the effect on the public finances that it has. We then briefly discuss the pacing and nature of the cuts to public spending designed to address this problem. The chapter concludes with a foretaste of some of the longer term pressures on the public finances that the government will need to address (Chapter 6 of this report provides further detail).

The state of the economy

The recent financial crisis led to the UK entering recession, with the size of the economy shrinking in real terms by 7.2% between the first quarter of 2008 and the second quarter of 2009.² The UK technically pulled out of recession in the second half of 2009, when economic growth turned positive again.³ However, economic growth was just 1.8% in 2010 and 0.7% in 2011. And whilst recent revisions GDP figures by the Office for National Statistics (ONS) show that, unlike previously thought, the UK did not technically return to recession in the first part of 2012, the economy did not grow at all between Q4 2011 and Q4 2012. A key factor behind

²ABMI index, ONS 2013.

³A 'recession' is technically defined as a period beginning with at least two consecutive quarters of negative growth in real economic output and ending when there are two consecutive quarters of positive growth.

the stalling of the UK economy during 2012 was poor net trade (exports minus imports) figures, likely driven, at least in part, by the return of the Eurozone into recession.⁴

There have been signs of a somewhat more robust recovery in 2013, with the economy estimated to have grown by 0.3% in Q1 and 0.7% in Q2. But in its March forecasts the Office for Budget Responsibility (OBR) forecast that growth during 2013 as a whole will only be 0.8%. The average growth projection for 2013 made by the independent forecasters tracked by the Treasury is slightly higher, but still pretty anaemic at 1.3%.⁵

The medium-term outlook for the UK economy is somewhat rosier. Growth in 2014 is forecast to be 1.8% by the OBR (similar to the average figure from Her Majesty's Treasury's (HMT) panel of independent forecasters of 2.1% growth, and to the 2013 Green Budget forecast by Oxford Economics of 2.1% growth). The OBR predicts that growth will then speed up, rising to 2.3% in 2015, 2.7% in 2016 and 2.8% in 2017, which is similar to the Green Budget forecasts by Oxford Economics (2.4% growth in 2015 followed by 2.5% in 2016 and 2.9% in 2017).⁶

The relatively weak economic growth that has been experienced by the UK economy is concerning because it is indicative of a more permanent problem. This is illustrated in Figure 2.1, which compares forecasts for national income and potential national income. The dark green dashed line shows the government projection for the level of potential national income that was made in March 2008 (i.e. before the financial crisis) – the assumption was for real growth of 2.5% per year.⁷ The lighter dashed line shows the latest OBR projection for trend growth: they estimate that the potential capacity of the economy increased by an average of just 0.4% per year between 2007–08 and 2012–13; they currently forecast that it will grow by an average of 2.1% per year between 2013–14 and 2016–17.⁸ The implication of this is that the trend level of national income by 2016–17 is now thought to be a full 13.4% lower than was projected by the Treasury back in 2008. Actual output in 2016–17 is forecast to be 15.8% lower than trend output forecast for that year back in 2008.

⁴Slater, A. (2013).

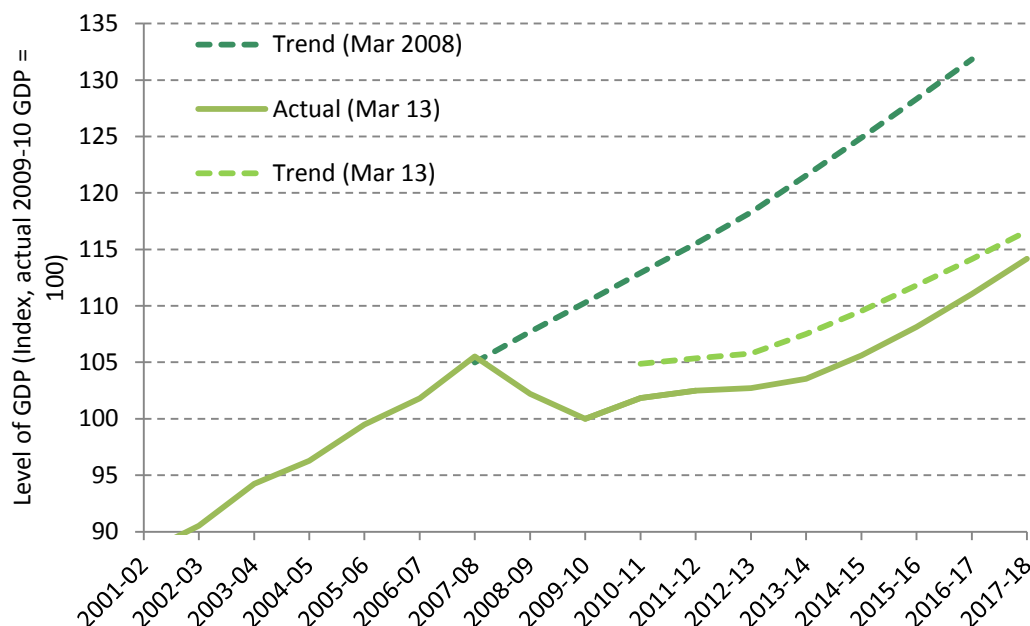
⁵As of September 2013. See <https://www.gov.uk/government/organisations/hm-treasury/series/data-forecasts>.

⁶Growth forecasts are, of course, subject to considerable uncertainty: for instance, whilst the OBR's central forecast for 2016 is for 2.7% growth, based on past forecast errors it thinks there is an almost 30% chance growth will be less than half that amount, and a 10% chance that the economy will in fact shrink by at least 0.3% (there is also a 50% chance growth could be higher than forecast). This significant uncertainty informs the methodology of adopting different scenarios for economic growth and public spending in Chapters 4 and 5 of this report.

⁷For the purposes of the public finance projections, a lower growth in potential national income of 2¼% was assumed.

⁸The lack of growth in potential national income during the financial crisis has yet to be adequately explained. In large part it appears to be due to a lack of productivity growth in the service sector, although again this is not particularly well understood.

Figure 2.1 Forecasts for actual and potential national income



Sources: Forecasts for actual GDP from OBR, Economic and Fiscal Outlook: March 2013. Out-turn figures for real GDP from Office for National Statistics, series ABMI. Potential GDP figures from T. Pybus, 'Estimating the UK's historical output gap', OBR, Working Paper 1, 2011 updated using OBR, Economic and Fiscal Outlook: March 2013.

The actual level of national income is shown by the solid green line, which is an outturn as far as 2011–12 and then the latest OBR forecast thereafter.⁹ The 2008 to 2009 recession is evidenced by the fall in actual national income. However, the low forecast for growth in potential national income means that, even given the very deep recession, the current level of national income is not forecast to be too far below the potential level of output. This so-called 'output gap' (the difference between actual and potential national income, expressed as a percentage of potential output) is estimated by the OBR to be 3.7% in 2013–14. This relatively modest estimated output gap means that, if correct, there is little spare capacity in the economy and therefore little scope for significantly above-trend rates of economic growth.¹⁰ The modest economic growth forecast is projected to close just under half of the output gap by 2017–18 (when it is still expected to be 2.1%).

The implications for the public finances

The problem for the public finances arises from the significant reduction in the forecast productive potential of the economy (as well as a particular decline in tax-rich activities such as property transactions and financial services). With a smaller economy, a given tax system will bring in lower revenues, and therefore the amount of public spending that can be supported will be lower. The fiscal consolidation plan is essentially a seven-year transition period over which time public spending will be reduced and the tax system changed such that

⁹Outturns for 2012–13 were not available in March 2013 when the OBR last set out its economic and fiscal forecasts.

¹⁰Note that different economic forecasters have different estimates for the size of the output gap. For instance, Oxford Economics estimate the output gap to be a bit larger than the OBR (5% in 2012), which would suggest more scope for growth in the medium term. Both the Oxford Economics and, to a lesser extent, the OBR estimates for the output gap are larger than those of other independent forecasters; the IMF, for example, estimates that the output gap was just 3% in 2012, and the OECD places the figure at just 2.1%. The size of the output gap is crucial in determining the scope for future growth, and hence the size of the structural government budget deficit (see below).

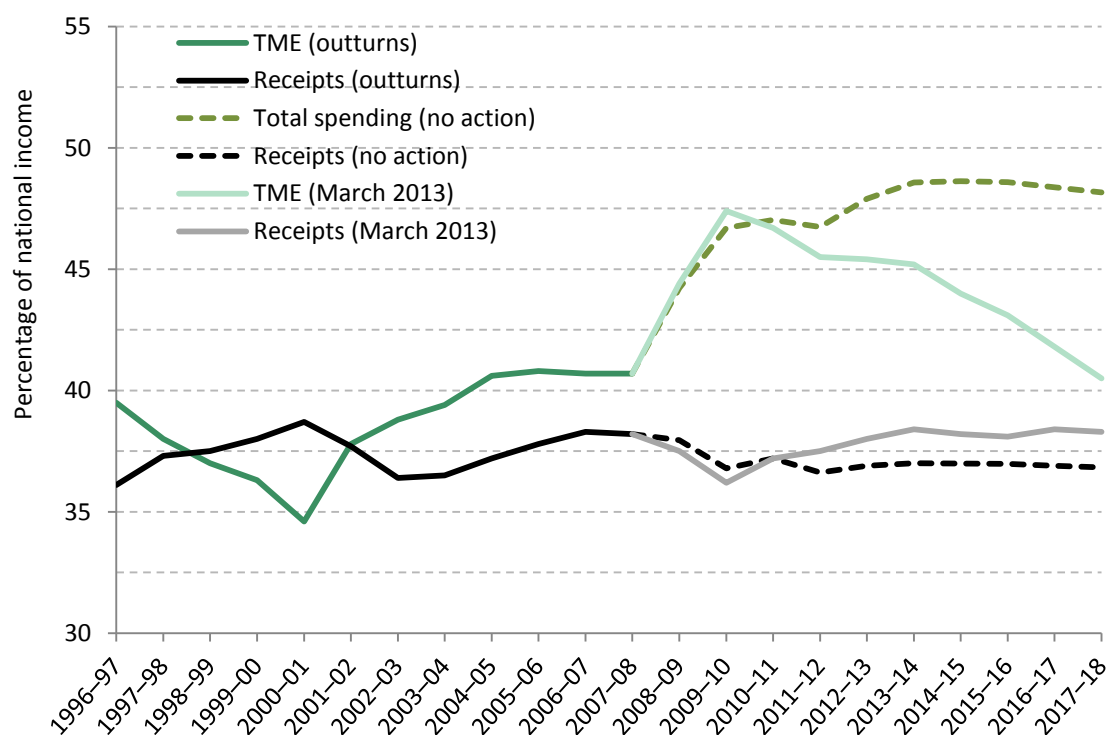
sufficient revenues will be brought in to finance the amount of public spending being undertaken, given the smaller economy.

The effect of the recession and the decline in the productive potential of the economy on the public finances is shown in more detail in Figure 2.2, which illustrates what would have happened to tax revenues and public spending as shares of national income in the absence of any new policy action since March 2008.

There would have been much greater effects on the spending side. In the recession spending shot up as a share of national income for two reasons: first, because spending automatically increases in recessions even without direct policy intervention (for example, on unemployment benefits and debt interest payments); second, because the decline in national income meant that cash plans for departmental spending that were set in the Comprehensive Spending Review in 2007 turned out to represent much larger shares of national income than previously planned.

The ‘no policy change’ assumption for public spending in 2008 was for real growth of 1.8% a year. If national income were forecast to recover to the levels previously forecast (as in an ‘ordinary’ recession) then over time spending would have fallen again as a share of national income. However, in the case of the ‘Great Recession’ of the late 2000s, because the productive potential of the economy is now projected to be significantly smaller in every year going forwards than previously thought, public spending would have remained at this significantly higher level in future in the absence of direct government policy to reduce spending.

Figure 2.2 Forecasts for spending and receipts with and without policy action



Note: ‘No action’ ignores the direct impact of all fiscal policy measures that have been implemented since Budget 2008.

Spending in 2012–13 exclude Royal Mail transfer.
Sources: ONS; OBR; Tetlow (2013).

In the absence of any policy action since March 2008 the government would be borrowing 9.2% more of national income (or £134 billion in today's terms) each year by 2012–13 than had been previously planned, and would continue to do so further into the future.¹¹ This would not have been sustainable and would have left the UK with an ever increasing national debt that would have surpassed 100% of national income before the end of the decade, 200% of GDP by 2040 and continued rising thereafter.¹²

Since such a fiscal position was clearly unsustainable, the previous Labour government and current coalition government both announced a number of tax increases and spending cuts designed to bring borrowing back to sustainable levels. The forecast profiles for tax revenues and spending under current policy are also shown in Figure 2.2. Revenues will increase slightly as a share of national income, but the majority of the consolidation is on the spending side. Some justification for that could be drawn from the fact that most of the 'problem' was also on the spending side, so that in fact both spending and revenues are being brought back to roughly the shares of national income that they were before the financial crisis.

The pacing and composition of spending cuts

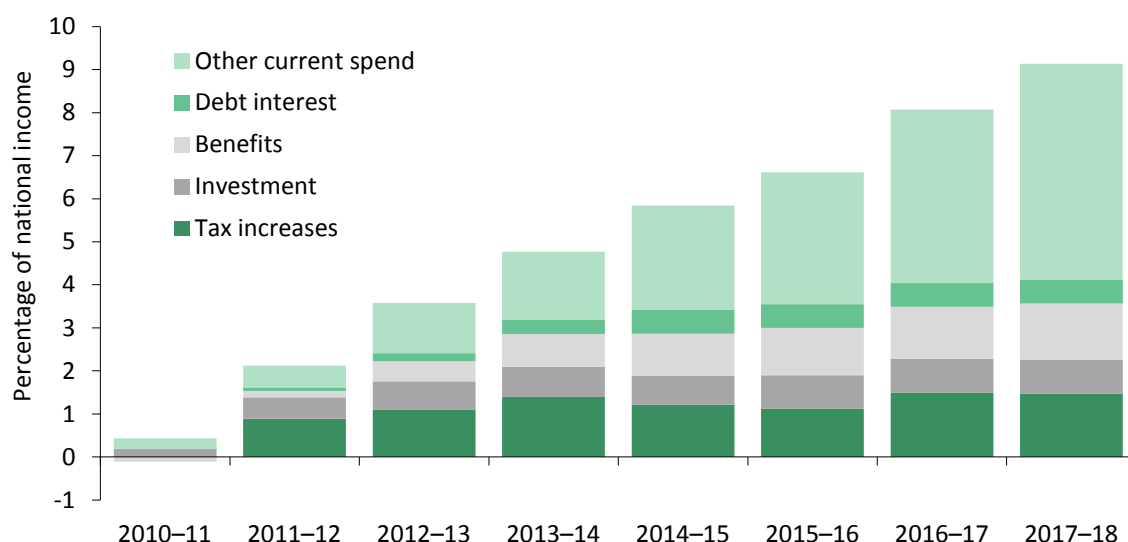
It should be noted that, while the UK government has set detailed plans on how the fiscal consolidation required by 2015–16 will be delivered, it has not confirmed how it plans to deliver the consolidation required in 2016–17 and 2017–18. However, HM Treasury and the OBR assume as a default that this additional effort will consist entirely of cuts in current public service spending. If this is the case, the UK government's plans, if delivered, will ultimately entail (by 2017–18) roughly 15% of the fiscal repair job to have been delivered by net tax increases, and 85% to have been delivered by cuts in public spending, in contrast to the coalition government's initial proposal of a 20:80 split. However, the increases in taxes have been 'front-loaded', whilst the cuts to public spending and especially the cuts to current public service spending have been 'back-loaded'. This can clearly be seen in Figure 2.3, which shows the contributions of reductions in spending and increases in taxes as a proportion of GDP to the fiscal consolidation for each year between 2010–11 and 2017–18.¹³

¹¹IFS Green Budget 2013.

¹²IFS Green Budget 2013.

¹³Figure 1.2 shows the planned changes in spending and taxes measured as a proportion of GDP as opposed to measured in 'real terms'. This means, for instance, that a 'cut in spending' means a reduction in spending as a proportion of GDP, which may entail spending growing in real terms but by less than GDP.

Figure 2.3 The fiscal consolidation over 7 years



Notes: Figures include realised underspends by government departments and latest estimate of Exchequer savings from changing to CPI indexation.

Source: Tetlow (2013).

Figure 2.3 also shows that, within government spending, the pace of cuts has also varied. Cuts to government investment spending have been more rapid than cuts to current spending: around 63% of the planned cuts to investment spending were made by 2011–12, with this planned to increase to 83% during 2012–13 and to 90% in 2013–14. On the other hand, only around 10% of cuts to other current service spending (including spending on public services) were made by 2011–12¹⁴, rising to 23% during 2012–13, and a planned 31% in 2013–14. In other words, more than two-thirds of the cuts to overall current spending on public services (and a few other items) as a proportion of GDP are yet to come. Chapters 4 and 5 of this report examines how these ongoing cuts to public spending affect the options available to the Welsh Government in setting its budget in 2014–15 and 2015–16, and the financial resources available to the Welsh Government in 2016–17 and beyond. This depends on exactly how the cuts in future years are allocated to different types of spending by the UK government, as well as whether the economy and public finances develop as expected (i.e. whether the planned fiscal consolidation needs to be extended or can be relaxed).

The UK government set out its plans for spending on public services for the four years from 2011–12 to 2014–15 in the 2010 Spending Review, and for 2015–16 in the June 2013 Spending Round. Table 2.1 shows the planned real-terms changes to current and capital Departmental Expenditure Limits (DELs) for each of these years, both overall and for a number of major Whitehall spending departments based upon the spending outturns for 2010–11 until 2012–13 and forecasts for 2013–14 onwards from the 2013 Public Expenditure Statistical Analysis (PESA) publication (HM Treasury, 2013).

DELs set out the amount each department can spend on the parts of their functions subject to multi-year budgeting and account most of departments' spending on public service provision and administration. DELs for current expenditure (excluding depreciation) in 2015–16 are planned to be 10.8% below the amount spent in 2010–11 after accounting for inflation,

¹⁴A significant underspend in 2011–12 means that the proportion of cuts actually delivered by 2011–12 was actually somewhat greater than 6%.

following planned real-terms cuts of 3.4% in 2011–12, 2.9% in 2012–13, an increase of 0.9% in 2013–14, and then cuts of 3.4% in 2014–15 and 2.5% in 2015–16 (percentages reported are all relative to 2010–11 spending so can be added up).^{15,16,17} DELs for capital expenditure in 2015–2016 are planned to be 11.8% below the amount spent in 2010–11 after accounting for inflation. The total DEL (including both capital and current spending) in 2015–16 is set to be 10.9% lower than the amount spent in 2010–11.

Table 2.1 Real change in UK Departmental Spending Limits (selected) 2010–11 to 2015–16 (%)

Department	Total change 2010-11 to 2013-14	Total change 2010-11 to 2015-16
Current^a		
NHS (Health)	3.2%	4.1%
Education	-2.4%	-4.6%
CLG Local Government (accounting for Business rate retention) ^{bc}	-9.7%	-26.0%
Defence	-11.3%	-22.8%
Transport	-27.5%	-43.9%
Home Office	-15.9%	-26.9%
<i>Total (accounting for BRRS)^c</i>	-5.3%	-10.8%
Capital		
NHS (Health)	0.4%	3.3%
Education	-46.6%	-40.9%
Defence	-0.9%	-14.8%
Transport	11.9%	18.4%
Home Office	-48.4%	-52.0%
<i>Total^d</i>	-19.9%	-11.8%

Sources: Calculated from tables in Chapter 1, Departmental Spending, PESA 2013 (HM Treasury) available at: <https://www.gov.uk/government/publications/public-expenditure-statistical-analyses-2013> See UK spending by area.xls Tables 3 and 4.

Notes: ^a Excluding depreciation; ^b For an explanation of the BRRS and how this has been accounted for, see footnote 18 below;

^c Total uses CLG figures that account for the business rate retention and are hence slightly higher for years 2013-14 and beyond

¹⁵Note that these figures (which are based on those from PESA 2013) take into account the business rate retention plans that came into force for the year 2013-14. For details on what this is and how it has been accounted for see footnote 17 below.

¹⁶Note these figures refer to the change as a percentage of the previous year's DEL which is different to the figures in the table which give the changes as a percentage of the 2009-10 DEL

¹⁷These figures actually underestimate the effective cut in 2013-14. This is because they do not take into account a £4.3billion transfer of council tax benefit from AME to DEL in DWP that was then distributed by a machinery of government change to the Wales, Scotland and CLG: Local Government departments. The details of this change are not available and so the DCLG and Scottish Government DELs could not be adjusted (the Wales DEL however, can be). If we were able to adjust for this change the cut to the total UK DEL and to DCLG would appear larger.

than those given in PESA. ^c The cuts to DCLG reported here do not take into account council tax benefit classification changes and hence underestimate the full extent of the cut to DCLG, see footnote 17 for more detail. ^d Does not take into account council tax benefit changes, see previous note.

Figures are real changes as a percentage of the figure for the year 2010-11. Total DELs include items not shown in this table (such as International Development).

The UK government has not cut all departments equally, however. In both the 2010 Spending Review and 2013 Spending Round, funding for the NHS was *increased* slightly in real terms (the much smaller Department for International Development has seen much bigger increases in its budget to meet a target of 0.7% of gross national income going to aid), and the cut to the Department for Education's current DEL has also been substantially less than the average. This means that other 'unprotected' departments will see cuts to their DELs that are in some cases substantially larger than the average cut. For instance, the Home Office, which provides most of the funding for the Police, is set to see a fall in its current DEL of 27% and its capital DEL of 52%, and the local government element of the Department for Communities and Local Government (CLG) is also set to see a large 26% cut in its current DEL.¹⁸ This, together with the freeze in council tax rates in 2011-12 and 2012-13, explains the large cuts English local authorities are making (IFS, 2012 and Crawford et al, 2013).

As highlighted above, the composition of the fiscal consolidation after 2015-16 has not yet been decided, but the default assumption in the public finances is that it will take the form of cuts to current public service spending. If, this falls entirely on departments' DELs, a further £25 billion of cuts will be required by 2017-18 (7.9%), taking the total cumulative cut to unprotected areas up to 32.9%.¹⁹ Of course, the UK government could decide to make further cuts to benefits or put up taxes: roughly £10 billion would allow the pace of cuts to DELs in 2016-17 and 2017-18 to be no higher than that planned by 2015-16.

It is important to note that the recent signs of a somewhat more robust economic recovery gathering pace do not mean that these additional spending cuts or tax rises can be avoided, or even scaled back. The plans outlined above are based on the OBR's forecast in March that the economy would strengthen, and that growth would return. While growth in 2013 does look likely to be higher than that forecast by the OBR, this does not mean that growth in future years will be higher than forecast by the OBR. Indeed, even if growth were higher than projected by the OBR over the entire forecast period to 2017-18, the scale of cuts or tax rises could not be materially reduced if that growth just represented a stronger erosion of spare capacity in the economy (as discussed above, under the OBR's forecasts, the economy is still expected to be operating just over 2% below capacity in 2017-18). Higher-than-forecast growth would only allow reductions in the scale of future cuts to spending or tax rises if it indicated stronger growth in the underlying productive capacity of the economy: it is far from clear whether this is the case at the moment.

¹⁸ The CLG: Local Government DEL has been adjusted for a policy change that allows local authorities to retain part of the business rates they collect (50% across all local authorities). To reach the 28.3% figure (as well as those in Table 2.1) the approximate volume of the rates to be retained has been added for each year following the changes. The approximation used for 2013-14 is that given in PESA (£11.3 billion) and for subsequent years are those given in the OBR EFO 2012 which are in line with the £11 billion to £12 billion range given in PESA.

¹⁹ Presentation by G. Tetlow at IFS 2013 Spending Round briefing (http://www.ifs.org.uk/budgets/sr2013/gemma_tetlow.pdf).

Beyond the forecast horizon: further pressures

The OBR's 2013 annual Fiscal Sustainability Report has suggested that even the very substantive cuts planned by 2017–18 will not be sufficient to ensure that the UK's fiscal position is stable in the long term. A steady ageing of the population will put increasing pressure on services such as health and social care, and require additional spending on the state pension. Under the OBR's baseline projections, demographic change will add the equivalent of around 0.6 percentage points of GDP (which, to put this in context is equivalent to £10 billion, given the level of GDP currently) to spending on health, social care, pensions and other old-age benefits, and public service pensions between 2017–18 and 2025–26. In 2035–36 this increases to 2.3 percentage points of GDP (£37 billion), and by the last year of its projections, 2062–63, the increase in spend is equivalent to 4.6 percentage points of GDP (£73 billion).²⁰

Under its projections where healthcare productivity grows in line with the last 30 or so years, rather than in line with economy-wide productivity growth (which is the case in its baseline projections), the upwards pressure on spending is much more dramatic: spending on the same items would have to increase by the equivalent of 1.1 percentage points of GDP (£18 billion) by 2025–26, 3.9 percentage points of GDP (£62 billion) by 2035–36 and 10.7 percentage points of GDP (£171 billion) by 2062–63.

The importance of productivity growth is an issue we return to in Chapter 6 of this report. But, even on the basis of the OBR's baseline projections, the UK will have to make substantial cuts to benefits or other services, fail to spend enough on health and social care to meet growing demands or find new revenues.

Before we assess the spending pressures facing Wales in the years ahead, the next chapter of this report examines the trends in Welsh Government spending since 2000–01, focusing on the cuts that have been made since 2010–11. The cuts made by Wales are compared with those made by the UK government on behalf of England, and those made by the Scottish Government. This helps provide further context for our analysis of potential scenarios for Welsh Government spending between now and 2025–26, in Chapters 4 and 5 of this report.

²⁰GDP forecast is calculated from OBR FSR's 'central' growth figures.

3. Welsh Government spending and spending plans: 2000–01 to 2015–16

Summary

- The Welsh Government is funded nearly entirely by a block grant provided by the UK Treasury. The change in this block grant is calculated using the Barnett formula, based upon changes in the budgets of Whitehall departments that deliver services for which the Welsh Government are deemed to have responsibility in Wales. Large increases in spending on the NHS and education in England therefore fed through to substantial increases in the amount of grant paid to the Welsh Government in the first decade following devolution.
- But cuts to government spending as part of the fiscal consolidation mean that the Welsh block grant has been cut substantially since 2010–11. The total block grant allocated by the UK government to Wales in 2013–14 is set to be 9.4% lower in real terms than that in 2010–11 (after adjusting for the transfer of funding for council tax benefit to the Welsh Government). Further cuts have been announced for 2014–15 and 2015–16, which, if implemented, would take the cut to 12.2%.
- The Welsh Government decides how to allocate the cut in its overall budget among the different service areas it funds. It has chosen to cut the health budget by 8.6% in real terms; the budget of the Department for Economy, Science and Transport by 20.8% and of Education and Skills by 10.1% between 2010–11 and 2013–14. The Department for Local Government has seen a relatively smaller reduction, amounting to a real-terms reduction between 2010–11 and 2013–14 of 4.5%. This figure excludes the transfer of funding for council tax benefit to the Welsh Government (where it appears as part of the Local Government budget) but exclude transfers into the local government settlement from other budget areas.
- These choices contrast with the decisions taken by the Scottish Government, and those taken by the UK government with respect to public services in England. Both the Scottish and UK governments chose to ring-fence NHS spending: between 2010–11 and 2013–14 real-terms spending on the NHS is to fall by just 0.4% in Scotland and rise by 3.1% in England. On the flip-side, the departmental budgets for local government fell substantially more rapidly than in Wales, by 7.6% and 9.5% in real terms in Scotland and England respectively.

The Welsh Government, like the devolved governments of Northern Ireland and Scotland, receives the majority of its funding in the form of block grants from the UK Treasury. It is then up to the Welsh Government to decide how to allocate this funding to different functions or departments. In this chapter, we first explain how the *changes* in the block grants are determined and track the Welsh block grant from 2000–01 to 2015–16. We then look in some detail at the how the cuts required since 2010–11 have been spread across service areas. Finally, these cuts are then compared with the cuts made by the UK government, largely on behalf of England, and those made by the Scottish Government.

3.1 The Welsh block grant, 2000–01 to 2015–16

Changes in the block grants provided to the Welsh, Scottish and Northern Irish governments are determined by the Barnett formula. This formula is designed so that, in principle, the block grants to the Welsh, Scottish and Northern Irish governments change by the same amount per person as the change in ‘comparable’ spending per person by Whitehall departments in England.²¹

‘Comparable spending’ is that spending in England on functions that are devolved to Scotland, Wales and Northern Ireland. It is, therefore, not applied to any changes in spending by Whitehall departments that is deemed to benefit the whole of the UK (for example, defence), and, for a given nation, it is not applied to increases in spending on functions that are not devolved to that nation. This is because spending by Whitehall will cover both England and that nation (for example, changes to spending on benefit administration by the Department for Work and Pensions (DWP) affect only Northern Ireland, as DWP’s spending covers England, Scotland and Wales). Because many Whitehall departments fund a mix of programmes – some of which are devolved and others not – calculating how much funding should be given to the devolved governments is not as simple as might be expected; this is discussed in more detail in Box 3.1.

Ultimately, the Barnett formula means that changes in the DELs for the Whitehall departments that fund service areas that are partly or fully devolved to Wales (such as Health, Education, Local Government and Transport) determine changes in the amount allocated to the Welsh Government. It is then up to the Welsh Government to decide how to allocate that money – and as we shall see, these choices can differ quite considerably from those made by the UK government for public spending in England.

Box 3.1. The Barnett Formula: calculating the changes in block grants

Not all functions of the various departments in Whitehall are devolved to Scotland, Wales and Northern Ireland, and the functions that are devolved vary by nation. To take account of this, the various sub-programmes of each department are given a weight that reflects whether the function is fully devolved (100%) or not devolved (0%). For example, the Rail Network Grant is devolved to Scotland and Northern Ireland (so is given a weight of 100% for these nations), but not devolved at all to Wales (so is assigned a 0% weight). A weighted sum of the individual percentages for each departmental sub-programme is used to calculate an overall percentage of a department’s expenditure that is devolved; this varies by nation.

²¹ For example, if there is a £1 billion cash increase in comparable English spending, the Scottish Government would see a £100.3 million increase in its block grant, the Welsh Assembly government a £57.9 million increase and the Northern Ireland Executive a £34.5 million increase, since the populations of Scotland, Wales and Northern Ireland are 10.03%, 5.79% and 3.45% of the English population (respectively) according to the mid-2009 population estimates (<http://www.statistics.gov.uk/statbase/product.asp?vlnk=15106>). The level of spending per head is higher in the devolved administrations than in England; hence one of the implications of the Barnett formula is that, as cash spending per head in England rises (falls), spending levels per capita will converge (diverge) across the UK. This is termed the ‘Barnett squeeze’.

an overall percentage of a department's expenditure that is devolved; this varies by nation. This departmental average is used to determine how changes in Whitehall departmental spending affect grants to the devolved administrations. For transport, for example, the overall percentages for the Department for Transport are 100% for Northern Ireland, 98.0% for Scotland and 73.1% for Wales. Therefore, a £1 per head increase in the budget of the Department for Transport would boost grants to Northern Ireland by £1 per head, Scotland by 98p per head and Wales by just 73.1p per head. A list summarising the areas (called comparable functions) devolved to each of the nations can be found in the Spending Review's supporting documents.^a

Changes in grants to the devolved administrations are calculated using departmental average percentages because changes at the level of the sub-programme are generally not known at the time grants are determined (e.g. at the 2013 Spending Round). If all sub-programmes see their spending change by the same proportion, then using the departmental average generates an appropriate change in grants to the devolved administrations to cover comparable functions. However, if the proportional changes in spending differ by sub-programme, then the changes in funding for the devolved administrations may not reflect the changes in the amount spent on comparable functions in England.

Changes in the local government (LG) portion of the budget for the Department for Communities and Local Government (DCLG) cause a tricky problem for the formula. In particular, because of problems in the way the formula deals with business rates revenues, when the budget for this department is going up more quickly than business rates revenues, Wales and England are treated more favourably than Scotland and Northern Ireland. But, when the budget is increasing less quickly than business rates revenues, or falling as is currently the case, Wales and England are treated less favourably than Scotland and Northern Ireland.

For instance, in the 2010 Spending Review, the LG portion of the budget for DCLG was cut in the Spending Review by 19.6% in cash terms. Grants to English local authorities funded by business rate revenues are the largest sub-programme of this budget (comprising 82.7% as of 2010). Because this tax is fully devolved to Scotland and Northern Ireland, and is set and collected by these devolved administrations, one would not want changes in business rates revenues in England to generate changes in grants to these devolved administrations. For this reason, Scotland and Northern Ireland are given a weight of 0% for this item. In contrast, non-domestic rates are not fully devolved to Wales, so the item is given a weight of 100%. This translates into the overall weight for DCLG:LG budget changes being 17.3% for Scotland and Northern Ireland but 100% for Wales.

At the sub-programme level, the overall cut to the DCLG:LG budget is made up of cash *increases* in national non-domestic rates payments, which are more than offset by cash cuts to other sub-programmes. Because the changes in grants to the devolved administrations are calculated at the department level, this means Scotland and Northern Ireland will see a cut of only 17.3% of the overall (19.6%) cash cut in DCLG:LG, rather than a combination of 0% of the increase from national non-domestic rates receipts and 100% of the larger cash cut to other sub-programmes, which together would have resulted in a much larger cut.^b As a result, Scotland and Northern Ireland will receive approximately £400 million and £150 million, respectively, more a year by 2014–15 than if the Barnett formula were applied at

the sub-programme level within the DCLG:LG budget. This is one reason why, despite areas facing bigger cuts in England – like Justice and Policing – being devolved to Scotland and Northern Ireland but not to Wales, Wales is facing a larger cut in its spending power, as discussed below.

It is important to note that the cut being delivered by the Barnett formula to Scotland and Northern Ireland is ‘too small’, rather than that to Wales being ‘too large’: Scotland and Northern Ireland are being protected from cuts that, if the Barnett formula were applied more coherently, they would otherwise face. However, if Wales were also treated this way, then Wales would have received about £230 million more in block grant by 2014–15 than it will under current plans (it would also have seen growth in its devolved business rates revenue as well – for the UK as a whole, the cash increased in business rates during this period is predicted to be 19%).

a. See page 15 and annex B of HM Treasury, *Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly: The Statement of Funding Policy*, 2010 (http://www.direct.gov.uk/prod_consum_dg/groups/dg_digitalassets/@dg/@en/documents/digitalasset/dg_191701.pdf).

b. An alternative way of thinking about this problem is that Scotland and Northern Ireland have been largely shielded from central government grants to English local authorities, *and*, at the same time, have benefited from increases in their own business rates revenues.

In the years after the Government of Wales Act led to the creation of the Welsh Assembly in 1999, the total Welsh block grant (which is roughly equivalent to the DEL allocated to it by the UK government) steadily increased in real terms, as shown in Figure 3.1 (this figure shows the amount actually spent for each year between 2000–01 to 2012–13 – which may be less than the DEL initially planned – and planned DELs for 2013–14 and 2015–16, after adjusting for the business rate retention scheme in England and the council tax benefit localisation from 2013–14 onwards). This reflects two things. First, and most important, were the large real-terms increases in overall departmental spending made by the UK government. Indeed, because the UK government was increasing spending on many of the functions devolved to Wales most rapidly (Health and Education spending being notable examples), the Welsh DEL increased a bit more rapidly than the overall UK-wide DEL. Second, the devolution of further areas of responsibility to the Welsh Government has led to a small increase in the size of the block grant. All-in-all, the Welsh Government’s DEL increased by 60% in real terms between 2000–01 and its peak level of just over £16.5 billion (in today’s prices) in 2009–10.

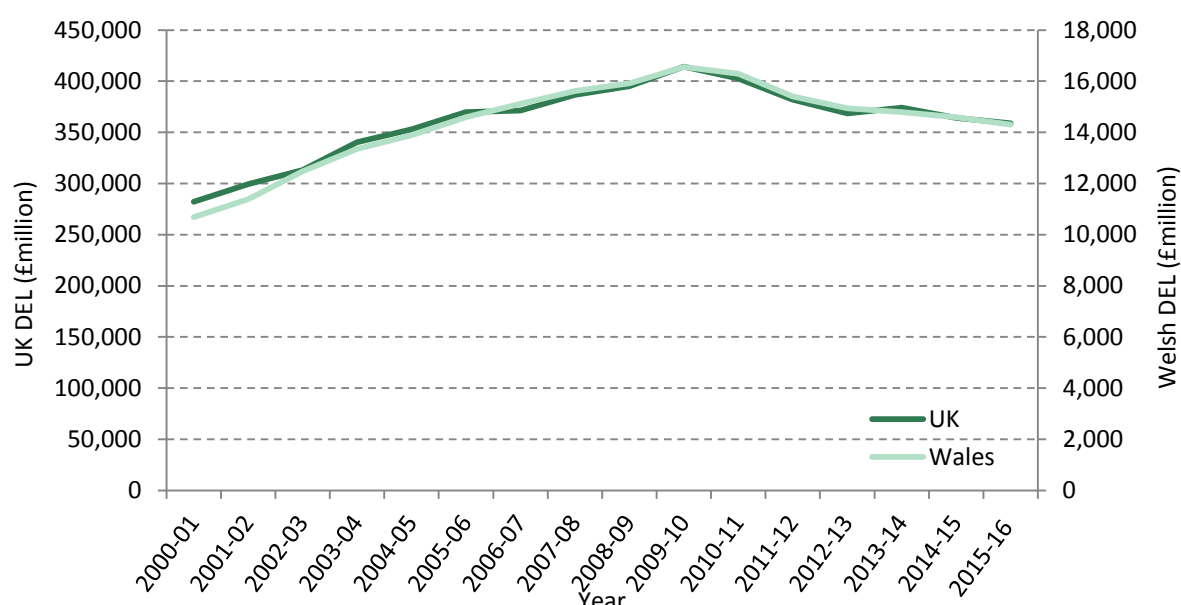
However, as was discussed in Chapter 2, following the financial crisis and associated deep recession, deep spending cuts have been enacted as part of the UK government’s attempts to tackle the structural budget deficit and restore the public finances to health. This led to the Welsh DEL being reduced each year between 2009–10 and 2012–13, which has led to a reduction in the amount spent by the Welsh Government. Indeed, the Welsh Government cut its spending by more than its DEL fell during this period, leading to an underspend of about £300 million in 2012–13, according to PESA 2013.²² This earlier underspend means that the cuts required in the current financial year, 2013–14, are actually smaller than was initially planned.²³ Of course, it is possible that there will be a further underspend in 2013–14, which

²²HM Treasury (2013), Tables 3.6 and 3.7, available at: <https://www.gov.uk/government/publications/public-expenditure-statistical-analyses-2013>.

²³Across the UK, the underspend for 2012–13 is estimated to have been £7billion according to PESA (calculated by subtracting the 2012–13 outturns from the ‘final provision adjusted for MOG’) or £11billion according to the definitions and estimates of the OBR’s EFO 2013.

may mean spending falls faster than needed to meet the plans set out. And there are further reductions in the planned Welsh DELs for 2014–15 and 2015–16.

Figure 3.1 Total Welsh DEL, and total UK DEL (2013–14 prices)



Notes: Welsh DEL expenditure since 2000 and UK total DEL, all in real terms (with UK DEL adjusted for BRRS and Welsh DEL for council tax benefit changes from 2013–14 onwards). These amounts are based on figures reported in the 2013, 2010 and 2006 editions of PESA. However, because of changes in how PESA classifies different spending over time, adjustments have been made to the figures reported in the 2010 and 2006 versions of PESA in an attempt to get a consistent series based on current (2013) definitions. Full details of this adjustment are available in Appendix B.

Source: PESA 2013, PESA 2010, PESA 2006 and author's calculations.

Overall, the Welsh block grant (DEL) in 2013–14 is set to be 9.4% below its level in 2010–11, the year when fiscal consolidation began in earnest (most of the cut in the Welsh DEL between 2009–10 and 2010–11 reflects the ending of temporary higher capital spending, introduced as a demand stimulus during the recession, rather than any true 'cuts' to the underlying level of public spending).²⁴ This consists of cuts to the capital DEL of 30% and the current DEL of 6.8%.²⁵ By 2015–16, the planned DEL will be 12.2% below its 2010–11 level, with the capital DEL 24.3% lower and the current DEL 10.7% lower. This will take the Welsh DEL back to its 2005–06 level, and given population growth, the DEL per person will be back to its 2004–05 level (12.8% lower than 2010–11).

3.2 Distributing the pain: Welsh Government budget allocations since 2010–11

The Welsh Government has already been forced to make tough decisions about how to spread cuts across the various service areas it manages and funds. In this section we examine whether it has relatively protected some areas, and hit others relatively hard.

²⁴The cut between 2009–10 and 2013–14 was 9.5%, consisting of a 38% cut to the capital DEL and a 5.4% cut to the current DEL.

²⁵These figures refer to the Welsh DEL in the sense of the departmental budget allotted by the UK government to Wales adjusted for the council tax changes.

The Welsh Government divides its resource and capital expenditure between a number of Main Expenditure Groups (MEGs) whose number and compositions reflect the allocation of ministerial portfolios. The structure of these MEGs is hence prone to frequent change as ministerial portfolios are changed. Thus, in order to make useful comparisons in spending on different functions over time, it is necessary to ‘translate’ the budgets so that they are in a single MEG structure; we show spending according to the current (2013–14) MEG structure.²⁶ The accounting system used in the Welsh Government’s budgets means that this can be achieved relatively straightforwardly back to 2010–11. However, it is not possible to go back further using published information without making a large number of assumptions.²⁷

It is also worth mentioning a complication with the terminology up front. Up until now, we have used the term ‘DEL’ to refer to the UK Treasury’s expenditure limits for Whitehall departments and, in the case of Wales, the size of the ‘block grant’ to Wales. But in the rest of this chapter (and in Chapter 5), when referring to ‘DEL’ we mean the expenditure limits set by the *Welsh Government* for its various MEGs (like the UK government, the Welsh Government splits its spending into annually managed expenditure (AME) and DEL for budgetary purposes). Readers should note that the total of these DELs generally differs somewhat from the ‘Welsh DEL’ (i.e. block grant) set by the Treasury, due to transfers from other Whitehall departments to the Welsh Government, and some differences in how the figures are reported by two governments.

Tables 3.1, 3.2 and 3.3 show the total, resource and capital budget allocations made by the Welsh Government for each year between 2010–11 and 2013–14, respectively. One of the most immediately striking points captured in the Tables is the extent to which capital spending has carried the bulk of the cuts compared to the resource DEL. Total capital DEL fell by 34.1% in real terms compared to the much smaller 6.1% cut to the total resource DEL. This reflects the large cuts made to Wales’ capital DEL by the Treasury (although the Welsh Government cut capital spending even further).

The second thing to note is that the Welsh Government plans to cut its spending in 2013–14 in real terms, despite the fact that the block grant made available to Wales by the UK Treasury is set to be higher than what was actually spent in 2012–13. This suggests a further underspend of its block grant by Wales is likely in 2013–14.

Turning to the cuts faced by different departments/service areas, like at Whitehall, there is a substantial degree of heterogeneity, especially for current spending. For instance, while current spending on the functions currently carried out by the Welsh Government’s Central Services and Administration department is planned to be 17.2% lower in real terms in 2013–14 than in 2010–11, current spending on the functions carried out by the Communities and Tackling Poverty department is actually set to be 27.1% higher in real terms. Other departments set to see relatively large cuts to their current budget include Economy, Science

²⁶For the budgets for the years from 2010–11 to 2013–14 in their contemporaneous MEG structures see Appendix A (Tables A.2 to A.5).

²⁷The accounting system used in the 2009–10 supplementary and earlier budgets is sufficiently different to that of the later budgets as to prohibit this kind of comparison. In general though, it seems as though the trends discussed below, including the real reduction in health spending and the relative protection of grants to local government, persist back to that year.

and Transport (down 13.6%) and Education and Skills²⁸ (down 7.9%), whilst spending on Culture and Sport, and Natural Resources and Food are also set to see an increase in their budgets (0.1% and 4.1%, respectively). All departments are set to face a cut in their capital budgets of a quarter or more by the end of 2013–14, with the biggest cuts being for Culture and Sport (69%), and the smallest being for Education and Skills (25%).

²⁸Most schools spending is not funded via the Department for Education and Skills, but instead is a responsibility of Welsh local authorities, which are funded via grants from the Welsh Government (mostly in the form of a block grant from the ‘Local Government’ MEG) and council tax.

Table 3.1. Total departmental expenditure, 2010–11 to 2013–14 (current MEG structure, 2013–14 prices, £ millions)

Main Expenditure Group	2010-11	2011-12	2012-13	2013-14	2014-15 (plans)	% change (2010-11 to 2013-14)
Health and Social Services	6,642	6,442	6,210	6,070	5,985	-8.6%
(Health alone) ¹	6,830	6,526	6,386	6,182	6,080	-9.5%
Local Government	4,730	4,506	4,497	4,516	4,370	-4.5%
Communities and Tackling Poverty	191	178	179	212	196	11.0%
Economy, Science and Transport	1,076	939	882	853	873	-20.8%
Education and Skills	2,069	1,931	1,966	1,861	1,817	-10.1%
Natural Resources and Food	431	427	399	414	388	-3.9%
Housing and Regeneration	599	545	521	466	434	-22.2%
Culture and Sport	171	143	138	140	135	-18.2%
Central Services and Administration	423	388	333	343	341	-19.0%
Council tax benefit ²				222		
Total (including council tax benefit)	16,519	15,584	15,301	15,208	N/A	-7.9%
Total (excluding council tax benefit)	16,519	15,584	15,301	14,986	14,635	-9.3%

Note: ¹ Sum of funds allocated to SPAs related to health less those spent on implementing the drugs misuse strategy, which is not classed as health spending in earlier budgets.

² separated out from Local Government DEL to remove anomalies related to devolution of council tax.

The above figures represent the real DELs given in the most recent supplementary budgets for each period. Past budgets have been translated into the new MEG structure by tracing transfers of SPAs and 'Activities' between MEGs using the breakdowns given in each budget and the included explanatory notes of the budgets that follow accounting changes.

Source: First supplementary Welsh budget 2013-2014, can be found at <http://wales.gov.uk/funding/budget/1stsupp1314/?lang=en> the others can be found at <http://wales.gov.uk/funding/budget/previousbudgetindex/?lang=en>.

Table 3.2. Departmental resource expenditure, 2010–11 to 2013–14 (current MEG structure, 2013–14 prices, £ millions)

Main Expenditure Group	2010-11	2011-12	2012-13	2013-14	2014-15 (plans)	% change (2010-11 to 2013-14)
Health and Social Services	6,387	6,207	6,156	5,941	5,845	-7.0%
(Health alone) ¹	6,205	6,129	5,992	5,838	5,755	-5.9%
Local Government	4,694	4,474	4,474	4,493	4,348	-4.3%
Communities and Tackling Poverty	148	157	160	188	180	27.1%
Economy, Science and Transport	619	581	540	535	529	-13.6%
Education and Skills	1,800	1,718	1,726	1,659	1,666	-7.9%
Natural Resources and Food	314	335	299	327	319	4.1%
Housing and Regeneration	190	183	176	176	172	-7.2%
Culture and Sport	125	130	127	125	123	0.1%
Central Services and Administration	385	352	304	319	318	-17.2%
Council tax benefit ²	-	-	-	222	-	-
Total (including council tax benefit)	14,662	14,138	13,961	13,985	N/A	-4.6%
Total (excluding council tax benefit)	14,662	14,138	13,961	13,763	13,500	-6.1%

Note: ¹Sum of funds allocated to SPAs related to health less those spent on implementing the drugs misuse strategy, which is not classed as health spending in earlier budgets.

² separated out from Local Government DEL to remove anomalies related to devolution of council tax.

The above figures represent the real DELs given in the most recent supplementary budgets for each period. Past budgets have been translated into the new MEG structure by tracing transfers of SPAs and 'Activities' between MEGs using the breakdowns given in each budget and the included explanatory notes of the budgets that follow accounting changes.

Source: First supplementary Welsh budget 2013-2014, can be found at <http://wales.gov.uk/funding/budget/1stsupp1314/?lang=en> the others can be found at <http://wales.gov.uk/funding/budget/previousbudgetindex/?lang=en>.

Table 3.3. Departmental capital expenditure, 2010–11 to 2013–14 (current MEG structure, 2013–14 prices, £ millions)

Main Expenditure Group	2010-11	2011-12	2012-13	2013-14	2014-15 (plans)	% change (2010-11 to 2013-14)
Health and Social Services	443	319	230	242	235	-45.5%
(Health alone) ¹	436	314	218	232	230	-46.9%
Local Government	36	32	23	23	22	-37.1%
Communities and Tackling Poverty	43	21	19	24	16	-43.8%
Economy, Science and Transport	457	358	343	317	344	-30.6%
Education and Skills	268	212	240	202	151	-24.7%
Natural Resources and Food	116	92	101	87	70	-25.6%
Housing and Regeneration	409	362	345	290	262	-29.1%
Culture and Sport	46	13	11	14	12	-68.8%
Central Services and Administration	38	37	29	24	23	-36.8%
Total	1,857	1,446	1,340	1,223	1,135	-34.1%

Note: ¹ Sum of funds allocated to SPAs related to health less those spent on implementing the drugs misuse strategy, which is not classed as health spending in earlier budgets.

² separated out from Local Government DEL to remove anomalies related to devolution of council tax.

Additional info: Local authority expenditure on education (which comes from both the Local Government MEG's DEL and grants from other MEGs was as follows (in £ thousands): 2,584,331 in 2010-11; 2,590,523 in 2011-12; 2,598,263 in 2012-13; 2,639,765 in 2013-14.

The above figures represent the real DELs given in the most recent supplementary budgets for each period. Past budgets have been translated into the new MEG structure by tracing transfers of SPAs and 'Activities' between MEGs using the breakdowns given in each budget and the included explanatory notes of the budgets that follow accounting changes.

Source: First supplementary Welsh budget 2013-2014, can be found at <http://wales.gov.uk/funding/budget/1stsupp1314/?lang=en> the others can be found at <http://wales.gov.uk/funding/budget/previousbudgetindex/?lang=en>.

The Welsh Government's biggest departmental budget is that for Health and Social Care. The current DEL for areas covered by this department has been reduced by 7% in real-terms since 2010–11, with that part allocated to health down by 5.9%: this is a substantial cut, broadly in line with the overall cut to Welsh Government current spending (excluding council tax benefit). This department has also seen large cuts to its capital budget – the largest in cash terms and the second largest in percentage terms – down 46% over the three years between 2010–11 and 2013–14.²⁹

Welsh local government, on the other hand, has fared relatively well, with a reduction in the local government MEG's current budget of 4.3% in real terms since 2010–11: the 'funding support for local government' component of which has decreased by 2.9% in real terms during the same period. However, a number of formerly specific grants have been transferred into the 'funding support for local government' budget, which means this headline figure may understate the reduction in the 'core funding' for local government. Using figures from the Welsh Local Government Financial Settlements, spending on those grants transferred into the core funding settlement totalled £127 million in today's prices in 2010–11. Adding this to the baseline level of funding in 2010–11 would make the cut in 'funding support for local government' between 2010–11 and 2013–14 equal to 5.6% in real terms (instead of 2.9%).

The capital budget for the local government MEG has been reduced substantially in proportional terms, but it should be noted that this budget was only ever very small (less than 1% of the current budget), so the absolute cash reduction is small. The capital DEL for the local government MEG only funds a small part of the capital investment of local authorities, who fund the majority of their investment via prudential borrowing, and via grants from other budgets. Taking this into account, Welsh local government financial statistics show that the overall reduction in capital spending by local authorities between 2010–11 and 2013–14 is substantial – around £200 million, or just over 32%, broadly in line with the reduction in the Welsh Government's overall capital DEL.

Tables 3.1 to 3.3 also show indicative spending plans for 2014–15 published at the time of the draft budget for 2013–14. This shows a fairly similar pattern of cuts to current spending as has been made between 2010–11 and 2013–14. The main exceptions to this are the Communities and Tackling Poverty MEG, which is set to see a cut to its current DEL after three years of increases, and Central Services and Administration, which is set to see a smaller cut this year (perhaps because efficiencies are close to being exhausted).

As was the case between 2010–11 and 2013–14, the indicative plans show a larger cut to the capital DELs than for the current DELs. However, since these were drawn up, additional capital spending has been announced for 2014–15 by the UK government, which will boost the amount available to the Welsh Government for capital spending: the capital budget can therefore expected to be boosted when the draft budget for 2014–15 is published. Indeed, there are indications that the draft budget will differ substantially from the indicative plans set out: for this reason, our analysis of the trade-offs facing the Welsh Government when allocating its budget to different spending areas takes the allocations in 2013–14 as its starting point, rather than the indicative plans for 2014–15.

²⁹ Figures calculated using Welsh Local Government Settlements, available at <http://wales.gov.uk/topics/localgovernment/finandfunding/settlement/?lang=en>.

The changing composition of the Welsh Government's budget

Figure 3.2 shows the impact of the changes in spending between 2010–11 and 2013–14 on the composition of the Welsh Government's current spending. This shows that the slightly-larger-than-average cut to the Health and Social Services MEG means its share of the overall Welsh current budget has fallen, but only very slightly, from 43.4% to 43.2% of the total since 2010–11. On the other hand, the smaller-than-average cuts to the local government MEG means that its share of the overall Welsh current budget has increased slightly, from 32.0% to 32.6%.³⁰ Thus, the composition of the current budget in 2013–14 is very similar to that in 2010–11, despite a fair degree of heterogeneity in the spending changes faced by different departments.

Figure 3.3 shows the impact of the changes in spending between 2010–11 and 2013–14 on the composition of the Welsh Government's capital spending: here, there have been some more notable changes in composition. For instance, the share of capital spending allocated to Health and Social services has fallen by 4.1 percentage points from 23.9% to 19.8%, and the share allocated to Culture and Sport has halved from 2.5% to 1.2%. On the other hand, relatively capital intensive departments,³¹ such as the Economy, Science and Transport (24.6% to 25.9%) and Housing and Regeneration (22.0% to 23.7%), as well as Education and Skills (14.5% to 16.5%) account for an increasing share of capital expenditure. This suggests that within the capital DEL, relative protection has been given to the capital-intensive areas of economic development, transport and housing, and investment in educational facilities.

However, because the cuts to capital spending have been so much larger than to current spending, the capital-intensive Economy, Science and Transport, and Housing and Regeneration MEGs have seen their share of the that Welsh Government DEL fall from 6.5% to 5.7%, and from 3.6% to 3.1%, respectively. The concentration of cuts on capital spending as opposed to current spending would, all else being equal, have led to a rise in the proportion of the total Welsh Government DEL going towards health and social services, as capital spending makes up only a small share of total spending in this area. But, the combination of large cuts in its capital DEL and a slightly-larger-than-average cut in its current DEL mean that the Health and Social Services MEG has seen its share of the total Welsh Government DEL hold steady at around 41.3% of the overall budget.

³⁰The proportion of the budget accounted by all other departments has fallen slightly, from 24.4% to 24.2%.

³¹Capital DEL makes up over a third of the total DEL of the Economy, Science and Transport MEG, and over half of the budget of the Housing and Regeneration MEG.

Figure 3.2 Composition of the Welsh resource budget since 2010

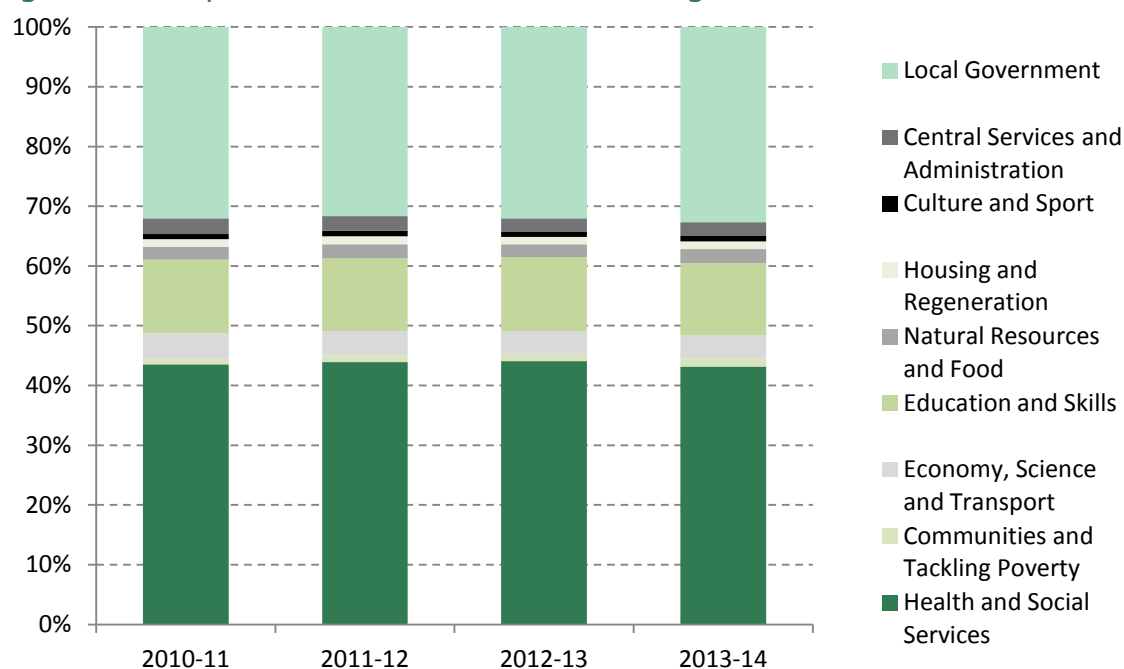
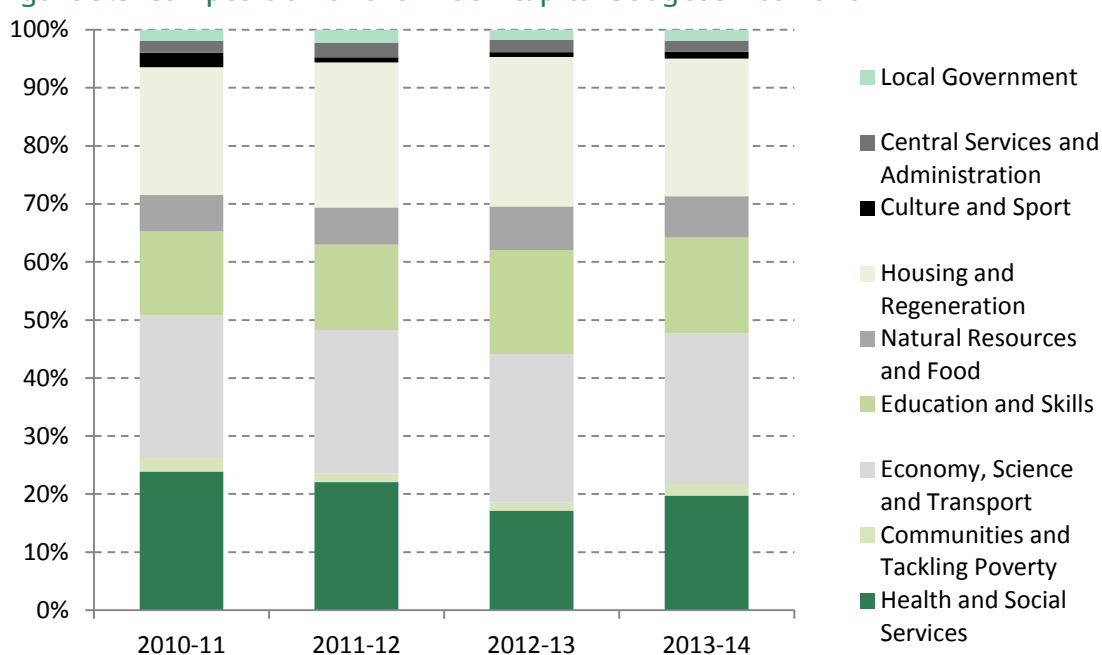


Figure 3.3 Composition of the Welsh capital budget since 2010



Note: Bars represent the resource DELs of the Welsh Government decomposed into the different MEGs as structured in the 2013-14 supplementary budget with council tax benefit removed.

Source: First supplementary Welsh budget 2013-2014, can be found at

<http://wales.gov.uk/funding/budget/1stsupp1314/?lang=en> the others can be found at

<http://wales.gov.uk/funding/budget/previousbudgetindex/?lang=en> GDP deflators from ONS.

The relative winner from the changes since 2010-11 is the local government MEG: the relative protection of its current DEL, and its very small capital DEL to begin with mean that its share of the total Welsh Government DEL has increased from 28.6% to 30.1% in the last three years.

3.3 Comparing the Welsh Government's decisions with those of the Scottish and UK governments

As is the case for the Welsh Government, the Scottish Government gets most of its resources in the form of a block grant from the UK Treasury.³² It has also had to make substantial cuts to its budget since 2010–11, although the amount it has received from the UK government has not fallen by as much as is the case for Wales (7.7% versus 9.4%).^{33,34}

Major differences in the departmental structures of the Welsh and Scottish Governments mean that it is not possible to 'translate' the budget allocations made in Scotland into the same MEG structure as exists in Wales. This precludes a direct comparison of the budget allocations in Scotland and Wales. However, the Scottish Government's spending areas are similar enough to those in Wales in some instances to allow some comparisons to be made, and doing this shows some contrasts between the spending priorities of the two devolved governments.

Table 3.4 shows the Scottish Government's (real) terms budget allocations for 2010–11 and 2013–14, and the percentage change between the two years, using the departmental structure used in Scotland's 2013–14 draft budget.³⁵

One notable contrast is that whilst the Welsh Economy, Science and Transport MEG has been one of the hardest hit – with a real-terms reduction in spending of 20.8% – its closest analogue in Scotland, the Department for Infrastructure, Investment and Cities, is well protected, with spending actually up 0.9% in real terms. This suggests less of a priority has been placed on transport and other infrastructure investment in Wales than in Scotland.

But the most striking differences between Scotland and Wales are for spending on health and local government. Despite a 4.4% real-terms decrease in total expenditure,³⁶ in Scotland health expenditure has increased by 0.4% in real terms since 2010–11, increasing its share of the overall by 1.6 percentage points over three years. Recall that the share of the total Welsh DEL (excluding council tax benefit) going towards health and social services remained broadly constant during the same time period. On the other hand, a 7.6% reduction in spending on local government saw its share of the total Scottish Government budget fall from 34% to 33%, around 1.0 percentage point, compared to the 1.5 percentage point increase in the share of the Welsh Government's DEL going to its local government MEG. Thus, in contrast to Wales, in Scotland, health has been a relative winner, and local government a relative loser from changes in budget allocations since 2010–11.

³²The full devolution of non-domestic rates means that the Scottish Government is slightly less dependent on the Treasury block grant. As explained in Box 3.1, the interaction of business rates devolution with the Barnett formula has also meant that Scotland has seen smaller cuts to its block grant than a more appropriate formula would have led to.

³³Figures refer to DEL (block grant) allocated to the two countries by the UK government.

³⁴The spending plans for the next two years to 2015–16 show this gap widening slightly further so that the real-terms reduction in the Scottish DEL will have been 10%, compared with 10.8% for the Welsh DEL.

³⁵This table is based on the table shown in Annex D of Scotland's 2013–14 draft budget, available at: <http://www.scotland.gov.uk/Publications/2012/09/7829/20>.

³⁶Note that Scottish expenditure figures include both AME and DEL. It was not possible to construct consistent figures for DEL only over time.

Table 3.4. Real Scottish Departmental expenditure since 2010–11 (£ millions)

Spending area	2010-11	2013-14	% change (2010-2013)
Health	11,853	11,900	0.40%
Wellbeing and Cities Strategy	88	164	84.35%
Finance, Employ and Sustainable Growth	3,626	3,322	-8.40%
Education and Lifelong Learning	2,979	2,909	-2.35%
Justice¹	1,511	1,226	-18.84%
Rural Affairs and the Environment	591	534	-9.59%
Culture and External Affairs	306	238	-22.08%
Infrastructure, Investment and Cities	2,521	2,545	0.93%
Administration	292	207	-29.21%
Crown Office and Procurator Fiscal	125	108	-13.21%
Local Government²	12,399	11,452	-7.63%
Total	36,291	34,605	-4.65%

Notes: ^{1,2}Police and fire services were transferred from local authorities to the Justice department from 2013-14 onwards. For comparison purposes the police and fire service expenditure has been transferred back to local government in this table.

The figures from 2010 and 2011 are outturns and 2012 is an estimated outturn, as given in Annex D of the 2013-14 Scottish draft budget. The figures for 2013-14 have been updated to those in the final budget act. These figures have been structured as they were in Annex D (which also subdivides each area further) with health separated out; this differs from the accounting used in Annex A and also differs from the system used in the Budget Bill and Act, which treats a number of agencies, such as the Food Standards Agency and the Forestry Commission, as separate items.

Source: Annex D of the Scottish draft budget can be found at <http://www.scotland.gov.uk/Publications/2012/09/7829/20>; the 2013 Scottish budget bill can be found at <http://www.scotland.gov.uk/Resource/0041/00412616.pdf>. The figures given in the bill are identical to those that were eventually passed in the act (but different to those in the draft budget).

Local government funds a similar range of services in both Wales and Scotland. Tables 3.5, and 3.6 show the allocations of local authorities' net revenue expenditure in Wales and Scotland, respectively. The allocation of spending is similar in both nations, with the largest items of local government spending being education – taking up 47% of spending in Wales, and 44% in Scotland – and social services – taking up 28% of spending in Wales and 29% in Scotland.³⁷ A similar proportion of spending is devoted to smaller items of expenditure, such as environmental services and transport, in both nations as well.

The relative protection of the local government budget by the Welsh Government is evident in the smaller cuts local government has had to make compared with Scotland. Whilst local government net revenue expenditure on services was cut by 8.3% in Scotland between 2010–11 and 2013–14, in Wales the cut was just 3.5%.

³⁷The police grant (i.e. spending categorised as 'law, order and protective services') has been subtracted from the Welsh total for these percentages in order to make the figures comparable with Scotland, where these services are no longer the responsibility of local authorities.

Table 3.5. Local authority net revenue spending in Wales £ millions (real)

Local authority funding area	2010-11	2013-14	% cut
Education	2,740	2,640	-3.6%
Libraries, culture, heritage, sport and recreation	306	263	-13.9%
Social Services	1,549	1,565	1.0%
Roads and transport	351	307	-12.4%
Local environmental services	465	435	-6.5%
Planning, economic and community development	169	125	-26%
Council fund housing (excludes housing benefit)	179	148	-17%
Central administration	107	177	66%
Total	5,867	5,660	-3.5%

Source: Budgeted net revenue expenditure for 2013-14 can be found at <https://stats.wales.gov.uk/Catalogue/Local-Government/Finance/Revenue/Budgets/BudgetedRevenueExpenditure-by-ServiceDetail>. Outturns for equivalent items in 2010-11 were calculated using a very detailed spending breakdown provided to us by the Welsh civil service.

Table 3.6. Local authority net revenue spending in Scotland £ millions (real)

Local authority funding area	2010-11	2013-14	% cut
Education	4,957	4,565	-7.9%
Cultural and Related Services	676	590	-12.8%
Social Work	3,033	2,960	-2.4%
Roads and Transport	533	458	-14.1%
Environmental Services	703	672	-4.5%
Planning & Economic Development	332	277	-16.7%
Non-HRA Housing (excludes housing benefit)	418	336	-19.4%
Central Services	594	445	-25.1%
Trading Services	-9	4	-151.2%
Total General Fund services ¹	11,237	10,308	-8.3%

Note: ¹This is total of the items included in the table, police and fire services, for example, have been excluded because they are not longer paid for at a local level as of this year.

Source: Figures for 2010-11 from the Scottish local government finance statistics publication 2010-11, Table 3.2: <http://www.scotland.gov.uk/Topics/Statistics/Browse/Local-Government-Finance/PubScottishLGFStats>. Figures for 2013-14 are from a further breakdown of the provisional outturn budget estimates 2013 we were kindly sent by the Scottish civil service. The figures for the first few items, however, are identical to those that can be found in the published POBE 2013, which can be found at <http://www.scotland.gov.uk/Topics/Statistics/Browse/Local-Government-Finance/POBEStats>.

In both countries social service spending was prioritised. Local government spending on social services in Wales actually *increased* in real terms (1.0%). And whilst the larger overall cuts to Scottish local government spending meant that their spending on social services *fell* 2.4% during the same three years, this was by far the smallest cut of any service area. Perhaps contrary to what one would expect given the ageing population, the average increase in Wales masks falls in the amount spent on adults aged 65 or over (–1.2%), and other adult social services (–1.7%), which is more than offset by a 6.5% increase in the amount spent on social services for children and families.

On the other hand, local governments in both nations made substantial cuts to spending on transport, planning, culture and housing. For instance, expenditure on transport was reduced by 12.4% in Wales and 14.1% in Scotland, whilst spending on housing was cut by 17% in Wales and 19.4% in Scotland.

Net spending on central services by local government appears to represent a striking contrast: whereas in Scotland central services spending this year is set to be 25% lower in real terms than in 2010–11, in Wales, it is set to be 66% higher.³⁸ However, one cannot interpret this as indicating differences in the changes in ‘administrative’ expenditure by local governments in the two nations. First, central services expenditure is reported net of contributions by other service areas (such as education) to the costs of administering their services, which can change as local governments adopt different rules for working out contributions. And second, it includes other types of spending, such as unallocated pensions and computing costs, which are also often volatile. The reported figure for Wales in 2010–11 was unusually low, likely due to volatility in these two components of central services spending, meaning one cannot say for certain how changes in spending on the administration of local government services has differed between Scotland and Wales in recent years.

Thus, the relative protection of grants to local governments in Wales has allowed smaller cuts in spending on many service areas than in Scotland, most notably for social services and education spending. Of course, the opposite side of this equation is the cuts to health spending in Wales that have not taken place in Scotland.

Comparisons with the decisions made for England by the UK government

Table 2.1 in the last chapter showed the changes between 2010–11 and 2013–14 (and 2015–16) in the DELs for a number of major Whitehall departments. Similar to Scotland and unlike Wales, the UK government decided to ‘ring-fence’ funding for the NHS in England, and in fact the allocation for this year allows for a real-terms increase of 3.2% over 2010–11 for the current DEL, and a 0.4% real-terms increase over 2010–11 for the capital DEL. The UK government also appears to have prioritised transport investment, with the Department for Transport’s capital budget actually up 12% between 2010–11 and 2013–14, which seems closer to the situation in Scotland than in Wales. And, again like Scotland, local government in England has seen substantial cuts in its DEL, falling 9.5% in real terms (after adjusting for the business rates retentions scheme) between 2010–11 and 2013–14, around double the cut that has been imposed in Wales.

³⁸ Local government spending on ‘central services’ should not be confused with the Welsh government’s Central Services and Administration MEG, which covers the administration of the Welsh central government.

Summary

It is not the case that Wales has taken a ‘salami slicing’ approach to the cuts: the size of the cuts to different departments does vary considerably, and not just because the share of capital spending (which has been cut much more) varies between departments. For instance, the current DEL for services now classified under the Communities and Tackling Poverty MEG has increased quite substantially over the last three years, whilst the current DELs for Administration and Economy, Science and Transport has been cut substantially. On the capital side, there is some evidence that cuts have been proportionally smaller for those departments that are relatively capital intensive such as Economy, Science and Transport, and Housing and Generation. But the spending priorities and decisions have clearly differed from those taken by the UK government on behalf of England, and by the Scottish Government. In particular, unlike in the two other nations of Great Britain, health spending has been cut substantially, and grants to local governments have been relatively protected. And a lower priority appears to have been placed on transport infrastructure investment than in the rest of the UK.

Whilst Scotland has yet to confirm its budget allocations for future years,³⁹ the increases in health spending and transport investment and large cuts to local government spending are set to continue in England until at least 2015–16. On the other hand, the indicative plans for 2014–15 published by the Welsh Government show a broad continuation of its policy of cutting health spending to allow for smaller cuts to local government spending. If this were to be confirmed in the budget for 2014–15 and continued in the remaining years of cuts, this would lead to the allocation of spending across services in Wales differing from England by much more than it did by the second half of this decade.

The rest of this report looks to that future and examines a number of scenarios for the size of the Welsh block grant, and thus the Welsh Government’s budget, between now and 2025–26 (Chapter 4), the trade-offs facing the Welsh Government when allocating its budget between service areas (Chapter 5) and the demand and cost pressures that will affect Welsh Government spending in the coming years (Chapter 6).

³⁹The Scottish Government has published a draft budget for 2014–15 which also includes indicative plans for 2015–16.

4. The public spending outlook to 2025–26

Summary

- The Government's plans imply the fiscal consolidation will be complete in 2017–18. This implies that spending could then begin to grow again in 2018–19 and beyond. However, it is possible that further fiscal consolidation is required beyond 2017–18, which might take the form of additional spending cuts. Because of this, and because the long-term rate of economic growth in the years ahead is unclear, the path for total UK government spending between 2017–18 and 2025–26 is uncertain. Therefore, in this report we consider four scenarios for total UK government spending over this period.
- The block grant for Wales will depend upon not only the overall level of government spending, but also how the UK government decides to allocate that spending between benefits and tax credits and various Whitehall departmental budgets. If, as in our most pessimistic scenario yet-to-be-allocated cuts in 2016–17 and 2017–18 fall entirely on departmental spending, and Whitehall offers no protection to English health and education spending, the Welsh block grant is set to fall by 9% in real terms to £13.7 billion in today's prices in 2017–18. Under our most optimistic scenario, where there are a further £10 billion of benefit cuts or tax increases by 2017–18, and where health and education spending are protected, the Welsh block grant would instead be 5% lower than today (at £14.3 billion).
- There is a wide range of plausible outcomes for the Welsh block grant in 2025–26: it not possible to give an upper or lower bound on what could be expected. Instead we are able to set out a range of scenarios, based on different paths for overall UK government spending and different options for how to allocate that between different areas.
- In the most optimistic scenario we consider, total UK government spending grows in line with the OBR's high productivity growth variant projection for GDP after 2017–18; English education and health spending are protected from further cuts in 2016–17 and 2017–18, with the latter increases in line with the OBR's '1% health productivity growth' scenario after 2017–18, and; £10 billion of additional benefit cuts or tax credits are made by 2017–18. Under this scenario, the Welsh block grant will be 19% higher than today by 2025–26, and 8% higher than in 2010–11 on a like-for-like basis. This may seem like a significant increase but a growing and ageing population, and likely cost pressures mean even this scenario would still be challenging.
- Our baseline scenario is the same as our most optimistic except that UK government spending grows in line with the OBR's baseline projection for GDP after 2017–18. Under this scenario, the Welsh block grant will be 16% higher than today by 2025–26, and 5% higher than in 2010–11. Accounting for the projected population increase that would make the block grant per person roughly 10% higher than today, but slightly lower than the level in 2010–11 (1% lower).

- In the most pessimistic scenario we consider, total UK government spending is held fixed in real terms between 2017–18 and 2020–21 and then grows in line with the OBR’s low productivity growth variant projection for GDP; no protection is offered to education and health spending from further cuts, with the latter increases in line with the OBR’s baseline projections for health spending; and no further benefit cuts or tax increases are made by 2017–18. Under this scenario, the Welsh block grant would be £14.6 billion in 2025–26, 3% lower than today (or 9% lower per person). And given the cuts already made, the block grant would be 12% lower than in 2010–11, 15 years after the fiscal consolidation began in earnest. As shown in Chapter 5, a block grant of £14.6 billion in 2025–26 would involve a set of trade-offs that are difficult to comprehend.

In this chapter of the report we look to the future and ask how the amount of money available to the Welsh Government may change in the coming years. In doing this we largely abstract from the potential changes to the funding of the Welsh Government resulting from the Silk Commission’s Report, although we do qualitatively discuss some of the implications of the proposed reforms in Box 4.1. In the absence of reforms, the Welsh Government’s budget will be determined by the Barnett formula based on the changes in the UK government’s DELs for different departments. This in turn will depend upon the overall level of UK government spending and how this is allocated between various departmental budgets and benefits and other spending.

The rest of this chapter proceeds as follows. In Section 4.1 we set out four scenarios for overall UK government spending in the period to 2025–26 based on the forecasts set out in the OBR’s March 2013 Economic and Fiscal Outlook, and the projections for 2018–19 and beyond set out in the OBR’s July 2013 Fiscal Sustainability Report. It also sets out, on current default policy, what these scenarios imply for the total DEL. In Section 4.2 we set out three scenarios for how the spending changes will be allocated between departmental spending and benefit and tax credit spending, and between different departmental budgets. This will determine the Welsh Government’s budget allocation from the Treasury. **Readers should note that the scenarios set out in this chapter and the next (which explores the trade-offs facing the Welsh Government when setting budgets for different service areas) are indicative only and do not put upper or lower bounds on the size of the Welsh Government’s budget and the amount various service areas it funds might receive.**

4.1 Scenarios for UK public spending to 2025–26

Following the 2013 Spending Round, the UK government has set out its plans for departmental and other spending for each year until 2015–16. It has also set out the overall government spending envelope for the years 2016–17 and 2017–18, and although it has not yet confirmed how it plans to allocate this between the various spending areas the default is that, without further policy action, the further cuts required in these years will fall on current departmental spending (as opposed to capital spending or benefits spending). It is planned that the fiscal consolidation will be complete by 2017–18, and that spending can then begin to grow again in 2018–19 and beyond. For its long-term projections the OBR assumes that, for the most part, except for the impact of demographic change, government spending will grow at the same rate as the economy in 2018–19 and beyond.

Of course, there is a risk that the fiscal consolidation is not completed as planned: the period of spending cuts has already been extended by three years from the plans initially set out by the UK coalition government in its June 2010 Budget, as the size of the hole in the public finances has been revised upwards as a result of sustained economic weakness. In the absence of further increases in taxes, this extension would require further cuts to government spending that would likely ultimately feed through into a lower budget for the Welsh Government.⁴⁰

But, there are also uncertainties about what the long-term rate of growth of the economy will be. In its long-term projections the OBR sets out three variants for long-term productivity growth (1.7%, 2.2% and 2.7%) and we use these as the basis for constructing three of our scenarios for overall UK government spending in the period between 2018–19 and 2025–26. Under these scenarios, the fiscal consolidation is completed on schedule, but differences in the long-term rate of sustainable economic growth feed through into differences in the rate of UK government spending growth in the later years of our projections. In particular, we assume that after 2017–18 total managed expenditure (TME) changes in line with the rate of GDP projected under each of the OBR's three scenarios.⁴¹ Our fourth scenario is our most pessimistic and assumes that overall UK government spending is unchanged in real terms between 2017–18 and 2020–21, and then grows in line with the projections for GDP under the low-productivity variant of the OBR's long-term projections. Appendix B provides more details on how we project UK government spending under the four scenarios (and, subsequently, how we project the Welsh Government budget and model the trade-offs between service areas when allocating the budget).

Table 4.1 shows the projections for the UK government's TME under each of the four scenarios described above. It also shows the outturns and implied projections for the total DELs under current default policy (i.e. no further tax increases or benefit cuts). Six years are shown: 2010–11, 2013–14, 2015–16, 2017–18 (all unaffected by the scenarios), 2020–21 and 2025–26. It also shows TME and DEL in 2017–18 and 2025–26 as a percentage of their 2013–14 values, and the level of TME and DEL in 2025–26 as a percentage of their 2010–11 values.

The table clearly shows a number of important facts.

First, that there has been a real-terms cut in TME between 2010–11 and 2013–14, entirely due to a substantial reduction in the total DEL from £392 billion to £363 billion (non-DEL spending actually increased). As discussed in Chapter 2 of this report, a substantial part of this was the result of cuts to the capital DEL, which are now largely complete.

⁴⁰IFS researchers examined the implications of further fiscal consolidation in their 2012 report for the Welsh Local Government Association (Crawford, Joyce and Phillips, 2012). At the time of that analysis, the UK government's spending cuts were planned to be completed by 2016–17. If, however, further fiscal consolidation was required (so that overall UK government spending was the same in real terms in 2020–21 as it was in 2016–17, benefits spending grew in line with the OBR's central long term projection between 2016–17 and 2020–21, and the Welsh Government saw its grants change by the same percentage as overall public service spending) then rather than grow by 2.9% per year in real terms between 2016–17 and 2020–21, the Welsh Government's budget would see cuts of 1.2% per year in real terms. This would equate to the Welsh Budget being over £2 billion per year lower in 2020–21 than if the fiscal consolidation had been completed by 2016–17.

⁴¹This differs somewhat from the methodology used by the OBR in its Fiscal Sustainability Report, which assumes after 2017–18 TME would grow in line with GDP if it were not for demographic change. This means it allows the projected increase in spending on health, social care and pensions resulting from demographic change to push up TME. Our method assumes that increases in these must be offset by spending relatively less in other areas so that TME is constant as a proportion of GDP.

It also shows that whilst TME is set to fall marginally between now and 2015–16, the cut in the total DEL is rather more substantial (£15 billion, or 4%). On default policy, this is set to continue in 2016–17 and 2017–18, so that while TME is forecast to be just 1% lower in today's prices, the total DEL is set to be 11% (or £40 billion) lower.

Interestingly, the projections for economic growth in the years between 2017–18 and 2020–21 contained in the OBR's 2013 Fiscal Sustainability Report do not differ between its 'low', 'central' and 'high' productivity growth variants: this is because the economy is projected to be still operating below potential in 2017–18 under each variant, giving scope for an above-trend 2.8% per year rate of economic growth for each of those three years. An increase of 2.8% per year in 2018–19, 2019–20 and 2020–21 would mean TME being £775 billion, compared to £720 billion this year. However, on default policy, DEL would still be a little lower than today – £361 billion compared with £363 billion – and over £30 billion lower than in 2010–11.

By 2025–26, the picture for public spending clearly differs between our first three scenarios, driven by the differences in the assumed long-term growth rate of labour productivity feeding through into lower or higher economic growth after 2020–21, and thus lower or higher growth in TME and the total DEL. Under the OBR's baseline ('central') projection TME in 2025–26 would be £873 billion per year, 21% higher than today's level. Under the high productivity growth variant TME would instead be £894 billion, or 24% higher than today, while under the low productivity growth variant TME would be £852 billion, or 18% higher than today.

Under default policy, the path for TME under the OBR's baseline projection for economic growth implies a total DEL of £406 billion per year in 2025–26, around 12% higher than that in 2013–14. This implies a growth rate of less than 1% per year, on average, in real terms, during a period of 12 years, which is very low by historical standards,⁴² and only a little higher than the projected 0.7% per year growth in the population. Under the high productivity growth variant, the total DEL would be £422 billion (16% above today's level), whilst under the low productivity variant it would be £391 billion (8% above today's level).

If further restraint in public spending is required after 2017–18 the picture could be dramatically worse. Under our fourth scenario, TME in 2025–26 would grow to £784 billion, around 9% higher than its level today. However, on default policy for the allocation of cuts in 2016–17 and 2017–18, the total DEL in that year would be £349 billion, 4% lower than the level today, and fully 11% lower than that in 2010–11. In other words, the total DEL would still be substantially lower than it was at the start of the main fiscal consolidation 17 years after the financial crisis and recession that necessitated action to restore the public finances to health. It is important to note that such a scenario is not that considered most likely by the OBR. But it is not implausible: the planned end date for government spending cuts has already been extended by three years from 2014–15 to 2017–18, and further extensions are a possibility.

⁴²Public spending has been divided between DEL and AME since 1998, meaning direct historical comparisons are not possible. However, it is possible to estimate spending on public services as TME minus debt interest minus benefits spending, and examine how this has changed over time. Using this definition spending on public services grew by 4.6% per year in real terms between 1997–98 and 2007–08, more than four times as fast as projected between 2013–14 and 2025–26 under the OBR's baseline projections.

Table 4.1. Some scenarios for UK government TME and the total DEL, 2010–11 to 2025–26, £ billions, in 2013–14 prices

Scenario	2010–11	2013–14	2015–16	2017–18	2020–21	2025–26	Spending in 2017– 18 as % of 2013–14	Spending in 2025– 26 as % of 2013–14	Spending in 2025– 26 as % of 2010–11
OBR central projection									
TME	737	720	718	713	775	873	99%	121%	118%
Total DEL	392	363	348	323	361	406	89%	112%	104%
OBR high-productivity variant projection									
TME	737	720	718	713	775	894	99%	124%	121%
Total DEL	392	363	348	323	361	422	89%	116%	108%
OBR low-productivity variant projection									
TME	737	720	718	713	775	852	99%	118%	116%
Total DEL	392	363	348	323	361	391	89%	108%	100%
TME frozen in real-terms between 2017–18 and 2020–21									
TME	737	720	718	713	713	784	99%	109%	106%
Total DEL	392	363	348	323	322	349	89%	96%	89%

Notes: Total DEL in 2010–11 is lower than that reported in PESA 2013 as a result of an adjustment aimed at ensuring non-domestic rates are treated on a consistent basis (from 2013–14, approximately half are accounted for in AME instead of DEL as a result of the localisation of non-domestic rates). See Appendix B for a full list of assumptions used in calculating these figures.

Source: PESA 2013 Budget tables, OBR Economic and Fiscal Outlook, OBR *Fiscal Sustainability Report* and authors' calculations.

Thus, to summarise, by 2025–26 the four different scenarios lead to rather different levels of TME and total UK DEL. Under our most optimistic set of assumptions, the UK's TME will be 24% higher than at present, which, given current policy, the OBR's projections for benefit spending and debt interest spending, and a few additional assumptions, would mean the total DEL would be 16% higher. However, under our most pessimistic set of assumptions, although TME would be 9% higher, the total DEL is projected to be £349 billion in today's prices, or 4% lower than in 2013–14.

What this means for the Welsh budget depends upon the choices of the UK government. In the next section we examine what these scenarios for overall UK government spending, together with the UK government's decision on how to allocate spending, imply for the block grant made available to the Welsh Government.

4.2 Scenarios for the Welsh Government budget to 2025–26

As discussed above, following Spending Round 2013, the Treasury has announced the grants that it will provide to the Welsh Government up to 2015–16: the grant in that year is planned to be £14.6 billion in today's prices, around £0.4 billion lower than in 2013–14 and £1.7 billion lower than in 2010–11.

Beyond 2015–16, the Welsh block grant will depend upon both overall UK government spending, *and* the allocation of that between benefits and the various UK departmental budgets. It will also depend upon whether the UK government decides to devolve certain tax powers to the Welsh Government as recommended by the Silk Commission,⁴³ and if so, how the tax revenues from these taxes change over time; Box 4.1 discusses qualitatively what the implications of such a move may be.

Box 4.1. How might tax devolution affect the Welsh Government budget?

Presently, the Welsh Government is funded almost entirely from block grants from the UK Treasury; changes in these grants are determined by the Barnett formula based upon changes in spending on Whitehall departments for which Wales has responsibility for comparable services in Wales (see Box 2.1 in Chapter 2 for more details). However, in its first report, the Silk Commission (Silk et al, 2013) recommended the devolution of a number of small taxes to Wales – Stamp Duty Land Tax, aggregates levy, landfill tax and the long-haul rate of Air Passenger Duty – the devolution of decisions over 10p of each income tax rate to Wales and the provision of limited borrowing powers for both capital and current spending. The aim of this is to improve the financial accountability of the Welsh Government, to give additional policy tools to Wales, and to give greater incentives to improve economic outcomes in Wales. However, the part-funding of the Welsh Government by its own taxes would also likely lead to a different path for its future budget than if it were funded exclusively via block grant from the Treasury.

⁴³ Silk et al (2013).

First, yields from the devolved taxes may grow faster or slower than the Whitehall departmental budgets on which the Welsh Government's budget currently depends. This may reflect different changes in tax yields in Wales compared with the rest of the UK (a risk that the earlier Holtham Commission termed 'Differential tax base growth'). For instance, the Silk Commission estimated that between 2000–01 and 2005–06 income tax revenues grew by just under 40% in Wales, compared with just under 30% in the UK as a whole. However, in the subsequent five years, income tax yields grew less quickly in Wales than in the UK as a whole, which means that for the 10 years between 2000–01 and 2010–11 as a whole the income tax yield is estimated to have increased by 4.1% per year in Wales, compared with 3.8% per year for the UK as a whole. The Silk Commission reports that if this differential growth were maintained in future, the Welsh Government's budget would increase by £6 million more per year than if fully block-grant funded, which is very small in the context of a £15,000 million budget. Of course, the potential gain (or loss) could be bigger than this if trends differed by more, although the Silk Commission comes to the conclusion that the changes are unlikely to be particularly large in either direction.

Second, taxes such as income tax and stamp duty land tax are cyclical with significant year-on-year volatility. If this fed directly through to the Welsh Government's budget, this would also become much more volatile than under present arrangements. However, the Silk Commission suggests calculating the block-grant reduction following tax devolution in such a way that shocks to tax revenues that affect the whole UK and not only Wales are borne by the UK exchequer rather than the Welsh Government (see paragraphs E.7 to E.13 of Silk et al, 2013). And, borrowing powers would allow the Welsh Government to smooth, at least in part, remaining volatility in its revenue. Together, these two factors would significantly ameliorate the increase in volatility associated with the part-funding of the Welsh Government budget via tax revenues.

Third, changes in both UK and Welsh Government policy could affect the yield of the devolved taxes. For instance, if the Welsh Government decided to increase or decrease the income tax rate in Wales, the amount of income tax raised in Wales would likely change, and this would feed through in to changes in the Welsh Government's budget. On the other hand, the Commission's recommended way of adjusting the block grant is designed to limit the impact of UK-wide tax policy changes – such as a change in the income tax personal allowance – on the Welsh Government's budget.

Thus, whilst tax devolution would mean a rather different system of funding the Welsh Government, and may lead to a somewhat different path from the scenarios set out in this report, unless the Welsh Government pursued a radically different tax policy, the picture we describe for the next 12 years is robust to the potential for tax devolution.

However, for the purposes of the quantitative analysis in this report, we assume that the current arrangements for funding the Welsh Government are maintained until 2025–26. Thus, we set out projections for the Welsh Government's block grant given the four scenarios for overall UK government spending (TME) set out in the previous section, and three scenarios for how the UK government may allocate TME between benefits and tax credits and different Whitehall departments.

The three scenarios for the allocation of TME that we examine are:

1. Further spending cuts in 2016–17 and 2017–18 are allocated entirely to DELs, with each department seeing the same percentage reduction in its budget. In 2018–19 and beyond, benefits spending and debt interest spending changes in line with the figures from the relevant projection from the OBR's 2013 Fiscal Sustainability Report, other AME increases by 1.5% per year in real terms and total DEL is calculated as a residual. Education and health spending changes in line with projections from the OBR's 2013 Fiscal Sustainability Report and every other department sees the same percentage change in its budget.
2. Further spending cuts in 2016–17 and 2017–18 are allocated entirely to DELs, with the Departments of Health and Education being protected from the cuts (i.e. their budgets are frozen in real terms), and every other department sees the same percentage reduction in its budget. In 2018–19 and beyond, benefits spending and debt interest spending changes in line with the figures from the relevant projection from the OBR's 2013 Fiscal Sustainability Report, other AME increases by 1.5% per year in real terms and total DEL is calculated as a residual. Education and health spending changes in line with projections from the OBR's 2013 Fiscal Sustainability Report and every other department sees the same percentage change in its budget.
3. Further spending cuts in 2016–17 and 2017–18 are allocated between a £10 billion cut in benefit spending and reductions to DELs, with the Departments of Health and Education being protected from the cuts (i.e. their budgets are frozen in real terms), and every other department sees the same percentage reduction in its budget. In 2018–19 and beyond, benefits spending and debt interest spending changes in line with the figures from the relevant projection from the OBR's 2013 Fiscal Sustainability Report, other AME increases by 1.5% per year in real terms and total DEL is calculated as a residual. Education spending changes in line with the central projection and Health spending changes in line with the '1% Health productivity' projection from the OBR's 2013 Fiscal Sustainability Report, and every other department sees the same percentage change in its budget.

The first of these scenarios is the *least* generous to the Welsh Government. In the second scenario, the protection of the budgets for the Departments of Health and Education leads to a *more* generous budget settlement for the Welsh Government, because spending on these departments makes up a large part of the spending that determines changes in the Welsh block grant via the Barnett formula (whilst the larger cuts to other Whitehall departments that are required under this scenario are not fully passed on to Wales as changes in spending on many of these, such as Defence, the Home Office, Justice and the Department for Work and Pensions, do not enter the Barnett formula). Finally, the third scenario is *most* generous for Wales because (a) the £10 billion in benefit cuts allow higher DELs, and (b) the relatively large increases in Department of Health spending in 2018–19 and beyond necessitated by the assumption of low health service productivity growth leads to bigger year-on-year increases in the Welsh block grant due to the high weight for Department of Health spending in the Barnett formula. However, it is important to note that reductions in benefit spending may, in some cases, lead to increased demand for public services provided or funded by the Welsh Government (e.g. housing, health or social services); this indirect effect may offset some of the additional funding available to services if benefits are cut. And, if extra funding is needed

for the NHS in England, it may be the case that extra funding is also needed for the NHS in Wales, again offsetting, at least in part, the direct effects of higher block grants in these circumstances.

The third scenario is the closest to the experience of the last 10 or so years: £10 billion in further benefit cuts (or, alternatively, tax rises) would keep the pace of cuts to the DEL in 2016–17 and 2017–18 equal to that delivered or planned for between 2010–11 and 2015–16; spending on the Department for Health and Department for Education has largely been protected from the cuts so far; and historically, before the crisis, health spending was growing more rapidly than other departmental spending, at least in part because of relatively low growth in health care productivity. But the other scenarios are real possibilities: the large cuts already required of many departments may mean it is not possible to continue to protect health and education and impose larger cuts elsewhere; and it may be challenging to identify further benefit cuts, especially if the state pension and pensioners' benefits are to be protected as has been the case to date.

Together with the four scenarios for the overall level of government spending (TME) described in the last section, this gives us **twelve** scenarios for the block grant provided to the Welsh Government. It should be remembered that these scenarios are indicative only, and although they have been designed to provide a range of plausible projections for the next 12 years no scenario should be taken as an upper or lower bound.

The scenario which combines growth in TME after 2017–18 in line with economic growth under the OBR's central projection, with assumption (3) above (benefits cuts, protection of education and health, and higher long-term growth in health spending) can be considered the *baseline case*. This is because it combines the OBR's best guess about long-term economic growth with a policy mix that reflects that of the recent past: there have *been* cuts to benefits, the UK government has protected health and education spending, and spending on health care has grown faster than other types of spending historically. This does not necessarily mean we consider this the most likely outcome, however.

The *most favourable* settlement for the Welsh Government budget is the scenario which combines growth in TME after 2017–18 in line with economic growth under the OBR's high productivity variant projection, with assumption (3) above (welfare cuts, protection of education and health, and higher long-term growth in health spending). The *least favourable* settlement for the Welsh Government budget is the scenario which combines a real-freeze in TME between 2017–18 and 2020–21 and growth in line with the OBR's low productivity variant projection thereafter, with assumption (1) above (no welfare cuts, and no protection of education and health). The difference in the projections for the Welsh Budget between these two scenarios is substantial, indicating the large degree of uncertainty looking 12 years ahead.

Table 4.2 shows projections for the block grant to the Welsh Government under each of the twelve scenarios. Six years are shown: 2010–11, 2013–14, 2015–16 (all unaffected by the scenarios), 2017–18, 2020–21 and 2025–26. It also shows the Welsh block grant in 2017–18 and 2025–26 as a percentage of its 2013–14 value, and the level of the block grant in 2025–26 as a percentage of their 2010–11 values. The *baseline case*, *most favourable* and *least favourable* scenarios are highlighted in **green** in the table (a fourth scenario, between the

central case and least favourable scenario is also coloured **green** in the table as, like the central, favourable and least favourable cases, it is used in Chapter 5 of this report when examining the trade-offs facing the Welsh Government when setting budgets for different service areas). In order to allow comparisons between the block grant in 2010–11 with the block grant in 2013–14 and later, we adjust the 2010–11 figures for the fact that council tax benefit was not devolved at that point. This involves adding £222 million to the reported Welsh DEL in that year.⁴⁴

The first thing to note is that the period between 2015–16 and 2017–18 is likely to involve further real reductions in the Welsh Government's DEL, irrespective of the choices made by the UK government. For instance, if as under choice (3), benefit spending is cut by a further £10 billion per year by 2017–18, the NHS and education spending are protected from any real-terms reduction and cuts are shared equally among other Whitehall departments, the Barnett formula implies a real-terms reduction in the Welsh Government's budget of around £300 million per year (or just over 2%) between 2015–16 and 2017–18. That would make the pace of cuts slower than has been delivered to date, and slower than expected for the period between now and 2015–16, but would leave the Welsh block grant some £800 million per year (or 5%) lower in real terms than in 2013–14, or around £2 billion lower than in 2010–11.

But the table also shows that the choices made by the UK government on how to allocate spending after the period covered by the 2013 Spending Round have a major impact on the block grant. For instance, if, as under choice (1), no further cuts are made to benefits, and no protection is offered by the UK government to health and education spending in England, the Barnett formula implies a real-terms reduction in the Welsh Government's budget of around £900 million per year (just over 6%) between 2015–16 and 2017–18: that is, cuts three times larger than under choice (3). This would be a pace of cuts around double that expected for the next two years, and broadly comparable to those delivered between 2010–11 and 2013–14. However, the cuts to date have relied on large reductions in capital spending, meaning the reduction in current spending has been smaller:⁴⁵ this is unlikely to be the case between 2015–16 and 2017–18, which would mean larger cuts in day-to-day spending.

Overall, under the three UK government policies we examine, the Welsh block grant in 2017–18 would be between 5% and 9% lower in real terms than it is today.

⁴⁴ It is not clear how much would have been given to the Welsh Government in 2010–11 if council tax benefit had been devolved at that point. £222 million is the amount transferred in 2013–14 for the purpose of council tax benefit. Note that in Figure 3.1 we instead did the opposite, stripping out £222 million from the figures for 2013–14 onwards to allow comparability with the Welsh DEL between 2001–02 and 2012–13.

⁴⁵ See Tables 3.1 and 3.2.

Table 4.2. Some scenarios for the Welsh block grant, 2010–11 to 2025–26, £ billions, in 2013–14 prices

Scenario	2010–11	2013–14	2015–16	2017–18	2020–21	2025–26	Budget in 2017–18 as % of 2013–14	Budget in 2025–26 as % of 2013–14	Budget in 2025–26 as % of 2010–11
OBR central projection									
Scenario 1	16.5	15.0	14.6	13.7	14.6	16.2	91%	108%	98%
Scenario 2	16.5	15.0	14.6	14.1	15.1	16.8	94%	112%	102%
<i>Scenario 3</i>	16.5	15.0	14.6	14.3	15.3	17.3	95%	116%	105%
OBR high-productivity variant projection									
Scenario 1	16.5	15.0	14.6	13.7	14.6	16.7	91%	111%	101%
Scenario 2	16.5	15.0	14.6	14.1	15.1	17.3	94%	115%	105%
<i>Scenario 3</i>	16.5	15.0	14.6	14.3	15.3	17.8	95%	119%	108%
OBR low-productivity variant projection									
Scenario 1	16.5	15.0	14.6	13.7	14.6	15.8	91%	105%	96%
<i>Scenario 2</i>	16.5	15.0	14.6	14.1	15.1	16.4	94%	109%	99%
Scenario 3	16.5	15.0	14.6	14.3	15.3	16.9	95%	113%	103%

Table 4.2. Some scenarios for the Welsh block grant, 2010–11 to 2025–26, £ billions, in 2013–14 prices (continued)

Scenario	2010–11	2013–14	2015–16	2017–18	2020–21	2025–26	Spending in 2017– 18 as % of 2013–14	Spending in 2025– 26 as % of 2013–14	Spending in 2025– 26 as % of 2010–11
TME frozen in real-terms between 2017–18 and 2020–21									
<i>Scenario 1</i>	16.5	15.0	14.6	13.7	13.5	14.6	91%	97%	88%
Scenario 2	16.5	15.0	14.6	14.1	13.9	15.1	94%	101%	91%
Scenario 3	16.5	15.0	14.6	14.3	14.1	15.6	95%	104%	94%

Notes: Total DEL in 2010–11 is higher than that reported in PESA 2013 as a result of an adjustment aimed at ensuring support for council tax is treated on a consistent basis (from 2013–14, it is included in the Welsh Government block grant, whereas prior to that it was treated as part of UK-wide AME). See Appendix B for a full list of assumptions used in calculating these figures.

Source: PESA 2013 Budget tables, OBR Economic and Fiscal Outlook, OBR Fiscal Sustainability Report and authors' calculations.

The picture after 2017–18 depends crucially upon the overall resources available to the UK government as well as choices made over how to allocate those resources. Under the scenarios where TME grows from 2018–19 onwards (the ‘low’, ‘central’ and ‘high’ OBR productivity growth variants), if the UK government protects health and education spending from the cuts required prior to that date, the Welsh block grant will slightly *exceed* its 2013–14 real-terms level by 2020–21: by £100 million to £15.1 billion, or by £300 million to £15.3 billion, if, in addition to protecting health and education, further cuts to welfare are made. However, spending would still be below its 2010–11 level. In other words, three years of growth in the block grant would be enough to slightly-more-than undo the projected fall between now and 2017–18, but not enough to undo the cuts that have taken place to date. If, on the other hand, the UK does not protect health and education from cuts in 2016–17 and 2017–18, the larger cut to the Welsh block that would imply would mean that subsequent increases would not be enough to get back to current levels by 2020–21: at £14.6 billion it would still be approximately £400 million lower than today (and £1.9 billion lower than in 2010–11).

By 2025–26, the gap between the various scenarios widens further. For instance, under our most *optimistic* scenario (featuring high productivity growth, benefit cuts and protection for UK health and education spending in 2016–17 and 2017–18, and additional funding for health after 2018–19 to cope with low productivity growth in the sector), the Welsh block grant would be £17.8 billion per year, around 19% higher than the current £15.0 billion and 8% higher than the £16.5 billion reached in 2010–11. This may seem like a significant increase, but there are at least three important reasons why even this scenario would still be very challenging. First, the most recent population projections show the Welsh population in 2025–26 being 5.0% higher than today, and 6.4% higher than in 2010–11. That means the block grant *per person* would be a smaller 13% above today’s levels and just 1% above its 2010–11 level. Second, at the same time as it will have grown, the Welsh population will also have aged, and this is likely to put upwards pressure on health and social care spending. And, third, part of the growth in the block grant under this scenario reflects additional funding for the health service in England to compensate for relatively low productivity growth: if it is necessary to boost health spending in England, it seems more than plausible that there will be a need to boost spending on health in Wales, especially as health spending in Wales has not been spared the cuts to date, as has been the case in England.

Under our *baseline* scenario, the Welsh block grant would be £17.3 billion per year, around 16% higher than the current £15.0 billion, and 5% higher than in 2010–11. Notice that the block grant per person in Wales in this instance would be 10% higher than today, and 1% *lower* than it was in 2010–11. With less to spend per person than 15 years earlier, and an older population, a Welsh Government in 2025–26 would face an unenviable task.

Our *more pessimistic* scenario is based on the OBR’s low productivity variant projection, and an assumption that the UK government protects health and education spending from further cuts, but that no more welfare cuts are made, and the only increases in health spending after 2017–18 are due to ageing (i.e. either health care productivity does not lag, or if it does, then no extra funding is made available for this). By 2025–26, the Welsh block grant would be £16.4 billion, roughly 9% higher than today (4% per person), or roughly similar (but 7% lower per person) than in 2010–11. Such a scenario is plausible and need not depend on the exact policy mix described. Perhaps, for instance, the UK government does make further

benefit cuts – which on its own would allow a bigger Welsh block grant – but at the same time, rather than cut all services apart from health and education by the same rate, concentrates cuts on those departments with high weights in the Barnett formula, such as Business, Innovation and Skills, Communities and Local Government and Transport to protect areas, such as Defence, Justice and the Home Office, that do not enter the Barnett formula because they are not devolved – which, on its own would reduce the Welsh block grant.

The long-term picture is, of course, much worse if further significant spending restraint is required of the UK government after 2017–18. Under our *most pessimistic* scenario, the block grant would continue falling to 2020–21, to £13.5 billion in today's prices, around 10% lower than the £15.0 billion this year. Whilst it would then start growing, it would still be below its current level in 2025–26, at £14.6 billion: a 3% fall, which translates in to a 9% fall per person. And compared with 2010–11, the picture is an (even more dramatic) 11% fall, or 17% fall per person. As we see in the next chapter, the choices facing the Welsh Government under such a scenario would be particularly stark.

Summary

The size of the Welsh block grant in 2025–26 will depend on both the overall amount available to the UK government to spend and its choice of how to allocate that spending between its various departments and benefits. But the outlook for the Welsh budget in 2025–26 looks challenging even under the most optimistic scenario set out above: whilst the block grant would be 19% higher in real terms than today, this is in the context of substantial cuts already having taken place, and the prospect of both a larger and older population, meaning the grant per person would be little higher than in 2010–11. Under our other less optimistic scenarios based on the OBR's 'high', 'baseline' or 'low' productivity variant projections, the grant per person would be *lower* than in 2010–11, although the amount would depend very much on the choices made by the UK government on what spending to prioritise. Thus, budgets would continue to be very tight even after the end of the fiscal consolidation in 2017–18, and eight years of spending growth would still leave the block grant per person lower than it was before the seven years of cuts began.

The picture would be even bleaker if the UK government needed to engage in further fiscal consolidation after 2017–18, as shown by our scenarios where TME is held fixed in real terms until 2020–21. In our most pessimistic scenario, the block grant per person in 2025–26 would be about 9% per person lower than today, and a full 17% lower than in 2010–11. In the context of an ageing population, that would create a very stark set of choices for the Welsh Government in allocating its budget across services.

It is to that question – the trade-offs facing the Welsh Government when setting budgets for different services areas – to which we now turn in the next chapter of this report.

5. The trade-offs facing the Welsh Government when setting departmental budgets

Summary

- It is not possible to determine upper or lower bounds on the amounts available to different service areas funded by the Welsh Government. Instead, we set out the implications of a number of choices the Welsh Government *could* make to allocate its budget, the total amount of which is determined by the scenarios set out in Chapter 4 of this report.
- Under our baseline scenario for the Welsh block grant, further cuts of 5% in real-terms will be required by 2017–18. If the Welsh Government were to protect health spending, that would require cuts to its funding for other service areas – including things such as schools and social services – that averaged 9%. If the Welsh Government were to extend the protection to its funding to local government for schools and social services, the cuts to unprotected areas would have to average 13% to balance the budget. Coming on top of existing cuts, such a cut could take the amount spent on the Department for the Economy, Science and Transport, for instance, to almost one-third below its 2010–11 level.
- Under our most pessimistic scenario for the Welsh block grant, further cuts of 9% in real terms will be required by 2017–18. In this case, protecting health, schools and social services would require cuts averaging 24% across all other service areas. Coming on top of the cuts already delivered, this could take the amount spent on the Department for the Economy, Science and Transport, for instance, to 40% below its 2010–11 level.
- Under our baseline scenario for the Welsh block grant in 2025–26, if the Welsh Government were to protect its funding health, social services and schools from any further cuts, and once its budget starts growing again, increase spending on all services area at the same rate, spending on unprotected areas in 12 years' time would be 6% higher in real terms than now: after accounting for population growth, that would equate to just 1% more per person. If, in addition to protecting them from cuts, relatively large increases in spending on health (5% per year), social services (4.5%) and schools (2%) were felt needed after 2017–18 to cope with rising demands and costs and to undo some of the earlier cuts, spending on other services would need to be 24% lower than today, which equates to a fall of 28% per person. And, spending on these services would still be falling: with the rate of cut averaging 1.7% per year between 2017–18 and 2025–26.

- Things look little easier under our most optimistic scenario for the Welsh block grant in 2025–26. But in our more pessimistic scenario things would be substantially worse. Even if all that was done was to protect health, social services and schools spending from further cuts, spending on other areas would be 2% lower now, equivalent to a 7% fall per person. Providing relatively large increases in health, social service, and schools after 2017–18 would require very large cuts elsewhere. Under one option, spending across other services would need to be 41% lower than today and still falling at a rate of 7% a year in 2025–26.
- Under our most pessimistic scenario for the Welsh block grant, the difficulties the Welsh Government would face in trading off spending on different services are difficult to comprehend. Protecting just health from further cuts and then sharing spending increases equally across departments would leave health spending only 8% higher than now – just 3% higher per person – and would require spending 10% less on other areas, including schools and social services, in 2025–26. Providing relatively large increases in health, social services and schools after 2017–18 would decimate the rest of the budget, with one option requiring spending 73% less than today on areas such as transport, culture, and housing. Such large cuts seem implausible.
- The scale of the challenge implied by our more pessimistic – but not implausible – scenarios means advanced planning by the Welsh Government for the trade-offs that it would make between different public services over the next decade (and beyond) would be sensible. It will also be important to understand the demand and cost pressures facing public services, and to develop policies to try to reduce those pressures.

In this chapter of the report we explore the difficult trade-offs facing the Welsh Government when setting its budget by looking at how much would be available to spend on different service areas under the scenarios for the overall Welsh budget set out in the last chapter. In doing this, we draw inspiration from the qualitative discussion of spending pressures facing the Welsh Government discussed in Chapter 6, and work from a concurrent project by Mark Jeffs and Michael Trickey forecasting spending needs in different service areas in Wales.⁴⁶ As mentioned at the start of the last chapter, **readers should note that the scenarios set out here are indicative only and do not put upper or lower bounds on the amounts available to different service areas funded by the Welsh Government.**

Given a particular overall budget, the choices available to the Welsh Government in how to allocate that across services are in principle infinite. However, the Welsh Government has indicated its desire to prioritise spending on health, schools and social services in the years ahead, and demographic change and cost pressures are also likely to encourage more generous settlements for these budgets than for others. Thus, in this chapter we illustrate the trade-offs facing the Welsh Government by examining the implications of four particular budget choices that appear plausible outcomes for Wales.

1. The Welsh Government protects health spending from any further real-terms cuts after 2013–14, and shares the cuts to its budget equally across other service areas.

⁴⁶ Jeffs and Trickey (2013).

Once its budget starts growing again in real terms, the increases are shared equally across all departments.

2. The Welsh Government protects health, schools and social services⁴⁷ spending from any further real-terms cuts after 2013–14, and shares the cuts to its budget equally across other service areas. Once its budget starts growing again in real terms, the increases are shared equally across all departments.
3. The Welsh Government protects health, schools and social services spending from any further real-terms cuts after 2013–14, and shares the cuts to its budget equally across other service areas. Once its budget starts growing again in real terms, health spending grows by 1.5% more per year than the total Welsh budget in real terms, and social services spending by 1% more. Each other department sees its budget change by the same percentage so that the overall budget balances.
4. The Welsh Government protects health, schools and social services spending from any further real-terms cuts after 2013–14, and shares the cuts to its budget equally across other service areas. After 2017–18, health spending grows by 5% per year in real terms, social services spending by 4.5% in real terms and schools spending by 2% per year in real terms. Each other department sees its budget change by the same percentage so that the overall budget balances.

As discussed in Chapter 3, to date, whilst the Welsh Government has cut health spending a little less than the average, it has not provided full real-terms protection, as has been the case in England. Choice (1) is designed to show what offering such protection means to the health budget and other budgets. Choice (2) shows the implications of extending that real-terms protection to spending on schools and social services.

But there are also choices facing the Welsh Government about what to prioritise once the spending cuts have ended. Choice (3) shows that if, in addition to protecting health, social services and schools from further cuts, somewhat larger increases are provided after 2017–18, the amount available for other service areas is significantly constrained. Choice (4) is inspired by the historic rates of spending growth on health and social services,⁴⁸ which are even larger than under choice (3), driven by projected increases in demand – due, at least in part, to demographic change – and costs – due, at least in part, to relatively slow productivity growth. Under choice (4), in our most pessimistic scenario for the overall Welsh Budget,

⁴⁷Note, that most schools and social services spending is not carried out directly by the Welsh Government, but instead is carried out by local authorities. However, the Welsh Government provides a block grant to Welsh local authorities that funds most of their spending on these and other services (this grant equalled £4.5 billion in 2013–14), with the remainder of their spending funded by council tax and a number of specific grants for particular services. In order to explore the implications of protecting schools and social services spending, we calculate the proportion of overall local government service spending (minus housing benefit and the police grant) that goes towards schools and local education authorities and social services, and apply protection to the same proportion of the Welsh Government's local government budget. For this to imply overall spending on schools and social services is protected, the amount allocated from council tax revenues and specific grants would also have to be frozen in real terms. In practise, this may not be the case, which means our scenarios do not guarantee real-terms protection for schools and social services spending. However, the purpose of these scenarios is indicative only and they are sufficiently accurate to show the nature of the trade-offs when setting departmental budgets.

⁴⁸The spending of the Welsh Government on health and social services had been growing quite rapidly before the financial crisis and the ensuing cuts. Historic editions of PESA (from 2009 and 2007) can be adjusted using the overlap with later versions to give a consistent series regarding the spending by sub-function of the Welsh Government (see appendix B.2). Using these adjustments we estimate that spending on health by the Welsh Government grew on average by 5.3% a year between 2001–02 and 2010–11 and on social services (defined as the personal social services element of social protection and social protection n.e.c.) by 4.3% per year. For information on how these sorts of historic estimates can be calculated, see appendix B.2.

budgets for services other than health, social services and schools, will have to be cut *every year* between now and 2025–26, even once overall spending growth resumes.⁴⁹

Together with the twelve scenarios for the Welsh Government budget set out in the last chapter, these four choices give us **forty eight** scenarios for the amounts allocated to different service areas. It is not practical, nor would it be particularly informative, to present in full the projected budgets for each Welsh Government department under each of these scenarios.⁵⁰ Instead, we show results for **sixteen** scenarios that show the trade-offs between spending on different services under what can be considered our *baseline* projections for the overall Welsh Government budget, *our most optimistic* projection and two *more pessimistic* projections (including our *most pessimistic*). The results reported focus on the percentage change in the amount allocated to health, schools, social services and other service areas between now and 2017–18 and 2025–26 under each of these scenarios.

The trade-offs out to 2017–18

Under our various scenarios, in 2017–18, the Welsh block grant, and thus the Welsh Government's available budget, will depend only upon the choices made by the UK government in how to allocate further spending cuts after 2015–16: by assumption the size of the overall UK-wide spending cut is fixed at that projected in the OBR's March 2013 Economic and Fiscal Outlook. This means that, rather than looking at four scenarios for the overall Welsh Budget in 2017–18, we have only *three*, as both our *baseline* and *most optimistic* scenarios are based on the UK government protecting health and education spending and making further benefit cuts (it is only after 2017–18 that these two scenarios differ). Furthermore, the above-average increases in spending on health and social services that kick in from 2018–19 under our third and fourth modelled choices for the Welsh Government do not impact the trade-offs it faces over the next four years to 2017–18. This means that, in effect, we only model *two* choices for the Welsh Government: to protect only health spending (choice 1), or to, in addition, protect social services and schools spending (choice 2).

Table 5.1 therefore shows the percentage change in the real-terms budget allocations to:

- Health
- Social services
- Schools
- All other services

under choices (1) and (2), given our three scenarios for the Welsh Government's overall budget in 2017–18. It also shows the percentage change *per person*, which accounts for the projected population growth over the next four years.

⁴⁹Under choice (3), the assumed growth rates of health and social services spending once the overall Welsh budget is increasing are linked to the growth rate of the overall Welsh budget (the growth rates for health and social services are 1.5 and 1.0 percentage points higher per year, respectively). This means the growth rates of health and social services spending are higher (lower) under scenarios with higher (lower) growth in the overall budget. Under choice (4), in contrast, the growth rates of health and social services spending are fixed in absolute terms. This is a key difference between scenarios (3) and (4).

⁵⁰The accompanying spreadsheets, available to stakeholders from Wales Public Services 2025, provide full details of each scenario. A simplified spreadsheet allowing the user to set different departmental budgets in order to explore the trade-offs when doing so is available.

The first thing to notice is that protecting even just health would involve a substantially larger cut to other service areas than the cut to the total Welsh Government budget. For instance, under the optimistic and baseline scenarios, the cut in the Welsh Government's budget between now and 2017–18 will be 5%, but the cut in areas other than health would have to be 9% if health were to be spared from any further spending cuts. Population growth means that this cut would be equivalent to 10% per person (and 'protected' spending on health per person would be 2% lower).

Extending the protection to social services and schools (by part-protecting grants to local government and requiring them to prioritise schools and social services spending) would require cuts of 13% (or 15% per person) to other service areas by 2017–18. Such a cut would take the amount spent on the Department for Education and Skills to 22% below its 2010–11 level, the Department for the Economy, Science and Transport to 31% below its 2010–11 level and Housing and Regeneration to 33% below its 2010–11 level. These are substantial cuts.

Table 5.1. Scenarios for the percentage change in real-terms spending relative to 2013–14, for different service areas funded by the Welsh Government to 2017–18

Scenario	Choice 1		Choice 2	
	% Change	% Change per person	% Change	% Change per person
Optimistic/Baseline scenario				
Health	0%	-2%	0%	-2%
Social Services	-9%	-10%	0%	-2%
Schools	-9%	-10%	0%	-2%
Other Services	-9%	-10%	-13%	-15%
Total Welsh Budget	-5%	-7%	-5%	-7%
More pessimistic scenario				
Health	0%	-2%	0%	-2%
Social Services	-10%	-12%	0%	-2%
Schools	-10%	-12%	0%	-2%
Other Services	-10%	-12%	-16%	-17%
Total Welsh Budget	-6%	-8%	-6%	-8%
Most pessimistic scenario				
Health	0%	-2%	0%	-2%
Social Services	-15%	-17%	0%	-2%
Schools	-15%	-17%	0%	-2%
Other Services	-15%	-17%	-24%	-25%
Total Welsh Budget	-9%	-11%	-9%	-11%

Source: PESA 2013 Budget tables, OBR Economic and Fiscal Outlook, OBR Fiscal Sustainability Report, Welsh Government First Supplementary Budget 2013–14, Welsh Local Government Budget Estimates 2013–14 and authors' calculations.

The table also shows that the choices the UK government makes about whether to cut benefit spending further and whether to continue to protect health and education spending will have a big influence on how difficult the trade-offs facing the Welsh Government in the years ahead will be. Under our most pessimistic scenario, where it does neither, if the Welsh Government decided that it did need to protect health spending (it has not done to date), other areas would see a cut of 15% on average by 2017–18. Extending protection to social services and schools would require cuts to unprotected departments of 24%, equivalent to 25% – or a quarter – per person. Such a cut would take the amount spent on the Department for Education and Skills to 32% below its 2010–11 level, the Department for the Economy, Science and Transport to 40% below its 2010–11 level and Housing and Regeneration to 41% below its 2010–11 level. Hence, offering full protection to health, social services and schools spending, which makes the scale of cuts to other departments look challenging even under our optimistic/baseline scenarios for the Welsh Government’s total budget, would require a scale of cuts to unprotected departments that would be very difficult to deliver.

The trade-offs out to 2025–26

Whilst in our *most optimistic*, *baseline* and *more pessimistic* scenarios for the Welsh Government budget see it above current levels by 2025–26, the Welsh Government will still be facing difficult trade-offs in setting its budgets for various departmental budgets twelve years from now. If the UK government has to engage in further downward pressure on departmental spending between 2017–18 and 2020–21, our *most pessimistic scenario* shows the picture for 2025–26 looks very difficult indeed, especially if the Welsh Government feels compelled to boost spending on health and social services after 2017–18 (choices 3 and 4) to cope with an ageing population and low productivity growth in these sectors.

Table 5.2 shows the percentage change in the real-terms budget allocations to:

- Health
- Social services
- Schools
- All other services

under choices (1) to (4), relative to the level of spending in 2013–14 and given four of our scenarios for the Welsh Government’s overall budget in 2025–26. It also shows the percentage change *per person* relative to 2013–14, which accounts for the projected population growth over the next 12 years: over this time horizon, population growth will have a fairly sizeable impact. Note that different departments have already faced different-sized cuts, which means that a cut of a given size in *future* years can mean a larger or smaller *total* cut (since 2010–11) for different departments, depending on whether it has had a larger or smaller than average cut in funding already.

Under our most *baseline* scenario for the Welsh Government’s budget in 2025–26, protecting health from further cuts, and then increasing it in line with the overall Welsh budget after the cuts have ended would allow health spending to be 22% higher in real terms than today, equivalent to 16% extra per person. The amount available for other services would be 12% higher, or 6% higher per person. Adding in protection for schools and social services from any further cuts (and again, increasing in line with the overall Welsh budget after the cuts

have ended) would mean the amount available for other services in 2025–26 would be just 6% higher than today, which after accounting for population growth would mean just a 1% rise in spending per person over the next 12 years. Given the cuts that have already taken place, this would mean that, 15 years after the cuts began in earnest, such a fall would mean:

- the amount spent on the Department for Education and Skills in 2025–26 would still be 5% below its 2010–11 level;
- the amount spent on the Department for the Economy, Science and Transport would be 16% below its 2010–11 level; and
- the amount spent on the Department for Housing and Regeneration would be 18% below its 2010–11 level.

But, a health and social services budget increasing by 22% over 12 years equates to an annual average increase of only 1.7% (or by just 1.3% per person), which is substantially below most projections for what is needed to be spent to cope with the ageing population and potentially rising costs associated with low productivity growth. As discussed in Chapter 6 and Jeffs and Trickey (2013), other projections show a need for substantially larger increases.

As stated above, our third choice for the Welsh Government involves increases in the health and social services budget after 2017–18 of 1.5 percentage points and 1 percentage point above the rate of increase of the overall Welsh budget, respectively. Under our *baseline* projections for the overall Welsh Government budget, this translates into real growth of 4% and 3.5% per year, respectively, for health and social services spending. This would require all other areas of spending (including schools) to grow by just 0.9% per year in real terms between 2017–18 and 2025–26 on average. Under such a scenario, in 2025–26 spending on health would be 37% higher than today, spending on social services 32% higher and spending on schools 7% higher. On the other hand, spending on all other services would be 7% *lower*, equating to a cut of 11% per person. Given the cuts that have already taken place, this would imply spending on some departments still being down well over a quarter compared to 2010–11 levels (for instance, Housing and Regeneration, and the Economy, Science and Transport).

The fourth choice set out above has real-terms health spending increasing by 5% per year after 2017–18, social services spending growing by 4.5% in real terms and education spending increasing by 2% per year in real terms. In the first two cases, these are substantial increases, but these are not inconceivable given rising demand and costs, and the potential need to ‘undo’ some of the cuts that have already been imposed. For instance, a 5% per-year increase in health spending after 2017–18 would leave spending 48% higher than today (39% higher per person) which equates to an annual average increase of 3.3% over 12 years. And, given the cuts that have taken place, the average annual increase between 2010–11 and 2025–26 would be just 2%, which does not look generous by historic standards.

Such increases for health, social services (up 42% by 2025–26) and, to a lesser extent, schools (up 17%) would require cuts to all other services of 24% – or almost one quarter. Once one accounts for population growth, that is equivalent to 28% per person. Coming on top of the cuts already imposed, spending on the Department for Education and Skills would be 32% below its 2010–11 level, the Department for the Economy, Science and Transport to 40% below its 2010–11 level and the Department for Housing and Regeneration to 41% below its

2010–11 level. Furthermore, spending on such departments would need to be cut by on average 1.7% per year between 2017–18 and 2025–26 to fund the health, social services and schools spending envisioned in this scenario, which means austerity for such departments would become a permanent feature of the Welsh budget.

Thus, our *baseline* scenario for the Welsh budget will present challenging trade-offs for the Welsh Government, with it being difficult to provide the resources needed to adequately fund vital services such as health and social services without imposing very tough settlements on other areas of spending.

The picture does not look much better under even our *most optimistic* case for the overall Welsh budget. For instance choice (3) – which in this case delivers 4.3% annual increases to health and 3.8% annual increases to social services spending between 2017–18 and 2025–26 – would still leave unprotected areas with 4% less to spend than today (compared with 7% less under our *baseline* scenario).

But the picture does look substantially worse under our *more pessimistic* case for the overall Welsh budget. Even under choice (1), where all that is protected from further cuts is health, spending on all other areas – including schools and social services – would be just 4% higher than today, which equates to a 1% cut *per person*. Choice (3), which in this case delivers a 3.4% annual increase to health spending and 2.9% annual increase to health spending after 2017–18 (and protection of both of these and schools from further cuts prior to 2017–18) would leave spending on health 31% higher than now, spending on social services 26% higher, spending on schools just 2% higher, and spending on all other items 14% lower than today. Indeed, spending on areas other than health and social services, after initially rising a bit between 2017–18 and 2022–23 would then begin to fall again, at a rate that would accelerate over time (and that averages 0.2% per year between 2022–23 and 2025–26). Under choice (4), the amount available to areas other than health, social services and schools would be a full 41% below current levels, and would be falling at a rate of 7% per year by 2025–26. Coming on top of the cuts already imposed, spending in that year on the Departments for the Economy, Science and Transport, and Housing and Regeneration would be well below half its 2010–11 level.

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Table 5.2. Scenarios for the percentage change in real-terms spending relative to 2013–14 for different service areas funded by the Welsh Government to 2025–26

Scenario	Choice 1		Choice 2		Choice 3		Choice 4	
	% Change	% Change per person	% Change	% Change per person	% Change	% Change per person	% Change	% Change per person
Optimistic scenario								
Health	25%	19%	25%	19%	40%	33%	48%	41%
Social Services	15%	9%	25%	19%	35%	28%	42%	35%
Schools	15%	9%	25%	19%	10%	5%	17%	12%
Other Services	15%	9%	9%	3%	-4%	-9%	-16%	-20%
Total Welsh Budget	19%	13%	19%	13%	19%	13%	19%	13%
Baseline scenario								
Health	22%	16%	22%	16%	37%	30%	48%	41%
Social Services	12%	6%	22%	16%	32%	25%	42%	35%
Schools	12%	6%	22%	16%	7%	2%	17%	12%
Other Services	12%	6%	6%	1%	-7%	-11%	-24%	-28%
Total Welsh Budget	16%	10%	16%	10%	16%	10%	16%	10%

Table 5.2. Scenarios for the percentage change in real-terms spending relative to 2013–14 for different service areas funded by the Welsh Government to 2025–26 (continued)

Scenario	Choice 1		Choice 2		Choice 3		Choice 4	
	% Change	% Change per person	% Change	% Change per person	% Change	% Change per person	% Change	% Change per person
More pessimistic scenario								
Health	16%	11%	16%	11%	30%	24%	48%	41%
Social Services	4%	-1%	16%	11%	26%	20%	42%	35%
Schools	4%	-1%	16%	11%	2%	-3%	17%	12%
Other Services	4%	-1%	-2%	-7%	-14%	-18%	-41%	-44%
Total Welsh Budget	9%	4%	9%	4%	9%	4%	9%	4%
Most pessimistic scenario								
Health	8%	3%	8%	3%	16%	11%	48%	41%
Social Services	-10%	-15%	8%	3%	14%	8%	42%	35%
Schools	-10%	-15%	8%	3%	-1%	-6%	17%	12%
Other Services	-10%	-15%	-21%	-25%	-27%	-31%	-73%	-74%
Total Welsh Budget	-3%	-7%	-3%	-7%	-3%	-7%	-3%	-7%

Source: PESA 2013 Budget tables, OBR Economic and Fiscal Outlook, OBR Fiscal Sustainability Report, Welsh Government First Supplementary Budget 2013–14, Welsh Local Government Budget Estimates 2013–14 and authors' calculations.

Of course, things look most difficult under our *most pessimistic* case for the overall Welsh budget. In that case, even under choice (1), while spending on health would be 8% per higher (or 3% higher per person) than now by 2025–26, spending on all other services including social services and schools would still be 10% lower (15% lower per person) than now. Extending protection also to social services and schools (choice 2) would mean spending on other services being 21% lower in 2025–26 than now. That is not much better than under choice (4) under our *baseline* scenario for the overall Welsh Budget, where there would be a cut of 26% for un-protected services by 2025–26. In that instance, however, a cut of 26% allowed health spending to grow by 48% by 2025–26, compared with just 8% under this, our most pessimistic, scenario. This example shows clearly that if the Welsh Government’s overall budget remains under pressure after 2017–18 (as in our *most pessimistic* scenario), even fairly sizeable reductions in spending on ‘unprotected areas’ can only provide very modest increases to areas such as health.

However, whilst things look difficult for ‘other services’ under choices (1) and (2) in 2025–26, at least the budgets for these departments would be growing by about 1.6% per year, on average, after 2020–21 – which, if it continued, would be enough to regain current levels by about 2033 under choice (1) or about 2040 under choice (2). This would not be the case though, if the Welsh Government decided to prioritise increases in spending on health and social services once its budget started growing again. For instance, under choice (3), which in our *most pessimistic* scenario for the Welsh budget would deliver average annual increases of health spending of 3.1% per year after 2020–21, spending on unprotected services would be 27% below its current level by 2025–26 and still falling at about 0.1 to 0.2% per year. Accounting for projected population growth, that corresponds to a continuing fall of about 0.5% per person per year.

But it is choice (4) which shows most clearly how tough the trade-off is between funding health and social services sufficiently in a world of rising demands and costs, and continuing to provide other vital public services. In this instance, delivering the 48% increase in the health budget (a 3.3% average annual real-terms increase over the next 12 years, which is below a number of projections of the necessary increases),⁵¹ 42% increase in its social services spending and 17% increase in its schools spending would require a 73% cut in spending on all other service areas. And by 2025–26 the annual cut to such services required to maintain this policy would be approaching 16% *per year*. Such a policy seems implausible; delivering it would likely require the Welsh Government and local authorities to abandon a vast swathe of important services that are currently provided and still have to substantially increase user charges and council tax to fund those that remain. Even doubling council tax, for instance, and using (most) of the additional revenue to reduce the Welsh Government’s contribution to local government spending would leave areas other than health, social services and schools facing cuts in the order of 50% by 2025–26.⁵²

Thus, under our most pessimistic scenario for the Welsh Government’s budget the choices open to the Welsh Government look unappealing indeed: with either difficult-to-imagine cuts

⁵¹See Chapter 6, and Jeffs (2013).

⁵²Authors’ approximation using an assumed net council tax yield of around £1.25 billion in 2025–26, in today’s prices. The reason most but not all of the additional council tax revenue would be used to reduce the Welsh Government’s contribution to councils is that councils would need to retain some to reduce the size of the cut to services other than schools and social services that they provide.

to unprotected services, or only very modest increases in health spending that would make it difficult to cope with rising costs and rising demands.

Summary

The Welsh Government will face a challenge in setting its budgets over the next 12 years in even our most optimistic scenario for its total budget. In particular, increasing spending on health and social services to meet rising demands and costs, and ensuring a fairly modest increase in schools spending after the cuts have ended, would require sizeable – and ongoing – cuts to spending on other departments such as Education and Skills, the Economy, Science and Transport, and Housing and Regeneration. Under our most pessimistic scenario, even very modest increases in spending on health, schools and social services by 2025–26 would require substantially less to be spent on other services than is spent now.

The scale of the challenge in our more pessimistic – but not implausible – scenarios means advanced planning by the Welsh Government for how it plans to fund public services over the next decade (and beyond) seems sensible. It will also be important to understand the demand and cost pressures facing public services, due at least in part to demographic change – issues which we discuss in the next chapter and which Jeffs and Trickey (2013) provides further detail on – and to develop policies to try to reduce these pressures.

6. The spending pressures facing Wales in the coming decades

Summary

- Wales, like the rest of the UK, has both a growing and ageing population. The latest projections are for the number of individuals aged 65 and over in Wales to increase by 22% by mid-2025, and by 43% by mid-2035, by when they will make up over one quarter of the Welsh population. The increase in the number aged 80 or over is set to be even more dramatic: rising by 40% over the next 12 years, and 90% over the next 22. The number of school-aged children is also expected to increase, albeit much more modestly. On the other hand, the number of people aged between 16 and 64 is expected to decline slightly over the next 22 years.
- Demographic trends vary substantially across Wales. For instance, whereas the number of 4- to 16-year olds is expected to increase by 7% across Wales by 2025–26, in Cardiff the increase is expected to be 26%, whilst in Powys the numbers are expected to decline by 6%. Conversely, parts of the country like Powys that already have a higher proportion of older people are expected to age most rapidly in the coming decades, whilst Cardiff will see only a small increase in the fraction of its population that are aged 65 and over and aged 80 and over. These differences in demographic trends will mean some areas are likely to experience a much greater increase in demand for certain public services than other areas.
- Increases in the number of older people are likely to lead to increases in the amount required to fund health care and social care. In its baseline projections, the OBR projects an increase in the proportion of national income spent on health care and social care of 0.8 percentage points by 2025–26. The costs are projected to continue rising until at least 2062–63, by which time costs are projected to rise by 3.0 percentage points of national income.
- However, the projections are subject to wide margins of error, reflecting uncertainty about future demands for health and social care, and the future costs of providing these services. Whilst the past is not necessarily a guide to the future, recent experience suggests that baseline projections may overstate demand by assuming no reduction in the demand for services at a given age as life expectancy increases, but may understate the costs by assuming health and social care productivity growth matches economy-wide productivity growth. There is also uncertainty around the underlying population projections. Thus, the amount needed to be spent on health and social care implied under current policies and the projected ageing of the population could be significantly more or less than in the OBR's baseline and variant projections.

- In using the existing projections for spending needs, it is important to realise that most relate to England only, or the UK as a whole. Differences in economic and demographic factors, and substantial differences in health and social care policies between Wales and the rest of the UK mean these analyses can only offer a rough guide to the spending pressures facing Wales in the coming decades: this is an area where more Wales-specific research would be beneficial.
- Demographic change will also put upwards pressure on the cost of providing free bus passes for those aged 60 and over, and the cost of education in Wales. In particular, differences in the projected change in the number of school-aged children mean that whilst some parts of Wales may see shortages of school places and require investment in new schools, others may see existing problems of surplus school places worsen.

Chapters 3 to 5 of this report have provided a quantitative analysis of the cuts to spending made by Wales so far and the difficult trade-offs it will face in setting budgets over the next 12 years under various scenarios for the Welsh block grant. In this chapter we place this analysis in the context of demographic change and other issues that may put substantial upwards pressure on the demand for and costs of public services in Wales. This qualitative discussion is purposefully brief and considers a small number of key issues only: a more detailed set of projections for the demand for different services can be found in Jeffs (2013).

The rest of this chapter proceeds as follows. In Section 6.1 we discuss the demographic projections for Wales for the next few decades, focusing on the period up to 2025–26. In Section 6.2 we discuss how these changes and other factors such as low productivity growth may put upwards pressure on the demand for and the cost of providing services in Wales.

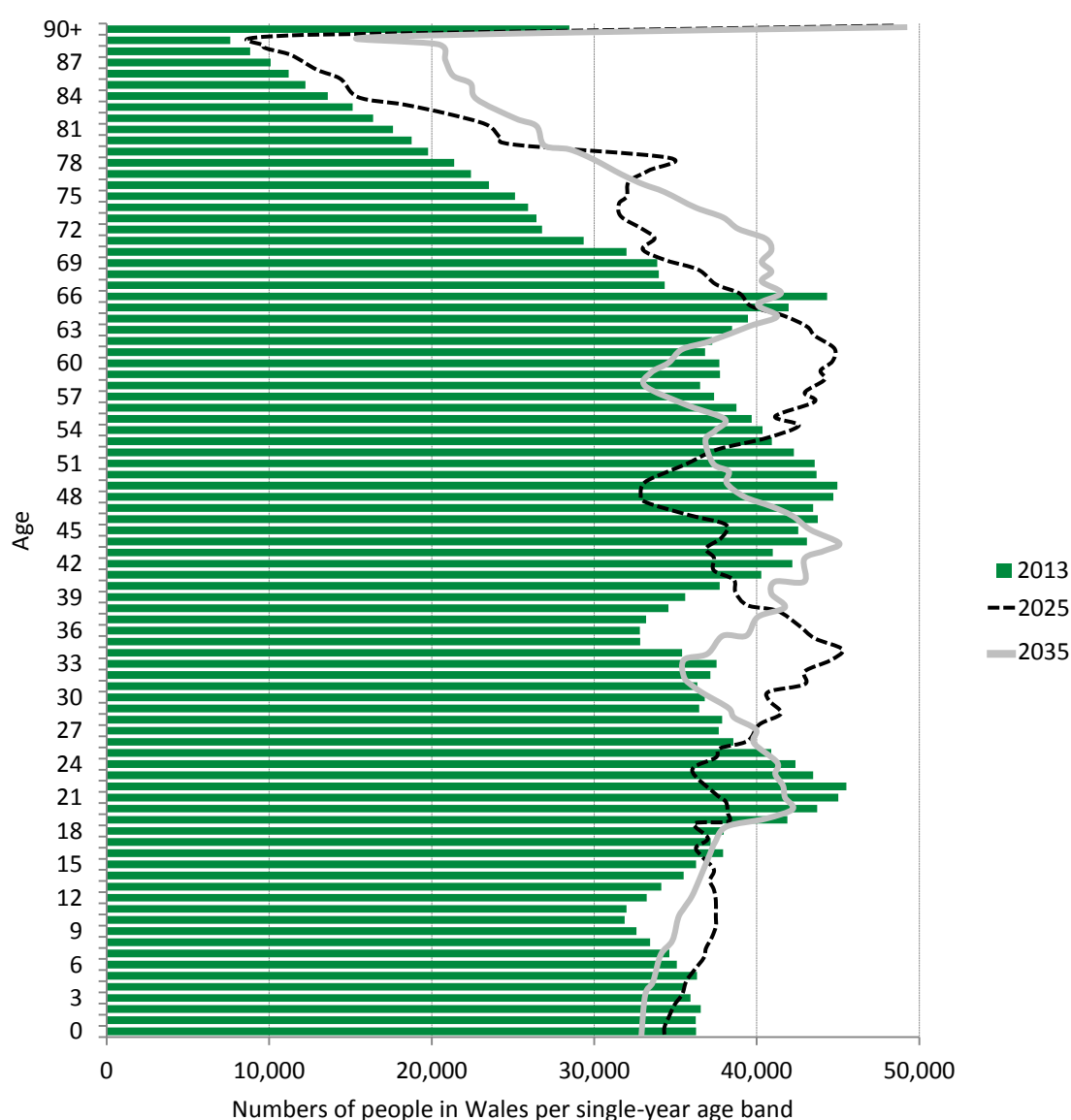
6.1 The changing demographics of Wales

Wales, like the rest of the UK, has a growing population. 2011-based projections suggest an increase of 5% between mid-2013 and mid-2025, taking the population to 3.2 million, and a further increase to 3.3 million by mid-2035.

Over this period, its age-structure is also projected to change substantially, as shown in Figures 6.1 and 6.2. The most notable change is the increase in the number of older people. For instance, the latest projections are for the number of people aged 65 or over to increase by 22% between now and mid-2025, and by 43% by mid-2035. As a result, the proportion of the Welsh population aged 65 or over is projected to increase from 19.5% in mid-2013 to 22.6% by mid-2025 and 25.9% by mid-2035.⁵³ The projections for proportional growth are even greater for older segments of the population. The number of those above 80 is predicted to have increased by 40% by 2025–26 and by 90% by 2035.

⁵³The 6.4 percentage point increase in the proportion of people aged 65 or over is very similar to projections for the UK as a whole. However, it should be noted that Wales is starting from the position of having a somewhat older population, and is forecast to experience slower overall population growth, meaning that the growth rate of the over-65 population is actually somewhat lower than in the UK as a whole.

Figure 6.1. Projected population by age, mid-2013, mid-2025 and mid-2035

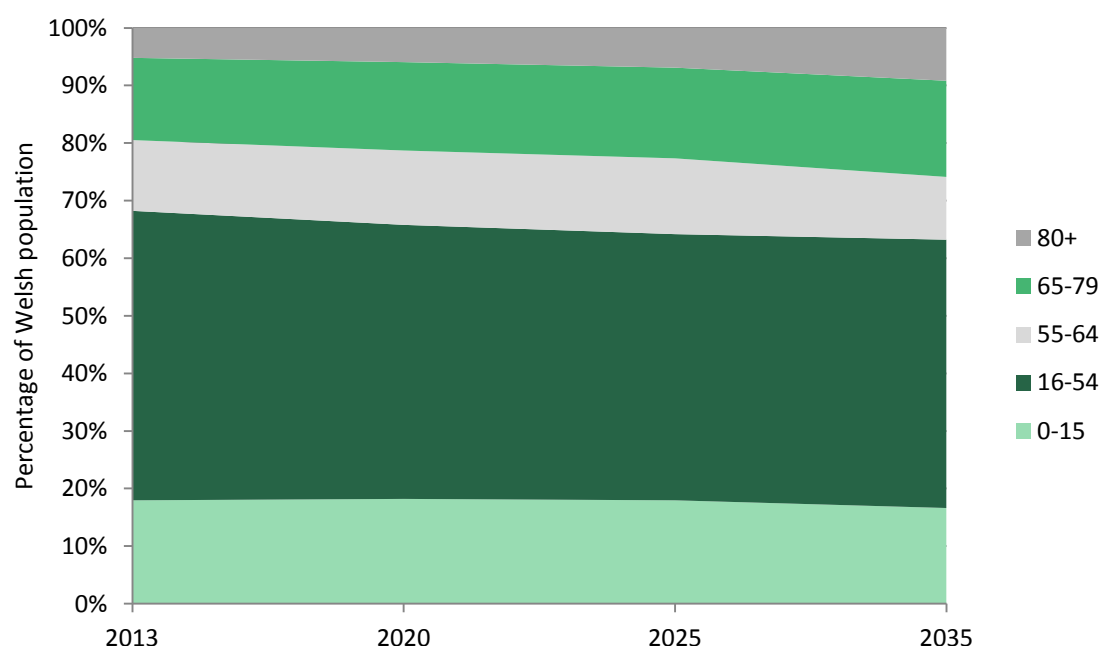


Note: the projected number of over 90s in 2035, at 79,156, is too great to fit on the chart.

Source: <https://statswales.wales.gov.uk/Catalogue/Population-and-Migration/Population/Projections/Local-Authority/2011-Based/PopulationProjections-by-LocalAuthority-Year>

Figure 6.1 also shows a substantial increase in the number of children at primary school age and secondary school age between now and 2025–26: indeed the number of children between the ages of 4 and 16 is projected to increase until mid-2026, at which point there will be 7% more 4 to 16 year olds than in 2013–14. After 2026, the number of children in that age group is projected to fall, but will still be 2.3% higher in 2035–36 than today. In contrast, the working-age population is projected to fall slightly over the next two decades.

Figure 6.2. Projected Welsh age distribution mid-2013 to mid-2035



Source: 2011-based population projections available from: <https://statswales.wales.gov.uk/Catalogue/Population-and-Migration/Population/Projections/Local-Authority/2011-Based/PopulationProjections-by-LocalAuthority-Year>

The ratio of the number of people aged 15 and under or over the state pension age to the number of working age is termed the dependency ratio.⁵⁴ The increase in the female state pension age to 65 by April 2018 (from between 61.5 to 62 during 2013–14), and of both male and female state pension ages to 66 between 2018 and 2020, and 67 between 2026 and 2028 will slow the rate at which the dependency ratio grows compared with an unchanged state pension age, as shown in Table 6.1. These increases in the state pension age are expected to lead to growing numbers of older people in work,⁵⁵ but with social security policy not a devolved matter the Welsh Government will not see a direct financial benefit from these increases. However, it does act to reduce the pressure on overall UK government spending, allowing more to be spent on public services (as opposed to pensions), thus indirectly increasing the resources available to Wales.⁵⁶

⁵⁴The idea behind this is that the consumption of children and those over state pension age is ‘dependent’ on the economic activity of those working age.

⁵⁵For some research regarding the effect of raising the pension age on older people’s employment see Cribb, Emerson and Tetlow (2013).

⁵⁶As discussed in the next section, financial help for funding personal and residential care is means tested, which means the Welsh Government may also benefit indirectly via lower contributions to social care as the income, and potentially the assets of older citizens, increases as they work longer in response to the higher state pension age.

Table 6.1. Welsh dependency ratio projections

Definition	2013	2020	2025	2035
2013 State Pension age	61.70%	67.39%	70.87%	76.14%
Contemporaneous State Pension age	61.7%	59.6%	62.0%	63.8%

Notes: the top row is the ratio of those under 15 and over 64 to those between those ages. The bottom row is the ratio of those under 15 and over that year's state pension age to those in between those ages. The reason the first figure is greater for the bottom row is that the female pensionable age is currently between 61.5 and 62 and hence women 62 and above have been included as 'dependent' for the bottom row.

Source: Author's own calculations. 2011-based population projections available from:

<https://stats.wales.gov.uk/Catalogue/Population-and-Migration/Population/Projections/Local-Authority/2011-Based/PopulationProjections-by-LocalAuthority-Year>.

Finally, it is worth noting that the projected changes in demography vary greatly across different parts of Wales. For instance, whilst the number of school-aged children in Wales as a whole is set to increase only modestly over this period, Cardiff is projected to see a 25.8% increase in the number of 4–16 year olds between 2013–14 and 2025–26. On the other hand, Swansea – Wales's second city – is expected to see a much smaller (4.8%) rise during the same period. And in Powys, there is projected to be a 6% fall in the number of 4–16 year olds. Conversely, the number of older residents is set to rise by more, at least relative to the population as a whole, in rural areas that already have rather old populations, than in Cardiff. For example, the proportion of the population that is over 65 is projected to have risen by 6.2 percentage points in Powys compared with just 1.4 percentage points in Cardiff by 2025, whilst the proportion that is over 80 is set to rise by 3.1 percentage points in Powys compared with 0.3 percentage points in Cardiff.

These differences suggest different parts of Wales will be affected quite differently by demographic change in the coming decades. Cardiff's increasing population of school-aged children may put pressure on school places in parts of the city. And whilst it will see an increase in the number of older residents, this is expected to be proportionally the smallest rise in Wales, which may make dealing with change easier to deal with. On the other hand, rural areas, such as Powys, which already have substantial numbers of older residents may find it increasingly difficult to support their rapidly ageing populations. And further declines in the number of school-aged children could worsen existing problems of surplus school places (and the resultant pressure to close schools).

6.2 Demand and cost pressures for Welsh public services

The ageing of the Welsh population looks set to lead to substantial increases in demand for health and social services: older people have more health problems and greater care needs than young people. With this rise in demand coming at a time when the amount of money available is severely constrained, the Welsh Government's budget looks set to face significant strain even under relatively optimistic scenarios for the years ahead, as shown in Chapter 5 of this report.

Unfortunately, whilst there exists a considerable literature quantifying the potential costs of ageing, other demand pressures and cost pressures for English and UK-wide public service spending, there is little such work for Wales (at present). The differences in policy,

demographics and even geography that exist between Wales and the rest of the UK means that many of the findings of the existing literature may not be directly applicable to Wales. However, in the absence of work specifically on Wales, this literature provides the best guide for how things may evolve in the coming years. This section therefore reports projections made for England and the UK as a whole, and discusses how things may differ in Wales. Jeffs (2013) uses the literature for England (amongst other things) to construct quantitative projections for spending needs in different areas, which is a vital contribution to begin plugging the knowledge-gap.⁵⁷

Health and social care spending

The Commission for the Funding of Care and Support (the ‘Dilnot Commission’)⁵⁸ commissioned projections from the Personal Social Services Research Unit (PSSRU) regarding the costs of health and social care in England in the decades ahead. The PSSRU’s baseline projections (based on the care spending system in place in England 2010) suggested that real-terms total public expenditure on long-term care for older people would rise 61% by 2025 and by 105% by 2030 compared with 2010. However, their projections were highly sensitive to changes in social care policy.

The OBR’s 2013 Fiscal Sustainability Report, which used the projections of the PSSRU as the basis of their long-term care spending projections, also looks at the future costs of care. The baseline scenario from this report shows spending on long-term social care increasing from 1.2% of GDP this year to 1.6% in 2025–26 and 2.4% in 2062–63. The baseline assumption is for demographic change to require an increase in health spending in the UK from 7% of GDP in 2017–18 to 7.4% in 2025–26 and 8.8% by 2062–63 due to ageing of the population.⁵⁹ Again, sensitivity analysis shows the projected level of spending to be highly sensitive to the assumptions made.

The earlier Wanless Review (Wanless et al. 2006) similarly projected substantial increases in the costs of health care and social care in the coming decades, driven by demographic change, but likewise found the magnitude of these increases highly sensitive to the assumptions made.

Therefore, there is a consensus that the amount spent on health care and social care will need to increase in the coming decades. But, in order to determine whether these analyses provide a useful guide to the *magnitude* of the impact of demographic change on spending on health and social services in Wales, two issues need to be considered:

- whether the methodology and assumptions underlying the projections are appropriate;
- whether England and Wales differ too much – both in terms of policy and on other social, economic and demographic dimensions – to enable analyses for the former to be used to inform policy in the latter.

⁵⁷This is a very useful exercise. However, a more comprehensive analysis of the demand and cost pressures facing Welsh public services still needs to be carried out.

⁵⁸The Dilnot Commission’s report is available online at: <http://webarchive.nationalarchives.gov.uk/20130221130239/http://dilnotcommission.dh.gov.uk/>.

⁵⁹Note that, given the real-terms freezes pencilled in to 2015–16 and an assumption of cuts in 2016–17 and 2017–18, health spending in 2017–18 is projected to be lower as a proportion of GDP than now (8.1%).

A discussion of the methodology underlying these projections

To project health and social care spending needs decades into the future, a substantial number of assumptions have to be made about both the demand for services and the cost of providing them.

On the demand side, perhaps the most basic driver of demand will be the changing age structure of the population. The projections discussed above are the baseline forecasts produced by the Welsh Government following the 2011 census, and showed a substantial increase in the proportion of the population aged 65 and over and, especially, aged 80 or over. This increase reflects the large cohorts of people now entering older ages (the ‘baby-boomers’), anticipated changes in life expectancy, and forecasts for fertility and net migration. However, the future levels of net migration, fertility and life expectancy are uncertain, and varying assumptions over these can lead to significant differences in the scale of ageing projected.⁶⁰

But taking the basic demographic projections – that is the number of people of different ages – as given, the demand for health care and social care in future years will depend upon what happens to the demand for those services among people of particular age groups, which is highly uncertain.

In their baseline scenarios, the OBR and the PSSRU largely assume that the underlying health care and social care needs of people of a given age will remain constant in the future.⁶¹ Thus, an 80 year old in 2025 or 2035 is assumed to have the same likelihood as an 80 year old today of requiring care, and to cost the health service the same, on average, as an 80 year old today (after adjusting for growth in the level of national income). This means that the current high average cost of social care and health care per person aged 80 relative to younger people, combined with the dramatic projected increase in the proportion of the population aged 80 or over, leads to the large increase in the costs of health care and social care as a proportion of national income.

But it is far from clear whether health care and social care demands will remain the same for people of a given age in future years. A substantial part of the increase in the number of older people projected is down to projected increases in life expectancy and one might expect that increase to be accompanied by increases in *healthy* life expectancy. If people are staying healthier for longer as they live longer, then this would probably lead to a *reduction* in health care and social care needs for a given age. This would tend to slow the upwards pressure of demographic change on health and social care costs, and, if healthy life expectancy is growing more quickly than total life expectancy, could even lead to falls in health care spending in future years.

There is some evidence that in recent years healthy life expectancy has increased a little quicker than total life expectancy. The ONS estimates, for instance, that between 2000–01

⁶⁰Unfortunately, the Welsh Government did not produce variant projections based on the 2011 census. However, the ONS did produce variants for its population projections based on pre-census 2011 mid-year estimates for 2010. Under their baseline assumptions, these showed the fraction of the population aged 75 or over increasing from 9% now to 12% by 2025 and 13.9% by 2035. Under its low life expectancy assumptions, on the other hand, the projections were 11.8% and 13.2%, respectively; and under its high life expectancy assumptions, the projections were 12.3% and 14.6%, respectively.

⁶¹There are some exceptions to this (for instance, for the projections of the numbers of people with learning disabilities) but these are fairly small. See OBR (2011, 2013b) for more details.

and 2007–08, healthy life expectancy increased by 2.3 years and 2.6 years for men and women respectively, compared with 2.2 years and 1.6 years for total life expectancy.⁶² And a recent study in the *Lancet* found that whereas if the rate of dementia for a given age and sex had remained constant since 1991, around 884,000 people in the UK would have been suffering from dementia by 2011, in fact only 670,000 were, implying a 24% fall in the risk of dementia at a given age.⁶³

Whether this can continue into the future is unclear: further increases in life expectancy might be the result of underlying improvements in health, or could reflect improvements in life-extending and life-saving treatments that may be costly, and may not increase healthy life expectancy or facilitate independent living. Thus, whilst recent evidence would suggest, all else being equal, assuming a fixed demand for health and social care at a given age is unduly pessimistic, this is not certainly the case.

On the costs side of the equation, an important factor driving the amount needing to be spent on health and social care will be the future productivity of the organisations providing these services. This too, is difficult to predict, in part because of uncertainty about how productivity has changed in recent years.

The OBR assumes for its baseline projections that health care productivity will change in line with whole economy productivity (which is assumed to grow at 2.2% per annum). Together with its assumption that underlying demand for health spending rises in line with national income, this implies that only changes in the age structure of the population affect the future level of health care spending. Under this scenario, health spending would increase by 0.2 percentage points of national income between 2017–18 and 2025–26, and by 0.8 percentage points of national income by 2035–36.

However, it also has a variant projection where health care productivity instead grows by just 1% per year. Under this scenario, Baumol's cost disease (see Box 6.1, below) leads to health spending increasing by 0.7 percentage points of national income by 2025–26, and 2.4 percentage points of national income by 2035–36. That is, around 0.5 percentage points more of national income would have to be spent on health care in 2025–26, and 1.6 percentage points more in 2035–36, if health care productivity grew by 1% per year, than in the OBR's baseline projections of health care productivity growth of 2.2% per year. This clearly shows that the rate of growth of health care productivity will play a major role in defining the cost pressures facing the UK government in the coming decades.

Box 6.1. Baumol's Cost Disease

Suppose that the health care sector sees productivity growth of only 1% per year, whilst economy-wide productivity growth, and thus real-terms wage growth, is 2.2% per year. Whilst productivity would have grown by less than the rest of economy, health care providers would need to ensure the wages they offered staff kept pace with

⁶²ONS statistics on healthy life expectancy are available online at <http://www.ons.gov.uk/ons/taxonomy/index.html?nscl=Healthy+Life+Expectancy#tab-data-tables>

⁶³Matthews et al (2013).

those in the rest of the economy. This would increase the cost of producing the same amount of health care by about 1.2% per year in real terms (the difference between the 2.2% real-terms wage growth and the 1% productivity growth), which would push up the cost of health care relative to other goods and services. Assuming that the demand for health care grows in line with real wages, this would imply a 3.4% real-terms increase in health spending per person to deliver a 2.2% increase in the quantity of health care services provided. Thus, over time, a larger and larger share of national income would need to be devoted to health care to keep up with demand because of the low productivity growth in the health care sector.

This phenomenon of low productivity growth and rising wages pushing up the cost of labour intensive services (such as health care, social care and education) was first described in this way in Baumol and Bowen (1966) in the context of the performing arts.

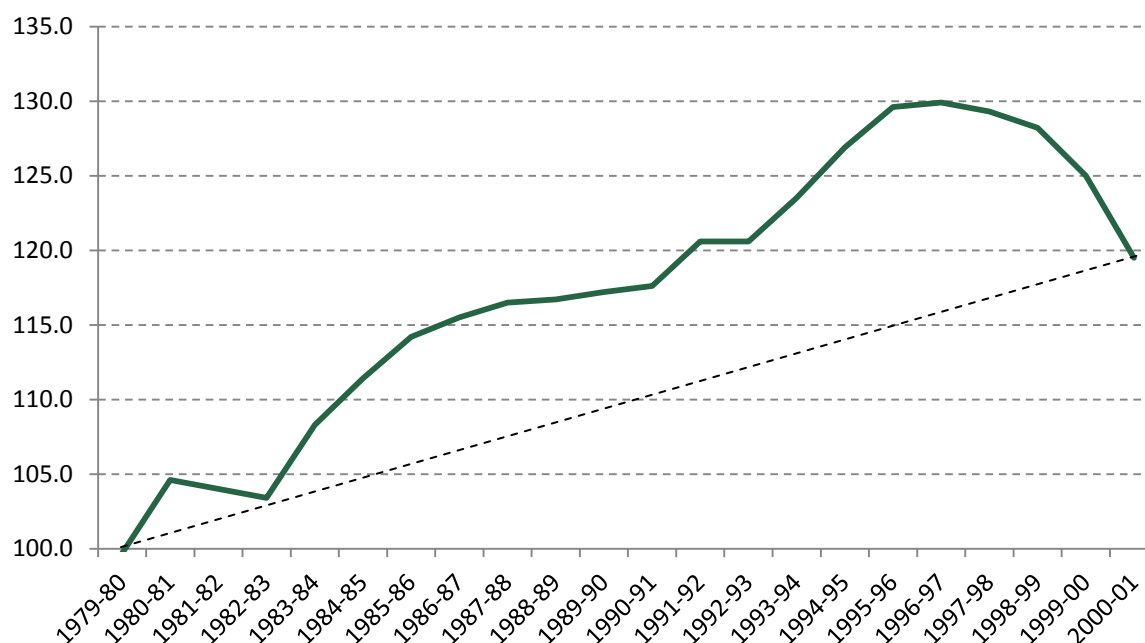
But what scenario is more likely? A number of studies have attempted to estimate productivity growth in the government-funded health care sector in the UK (i.e. the NHS), and have generally found productivity to grow less quickly than in the rest of the economy. For instance, in its most recent publication, the ONS estimates that health care productivity increased by, on average, 0.5% per year between 1997 and 2010. However, year-to-year growth is volatile in their estimates, with growth of 2% or more in 2001, 2005 and 2006, and falls in productivity of 2% in 2002, 2009 and 2010. Researchers at the University of York's Centre for Health Economics also find evidence of a weak productivity performance and substantial year-to-year volatility. But their estimates also vary quite substantially from those of the ONS for given years.⁶⁴

In its 2012 Fiscal Sustainability Report, the OBR expressed concern that both the ONS data and Centre for Health Economics estimates largely cover a period characterised by 'exceptional growth' in health care spending. In particular, it cited the National Audit Office (2012) as saying 'productivity might initially fall in periods of rapid input growth as any resulting increase in output might be slower to achieve'. The OBR therefore also made use of estimates in Oliver (2005), which covered the period between 1979–80 and 2000–01. Figure 6.3 shows the level of productivity estimated for each year covered by this study, with the level of productivity in 1979–80 indexed to 100.

The figure shows productivity rising by around 20% over 21 years, for an average growth rate of 0.9% per year. However, the trends are quite different before and after 1995–96: after increasing by an average of 1.7% per year between 1979–80 and 1995–96, productivity is then estimated to have *fallen* by an average of 1.6% per year between 1995–96 and 2000–01. These falls are before the large increases in NHS funding following the NHS plan in 2000 and contrasts with the estimates of fairly flat productivity during the late 1990s according to the ONS study.

⁶⁴Bojke (2012), and Dawson et al (2005).

Figure 6.3 Oliver's (2005) estimates of health care productivity, 1979–80 to 2000–01



Source: Originally, Oliver (2005), but this version is from OBR (2012).

Notes: Unlike the ONS and Centre for Health Economics, Oliver's estimates do not adjust for quality, and only cover part of the health care sector.

The OBR chose its assumption of 1% health care productivity growth for its sensitivity analysis by combining the change in productivity between 1979–80 and 1995–96 from Oliver's study, with the change since then according to the ONS. Past experience would suggest that health care productivity growth is likely to be less than 2.2% per year, which would suggest, all else being equal, costs rising by *more* than in the OBR's baseline projections. But the volatility of and uncertainty surrounding existing estimates of health care productivity mean that future productivity growth is still highly uncertain, and may be higher or lower than 1% per year.

A further issue worth mentioning is that the projections require an assumption about the health care and social care policies that will operate in the future. The latest Fiscal Sustainability Report includes the PSSRU's estimates of the costs of implementing the reforms to long-term care in England set out in the Government's response to the Dilnot Commission. The proposals include, amongst other things, capping the total amount a person is expected to contribute to their social care over their lifetime at £72,000, and an increase in the asset threshold used for means-testing state-funded care, both of which will raise the cost of social care to the government. But there is, of course, the potential for further reforms that may lead to changes in the cost of social care and health care in the years ahead.

Uncertainty around future policy, service demands and service costs therefore means that the projections for spending on health and social care for England and for the UK as a whole are therefore subject to significant margins of error.

Likely differences in impact between England and Wales

Differences in health and social care policies in Wales compared with England and the rest of the UK, together with differences in the social, economic and demographic characteristics of different parts of the UK, also suggest that the available spending projections can provide only suggestive evidence of the potential magnitude of cost pressures in Wales, rather than precise predictions.

As was mentioned above, Wales is projected to see a similar *percentage point* increase in the proportion of older people as England, but, given the higher proportion of older people to begin with in Wales, this amounts to a smaller *percentage* rise. How this will impact Wales's ability to cope with the demographic changes is unclear. On the one hand, a smaller proportional rise in the elderly population may ease the pressure. On the other hand, it could mean that the increases will be more problematic in Wales than in the rest of the UK because they arrive on top of an already difficult situation (especially in the more rural areas, where the population is projected to age most and is already oldest).

The lower cost of land in Wales, and lower labour costs, might reduce the absolute cost of population-ageing in Wales: it would simply be less expensive to construct and staff new health facilities and care facilities in Wales than in the rest of the UK. The extent to which lower labour costs can ameliorate the impact of population ageing, however, will depend upon future pay policies (including whether the government proceeds to localise public sector pay, and, if so, whether changes are made to the Welsh Government's block grant at the same time).

In terms of policy, it is worth noting substantial differences in both the organisation of the Welsh NHS from that in England, and the funding of social care in the two nations.

For instance, the commissioning of health care in Wales is currently handled by seven Health Boards covering different regions of the country, whilst in England, following the Health and Social Care Act 2012, commissioning has been the task of 211 Clinical Commissioning Groups headed by local GPs. There is also less emphasis on both 'internal' competition between NHS providers and 'external' competition between NHS providers and private sector providers in Wales than there is in England, where there has been a drive towards the greater use of private treatment centres for routine services.⁶⁵ And, in line with Scotland and Northern Ireland, prescription charges have been abolished in Wales, but remain in place in England.

Whether differences between England and Wales on the extent of competition between providers and the commissioning systems used leads to higher or lower productivity in one country is both unclear and controversial: it is very difficult to estimate health-sector productivity (as was discussed above), let alone link differences to particular structural differences between health services. What evidence there is is difficult to interpret, but suggests a somewhat mixed picture on the relative productivity of the Welsh NHS *vis à vis* its English counterpart. For instance, a Welsh Audit Office report,⁶⁶ found that Welsh GPs reported seeing more patients per week, on average, than those in other parts of the UK. However, it is not clear whether this indicates higher productivity among Welsh GPs or a

⁶⁵Boyce, S. (2011).

⁶⁶National Audit Office Study Team (2012).

poorer standard of service provided. Similarly, it finds that Wales also had the highest rate of emergency admissions, which could reflect low productivity and poor quality elsewhere in the health service (a measure of care quality), or higher underlying need for emergency care. The report also found that the average hospital stay in Wales (6.3 days) was substantially longer than that in England (4.3 days). A report by the Nuffield Trust⁶⁷ looking at performance and productivity in 1997, 2002 and 2007 was somewhat more critical of Welsh NHS performance, finding a worse performance on waiting times and lower ‘crude productivity’ (number of activities per nurse, doctor, etc.) than in England, with little evidence of offsetting improvements in other dimensions of care quality and performance.

But even if one could be certain that productivity in the NHS was lower in Wales than in England, the implications of this for the costs of health care *in the future* are not clear. On the one hand it could indicate that there is more scope for productivity gains in future, which would act to *reduce* the extent to which health care spending will have to rise in the coming years relative to England. On the other hand, especially if differences in productivity are growing over time, it could be indicative of the structure of the NHS in Wales being less conducive to productivity growth, which would *increase* the extent to which health care spending will have to rise relative to England. What is clear, however, is that more research on the productivity of the health care system in Wales, including benchmarking against other countries, would be useful for understanding the cost pressures facing the Welsh NHS and developing ways to reduce those pressures.

There are also substantial differences in the funding of social care in Wales and in England, which may mean projections for social care spending for England (or the UK as a whole) need to be seen as a guide only.

The current system of funding social care is presently somewhat more generous in Wales than in England. For instance, people with assets of less than £23,750 are able to receive free social care in Wales, whereas in England only those with assets below £14,250 receive such support (those paying between £14,250 and £23,250 pay for part of their care in England, with the amount payable based on a sliding-scale).⁶⁸ The Welsh Government also caps the amount that someone will have to pay at £50 per week if they are receiving care in their own home. If the Welsh system were to remain more generous than that in England, the rise in the demand for social care associated with ageing would be expected to be more costly for Wales (which subsidises care more) than England.

However, in response to the Dilnot Commission, the UK government has announced a substantial increase in generosity of the system of support for social care costs in England from 2016. This involves a lifetime cap on care costs of £72,000 (not including ‘hotel costs’ to pay for food and accommodation), and an increase in the asset threshold above which people are expected to fully pay for their care (provided total costs are still below the cap) from £23,250 to around £120,000.

⁶⁷Connolly, Bevan and Mays (2010).

⁶⁸Note that, whilst social care is provided free of charge for those below the stated thresholds, the local authority funding care can make a deduction from income to cover the ‘hotel costs’ of care, provided that the individual in question is left with at least an amount equal to the personal expense allowance (currently £24.50 in Wales and £23.90 in England).

The OBR's 2012 Fiscal Sustainability Report's projections for social care spending were based on existing policy in England; the 2013 report's projections were based on the policy announced in response to the Dilnot Commission. Similarly, the PSSRU has produced projections for England under both current policy and proposed policy. Unfortunately, because the Welsh system differs substantially from both the current and proposed systems for England, neither set of projections is particularly well suited for projecting social care costs in Wales. However, in the absence of bespoke projections, they can probably be used as a rough guide to spending pressures, as in Jeffs (2013).

Other areas of spending

Demographic change will also affect a number of other areas of spending in Wales in the coming decades.

First, the increase in the number of older people will push up the cost of providing free local bus transport for people aged 60 or over.⁶⁹ Providing these 'bus passes' cost Welsh local authorities £72 million in 2011–12 (the latest year for which data is currently available), making it a modest but non-negligible part of their service spending. Unlike in England, where the age at which people are entitled to bus passes is linked to the female state pension age (and has therefore already been raised to approximately 61 and 8 months as of August 2013), the eligibility age in Wales is fixed at 60. Over time, this will lead to the costs of free bus passes rising by more in Wales than in England. For instance, by the end of 2025–26, the state pension age (for men and women) is planned to be 67: fixing the eligibility age at 60 is projected to lead to additional 293,000 people being eligible for free bus passes in Wales than if the eligibility age were increased to 67.

Second, the increase in the number of school-age children projected for the next 12 years is likely to put upwards pressure on spending on schools: given the Welsh Government's latest population projections, maintaining current levels of spending per pupil will require a 7% increase in schools spending. However, as discussed above, the increase in the school-age population is projected to be uneven across Wales, with large increases in some parts of the country (most notably Cardiff) and decreases in other areas (such as Powys). This means that, whilst there is likely to be a need for new schools in parts of the country, other areas will be hit by a worsening problem of surplus places: both will be costly to address.

Finally, factors other than demographic change may put upwards pressure on spending in other areas. For instance, obligations to reduce the amount of waste sent to landfill and increase recycling rates led to the Local Government Association (LGA) to predict increased capital and current expenditure by local authorities in England in the period to 2020 in order to avoid potential fines which would be levied if targets set by the European Union were missed.⁷⁰ The LGA also highlight the role of the landfill tax in driving up waste management costs in recent years, and as a potential driver of costs in the future. Currently, landfill tax is not a devolved matter, but the Silk Commission (2013) suggested that the UK government should devolve landfill tax to Wales. The impact of any further increases in the landfill tax will

⁶⁹The Welsh Government also currently provides free transport for the over 60s on certain rail services in North Wales, but this scheme is only funded until the end of this year.

⁷⁰Local Government Association (2013).

depend upon whether the rates are set and the revenues retained by the Welsh Government, or set and retained by the UK government.

Summary

Demographic change looks set to put upwards pressure on Welsh Government spending in the coming decades, most notably on health and social care, but also on schools and concessionary travel. However, the scale of this impact is difficult to quantify, with both the demand for and cost of providing services in the years ahead uncertain. Based on the experience of the recent past, current baseline projections for the cost of health care and social care by the OBR, for instance, may *overstate* demand by assuming no reduction in the demand for services at a given age as life expectancy increases, but may *understate* the costs by assuming health and social care productivity growth matches economy-wide productivity growth. And projections for England or for the UK as a whole can only offer a guide for Wales because of economic and demographic differences between different parts of the UK, and differences in policy that may affect demand and cost pressures in the years ahead.

In the absence of a literature focused on projecting the demand for and cost of public services in Wales, it is important to use the more developed literature for England and the wider UK to explore scenarios for the pressures facing Wales. Work by Jeffs (2013) does this, drawing also on the available evidence that does exist for Wales. But this should be seen as a first part of a more ambitious programme of research on the cost and demand pressures facing Welsh public services, and ways to address those pressures.

7. Conclusions

This report has looked at the cuts made by the Welsh Government so far, set out a number of potential scenarios for the amount of money available over the next 12 years, and explored the trade-offs allocating spending across different departments would entail. Whilst there is significant uncertainty about the amount the Welsh Government will have to spend in the coming decade-or-so, one thing is certain: the difficult choices will not end once budgets start growing again.

Under our baseline scenario, after further falls between now and 2017–18, subsequent growth in the Treasury's block grant to Wales would leave the Welsh Government's budget in 2025–26 16% higher than today. This may sound like a generous increase. But it takes place in the context of a growing population which means this equates to a smaller 10% increase in the amount available per person. Much or all of this increase could be taken up by spending on health and social services as rising demand from an ageing population, and cost pressures as productivity lags with wider economy, mean additional resources are required for these services. For instance, if health, social services and schools spending are protected from any further cuts, and are increased by 5%, 4.5% and 2.0% per year, respectively, after 2017–18, spending on other services – such as housing, culture and transport – would be 24% lower than today in 2025–26, and still falling. Real-terms increases in health spending of 5% per year between 2017–18 and 2025–26 would be substantial. But it would follow on from a period of substantial cuts (between 2010–11 and 2013–14) and four years of no increases (2014–15 to 2017–18), meaning the increase per year averaged over the 15 years between 2010–11 and 2025–26 would be just 2%. This is much lower than the health service has historically enjoyed.

In our most pessimistic scenario, the trade-offs between priority services such as health, social services and schools on the one hand, and other services on the other, are difficult to comprehend. Providing the increases to health, social services and schools spending set out above would require spending on other services in 2025–26 to be cut by an implausible amount.

Given the scale of the challenge, difficult choices will have to be made about what services should be prioritised, and where cut backs will have to be made. However, the Welsh Government should also be focused on ways in which it can reduce the demand and cost pressures facing public services over the coming years. This will allow its budget to go further and would help make the trade-offs when setting budgets for different services easier to manage. The challenges for the next 10 years and beyond need to be planned for now: the nascent economic upturn is not going to make those challenges go away.

Appendix A. Additional Tables on Welsh Government spending

Table A.1. The real DEL assignments for Wales since 2000-01, 2013–14 prices

Year	Total DEL
2000-01	10,684
2001-02	11,388
2002-03	12,477
2003-04	13,355
2004-05	13,886
2005-06	14,590
2006-07	15,117
2007-08	15,623
2008-09	15,918
2009-10	16,555
2010-11	16,289
2011-12	15,401
2012-13	14,935
2013-14	15,009
2014-15	14,810
2015-16	14,524

Note: Figures adjusted to account for DEL and AME definition changes between different versions of PESA; see the note on Figure 3.1 for details.

Source: PESA 2013, PESA 2010, PESA 2006 and author's calculations.

Table A.2. DEL, by department 2013-14, contemporaneous prices

Main Expenditure Group	Total departmental expenditure limit (£ millions)
Health and Social Services	6,182
Local Government	4,516
Communities and Tackling Poverty	212
Economy, Science and Transport	853
Education and Skills	1,861
Natural Resources and Food	414
Housing and Regeneration	466
Culture and Sport	140
Central Services and Administration	343
Council tax benefit ¹	222
Total	15,208

Notes: ¹ separated out from Local Government DEL to remove anomalies related to devolution of council tax.

Figures represent nominal capital + revenue expenditure including depreciation.

Source: First supplementary Welsh budget 2013-2014, can be found at

<http://wales.gov.uk/funding/budget/1stsupp1314/?lang=en>

Table A.3. DEL, by department 2012-13, contemporaneous prices

Main Expenditure Group	Total departmental expenditure limit (£ millions)
Health, Social Services and Children	6,360
Local Government and Communities	5,140
Business, Enterprise, Technology & Science	264
Education and Skills	1,925
Environment and Sustainable Development	342
Housing, Regeneration and Heritage	626
Central Services and Administration	328
Total	14,986

Note: Figures represent nominal capital + revenue expenditure including depreciation.

Source: 2012-13 second supplementary budget can be found at

<http://wales.gov.uk/funding/budget/previousbudgetindex/?lang=en>

Table A.4. DEL, by department 2011-12, contemporaneous prices

Main Expenditure Group	Total departmental expenditure limit (£ millions)
Health, Social Services and Children	6,368
Local Government and Communities	5,148
Business, Enterprise, Technology & Science	300
Education and Skills	1,863
Environment and Sustainable Development	336
Housing, Regeneration and Heritage	645
Central Services and Administration	377
Total	15,037

Note: Figures represent nominal capital + revenue expenditure including depreciation.

Source: 2011-12 second supplementary budget can be found at

<http://wales.gov.uk/funding/budget/previousbudgetindex/?lang=en>.

Table A.5. DEL, by department 2010-11, contemporaneous prices

Main Expenditure Group	Total departmental expenditure limit (£ millions)
Health and Social Services	6,443
Social Justice and Local Government	4,454
Economy and Transport	997
Children, Education, Lifelong Learning and Skills	2,071
Environment, Sustainability and Housing	871
Rural Affairs	134
Heritage	180
Public Services and Performance	60
Central Services and Administration	373
Total	15,583

Note: Figures represent nominal capital + revenue expenditure including depreciation.

Source: 2010-11 second supplementary budget can be found at

<http://wales.gov.uk/funding/budget/previousbudgetindex/?lang=en>.

Appendix B. Adjustments, budget reconciliation and projection methodology

This appendix explains in more detail the methodology underlying our quantitative analysis of the Welsh Government's spending, and the projections of the Welsh block grant and Welsh Government spending options for future years. Section B.1 explains how we translated budgets from 2010–11 to 2012–13 into the current MEG structure. Section B.2 explains how we estimated the total Welsh DEL consistently back to 2000–01. Section B.3 explains how we projected the Welsh budget to 2025–26.

B.1 Translation of previous Welsh budgets into the current MEG structure.

The structure of the Welsh budget varies between years, reflecting ministerial portfolios at the time of the budget. However, budgets since 2010–11 have been broken down as follows:

1. Total expenditure is first divided between different departments with each department collectively referred to as a Main Expenditure Group (MEG).
2. These MEGs are further subdivided into Spending Programme Areas (SPAs).
3. SPAs are themselves broken down further into units describing their different functions, referred to as 'actions'.

Between budgets, MEGs are renamed and reorganised, reflecting the changing portfolios of Welsh Government ministers. Not only are SPAs regularly transferred from one MEG to another, but different actions can be transferred between SPAs (which might be in the same or different MEGs). All of these changes have to be accounted for in order to compare budgets from different years to see how spending on different service areas (such as health) has changed over time.

To track all these transfers and name changes, both the explanatory notes that accompany the Welsh budgets and the detailed spending breakdowns within the budget documents have been used.

The following examples illustrate the manner in which this was achieved:

- The 2010–11 final supplementary budget contained a MEG called 'Health and Social Services'. By the 2011–12 supplementary budget, this MEG had been abolished, and replaced with one known called 'Health, Social Services and Children', which in addition to the functions under the former 'Health and Social Services' MEG, also included the 'Children, Young People and Families' SPA that had in 2010 been part of the 'Children, Education Lifelong Learning and Skills' MEG, when it was known as the 'Children and Young People's Strategy' SPA. Thus, in order to calculate the change in spending on 'Health, Social Services and Children' between 2010–11 and 2011–12, the 'Children and Young People's Strategy' SPA had to be first subtracted from the

‘Children, Education Lifelong Learning and Skills’ MEG and added to the ‘Health and Social Services’ MEG in 2010–11.

- The 2012–13 final supplementary budget contained a MEG called ‘Business Enterprise, Technology and Science’ (BETS). In the first supplementary budget for 2013–14, this was abolished and replaced with one named ‘Economy, Science and Transport’ (EST). This new EST MEG contains the SPAs related to transport which had belonged to the old Local Government and Communities MEG in 2012–13. In addition, it *does not include* the Rural Affairs SPA which used to be part of BETS (this went to the new Natural Resources and Food MEG) or the WEFO SPA (that went to the new Central Services and Administration MEG). Therefore, to compare spending over time the old BETS budget for 2012–13 was ‘translated’ into the EST budget for that year by adding on the transport SPAs, and subtracting the rural affairs and WEFO SPAs.

Adjustment to the Welsh DEL for the devolution of council tax benefit.

The devolution of council tax benefit to Wales from 2013–14 resulted in a transfer of £222million from UK government AME to the Welsh Government DEL, which was allocated to the local government MEG. To allow for consistent comparisons of Welsh Government spending and the amount allocated to local government over time, this figure has been subtracted from the 2013–14 local government MEG’s DEL and recorded as a separate expenditure item. For the projections (see Section B.3), spending on council tax benefit has been frozen in real terms at its 2013–14 level.

B.2 Estimating historical Welsh DEL on a consistent basis

In order to estimate the total UK government DEL and the amount given to Wales as a block grant (the ‘Welsh DEL’), three editions of PESA needed to be used: 2006, 2010, and 2013. However, over time there have been methodological changes (such as the definitions of DEL and AME) which mean that different publications can provide different figures for these DELs for the same year. Thus, in order to construct an estimate based largely on *current* definitions (but counting business rates retained by English local authorities under the business rate retention scheme as part of DEL), adjustments to figures reported in earlier versions of PESA were required, making use of years for which there are overlaps in coverage.

For instance, both the 2013 and 2010 editions contain figures covering 2008–09. To adjust the DELs for years between 2004–05 and 2007–08 that were taken from PESA 2010, the following approach was used:

1. The percentage differences between the 2008–09 DEL outturns given in PESA 2010 and PESA 2013 were calculated.
2. The DELs for each department from previous years back to 2004–05 were then adjusted using these percentages.
3. The UK total DEL was then calculated as the sum of the individual department’s DELs for each year.

For example, the total DEL allocated to the Department for Business, Innovation and Skills for the year 2008–09 reported in PESA 2013 (£18.5billion) was 7% lower than that reported in PESA 2010 (£19.8billion). Hence, in order to estimate a consistent series, the amounts reported for 2004–05 and 2007–08 in PESA 2010 were also reduced by 7%. The implicit assumption when using this technique is therefore that the proportion of the DEL that was transferred to AME (or other departments) between was a constant 7% in each of those years.

For years prior to 2004–05 (making use of PESA 2006), this method could not be used because the departmental structure in 2006 differed substantially from that in 2010 and 2013. Instead the total DEL for the UK as a whole was adjusted so that the total for 2004–05 matched the adjusted 2004–05 calculated on the basis of the 2010 and 2013 versions of PESA. This required increasing overall DEL for 2000–01 to 2003–04 by 1.2% above what was reported in PESA 2006.

The Wales DEL was reported in the same way in PESA 2006 as in PESA 2010 and so the Wales DEL figures from PESA 2006 were adjusted in the same manner as the PESA 2010 figures. The Welsh DEL figures from PESA 2010 were adjusted upwards by 1.1% and those from PESA 2006 by 0.6%.

B.3 Additional adjustments and assumptions used when projecting the Welsh block grant and Welsh Government spending to 2025–26

Chapters 4 and 5 provide detail about the main assumptions underlying the various scenarios for the Welsh block grant and the allocation of the Welsh budget between now and 2025–26. However, in addition to these assumptions, a number of adjustments have had to be made in order to utilise our projection methodology.

Projecting the total UK-wide DEL

Figures for the total UK DEL after 2017–18 were calculated (before adjustments) by subtracting central government gross debt interest, social benefits and ‘other Annually Managed Expenditure’ from the projections for TME.

Central government gross debt interest was assumed to grow after 2017–18 at the same rate as total public sector gross debt interest, forecasts of which are given (as a percentage of GDP) in the OBR’s Fiscal Sustainability report. The initial value for central government gross debt interest (the value for 2017–18) is taken from the EFO.

From 2018–19 onwards the projections used for social benefit spending are taken from the OBR’s 2013 FSR (which are given as a proportion of GDP). For earlier years the figures used are those given in the OBR’s 2012 Economic and Fiscal Outlook. These two reports both give figures for the years from 2012–13 to 2017–18, however the figures for these years given in the FSR are on average 2.3% higher. The FSR’s projections have hence been adjusted down by 2.3% for consistency.

The definitions of UK DEL vary slightly between the OBR and HM Treasury. In 2015–16 (the last year for which we have available projections for total DEL from both PESA and the EFO) the HMT DEL was 3% higher than the OBR DEL. Our calculations estimate the OBR DEL, however it is the HMT DEL (used in PESA) that is of interest for the purposes of this report. To estimate the HMT DEL for the years after 2015–16 we first project the OBR DEL and then increase this amount by 3%.

Projecting the Welsh ‘block grant’

We project the Welsh ‘block grant’ using our projections for the total UK DEL, our assumptions for how this will be allocated between Whitehall departments, and the Barnett formula. There are two major complications with this.

First, whilst in general the same comparability factors (see Box 3.1) that are listed in the 2010 Statement of Funding Policy are still in use in the Barnett formula today, adjustments have to be made to account for the movement of support for council tax (the former council tax benefit) into the Department for Communities and local government’s DEL, and the shift of around half of business rates revenue from its DEL to AME as a result of the business rate retention scheme (BRRS), which has part-localised business rates.

Approximately £3.6 billion was transferred into the DCLG’s DEL as a result of the localisation of council tax support in England. This function was also devolved from the UK to the Welsh and Scottish Governments, meaning that in future the Barnett formula will have to provide funding for this function. This leads to an increase in the comparability factor for DCLG in the case of Scotland (Wales’ comparability factor was already 100%, and therefore cannot increase). Northern Ireland operates a different system of local taxation so was not directly affected by this change.

The introduction of the BRRS is estimated to have transferred approximately £11.3 billion from DEL to AME this year, rising to £12.9 billion in 2017–18. We assume this amount then rises in line with overall national income. Again, this change in classification necessitates an adjustment to the comparability factors for the DCLG for Scotland, and in this case, Northern Ireland: because business rates carry a zero consequential for Scotland and Northern Ireland, the shift of half of these revenues from DCLG’s DEL to AME *increases* the comparability factor for the department for these two countries. Following the adjustments required to account for the localisation of support for council tax, this leaves Scotland’s DCLG comparability factor at 43% (compared to 17.3% in the 2010 Statement of Funding Policy), and Northern Ireland’s at 23.8% (compared to 17.3%). Note that the council tax adjustment increases Scotland’s comparability factor but decreases Northern Ireland’s because council tax is a function completely devolved to Scotland but not devolved at all to Northern Ireland. In order to account for the fact that the BRRS does not apply to Wales, we also applied the Barnett formula (with a full 100% consequential) to the projected change in retained business rates revenue when calculating the block grant for Wales.

The second complexity in applying the Barnett formula is the result of needing to ensure that the individual UK government DELs sum to the total DEL calculated in the first stage of the projections. This is because the allocations to Scotland, Wales and Northern Ireland depend upon the amount allocated to the other Whitehall Departments via the Barnett formula; but the amount allocated to the other departments depends upon how much of the total DEL is

left after allocations to Wales, Scotland and Northern Ireland are made. Satisfying both conditions requires iterating over the two calculations until convergence is achieved and consistent figures for all DELs are found.

Projecting the Welsh Government's budget's total DEL

For a number of reasons, the total amount allocated by the Welsh Government to its MEGs' DELs exceeds the total amount allocated to the Welsh Government by the UK Treasury via the Welsh block grant. Thus, in order to examine the trade-offs facing the Welsh Government when setting the budgets for its MEGs, we need to move from our projections for the Welsh block grant, to projections for the Welsh Government's total stated DEL. To do this, we assume that the Welsh Government's total DEL grows at the same percentage rate as the Welsh block grant under our various scenarios.

For example, the Welsh block grant is due to be reduced by 1.1% in real terms relative to the 2013–14 figure. We therefore assume a 1.1% fall in the Welsh Government's total DEL in 2014–15 too.

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