Chief Economist's Report 2019

Recent economic performance and shorter-term prospects

Brexit uncertainty continues to weigh on growth prospects for Wales and the UK as a whole; if the incoming UK government continues with a plan to leave the EU, the severity of the impact will depend on the form that Brexit takes and on the extent of the dislocation associated with the process of leaving. The prospect of leaving the EU without a trade deal remains a possibility, and even if this is averted, it is likely that a prolonged period of uncertainty while new trade arrangements are negotiated and implemented will reduce growth. Wales would be hit disproportionately by a "hard" Brexit.

Drivers of Welsh short to medium-term economic performance

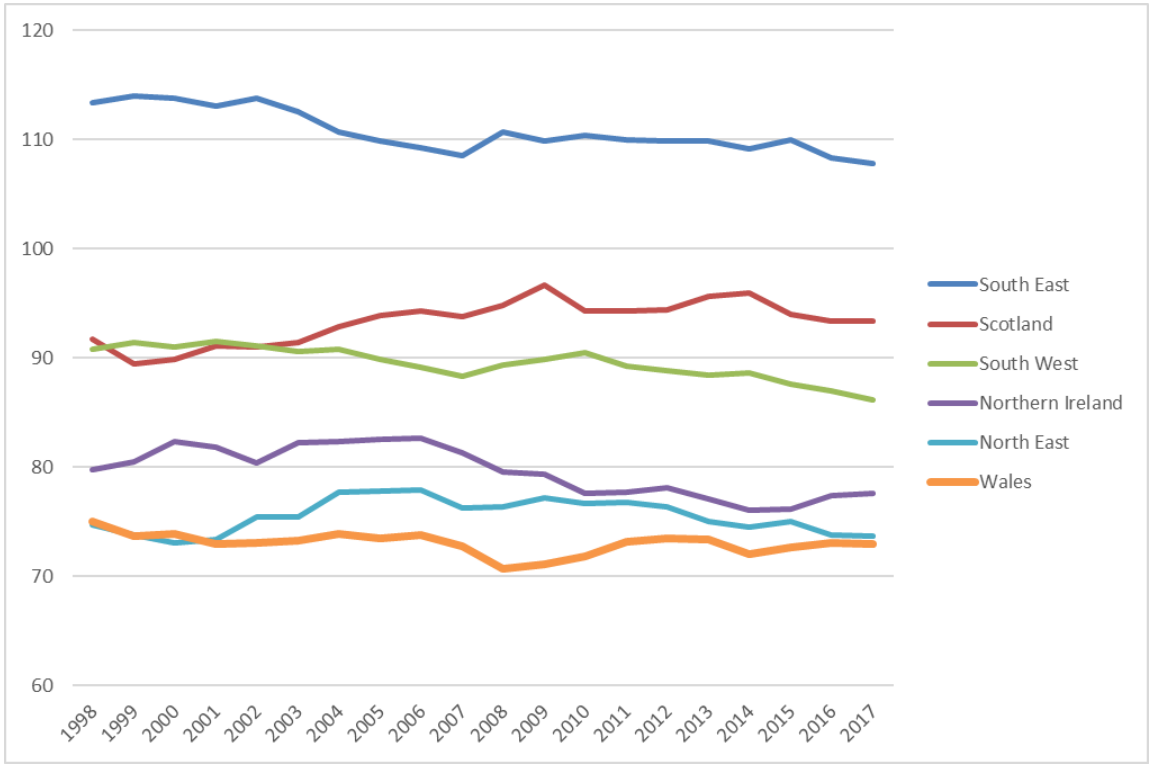
Over the short to medium term, the performance of the economy in Wales generally tracks quite closely to that of the wider UK[1], albeit with some fluctuation. This fluctuation may reflect statistical variability as well as real effects related to the speed of transmission of economic shocks across the UK.

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

GVA has a number of well-known limitations as an indicator of economic performance, and still more as a measure of well-being. For this reason, it is crucial that GVA is considered only in the context of a wider range of indicators. This is discussed further below.

[1] When monitored on a "per head" basis

Figure 1: GVA per head - Wales and selected UK countries and regions (UK=100)



Source: ONS

For Wales, as for most parts of the UK, there has been little if any trend movement relative to the UK as a whole over recent years. (The reasons for Wales's relatively weak performance in terms of *levels* of GVA per head are discussed below.)

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

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

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

The Office for National Statistics (ONS) has started releasing more timely estimates of GDP growth for Wales (and other UK countries and regions) on a quarterly basis. These are experimental statistics, subject to revision and appear volatile. The data are difficult to interpret and do not yet add to our understanding of the factors shaping Welsh economic performance.

Recent UK economic performance

Over the last year, economic growth across the UK has continued the weak path seen since the Brexit vote. In the second quarter of 2019, growth was minus 0.2%, following a first quarter increase of 0.6%, in part reflecting temporary factors including stock building in advance of the then expected Brexit date of 30 April. The first estimate of growth in the third quarter was 0.3%, but is again difficult to interpret for similar as a result of uncertainty related to Brexit. Taking the whole period since the referendum, the UK has grown more slowly than other developed economies and well below the long run trend of just over 2 per cent per year.

Figure two compares quarterly growth for the UK, the EU as a whole, the USA and the G7 up to the second quarter of 2019. The UK has grown more slowly than the EU in almost every quarter since the referendum. Compared with the rest of the EU, the UK's growth underperformance had reached around two per cent by mid-2019. This amounts to around £400 per head in Wales per year.

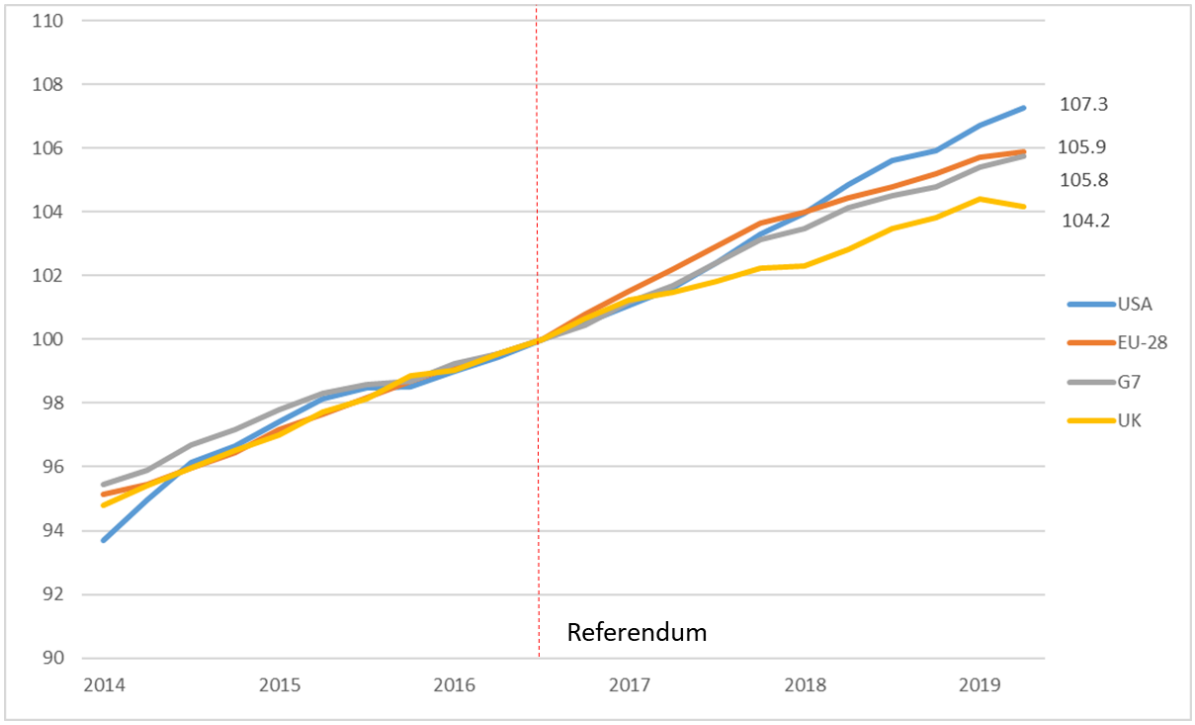
Comparison with both the USA and the G7 confirms this story of growth underperformance for the UK since the referendum.

Attribution of (much of) the underperformance to the Brexit vote is made plausible by the causal channels identified by the Bank of England as key sources of slower growth: the erosion of people's real incomes as a result of the depreciation of sterling following the vote (in anticipation of longer-run negative economic effects) and the impact of Brexit related uncertainty on business investment decisions[2].

A short to medium-term impact of around 2% per cent of GDP is consistent with many mainstream assessments made prior to the referendum – in magnitude if not in timing (where many expected a more immediate "hit").

[2] The Bank of England's analysis of the impact of Brexit on firms: https://www.bankofengland.co.uk/working-paper/2019/the-impact-of-brexit-on-uk-firms

Figure 2: GDP growth – UK in context (Q3 2016 = 100)



Source: OECD

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

Shorter-term economic prospects

Prospects for the next few years depend crucially on the choices of an incoming UK government on its approach to Brexit including, in particular, on the form of any final Brexit trade deal.

A “cliff edge” break at the end of the agreed transition period, would be expected to result in a very high level of disruption over the short term.

Even if an exit without a trade deal is averted, it is likely that a prolonged period of uncertainty while new trade arrangements are negotiated and implemented will reduce growth.

There is a strong consensus among independent mainstream economists that the “medium term” (ten to fifteen year) impact on the UK economy of any trade deal would be directly proportional to the degree of access retained to the EU single

market, with estimates ranging up to 10% of annual income under the “harder” versions of Brexit.

It should be noted that these are estimates of the *difference* that Brexit might make to economic outcomes – they are not themselves forecasts of economic outcomes. Forecasting actual outcomes would in turn require the forecasting of a wide range of other determinants, for example global economic conditions. Such forecasting is extremely challenging, indeed arguably impossible, and therefore contrasts with the assessment of the likely impact of changes to international trading arrangements, where there is a wider and more securely established body of evidence.

The preferred approach of the outgoing UK government was for a Free Trade Agreement with the EU, with the UK diverging from single market rules and not participating in a Customs Union.

Analysis carried out both for the UK government and by independent experts suggests that such an outcome would have a negative impact on the UK economy that is towards the upper end of the potential range of effects. Analysis has also indicated that the benefits of new trade deals (should it prove possible to negotiate them) could offset only a very small part of these costs.

The actual outturn for the UK economy will of course also depend on the wider global context, for example developments in the current trade dispute between the USA and China and other developments affecting our main trading partners, particularly in the Eurozone.

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

However, in the event of a severe downturn following a decision to leave without a trade deal, it appears likely that economy-wide effects from retrenchment by consumers and business would be larger than the effects from the impact of new barriers on particular industries. Furthermore, over the medium term, the extent of the structural change that would be expected even in the absence of Brexit means that the exposure of current businesses may be a poor guide to the eventual sectoral or spatial incidence of effects.

Longer-term economic prospects: UK context

As noted in last year’s report, slow productivity growth over the last decade has resulted in very little growth in people’s real wages and incomes and contributed to the challenges faced in funding public services. The reasons for

this trend, which is unprecedented in modern economic history – and which has affected the UK particularly badly – are not completely understood. If the trend continues, it may result in profound social and political challenges.

The economic drivers of living standards

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

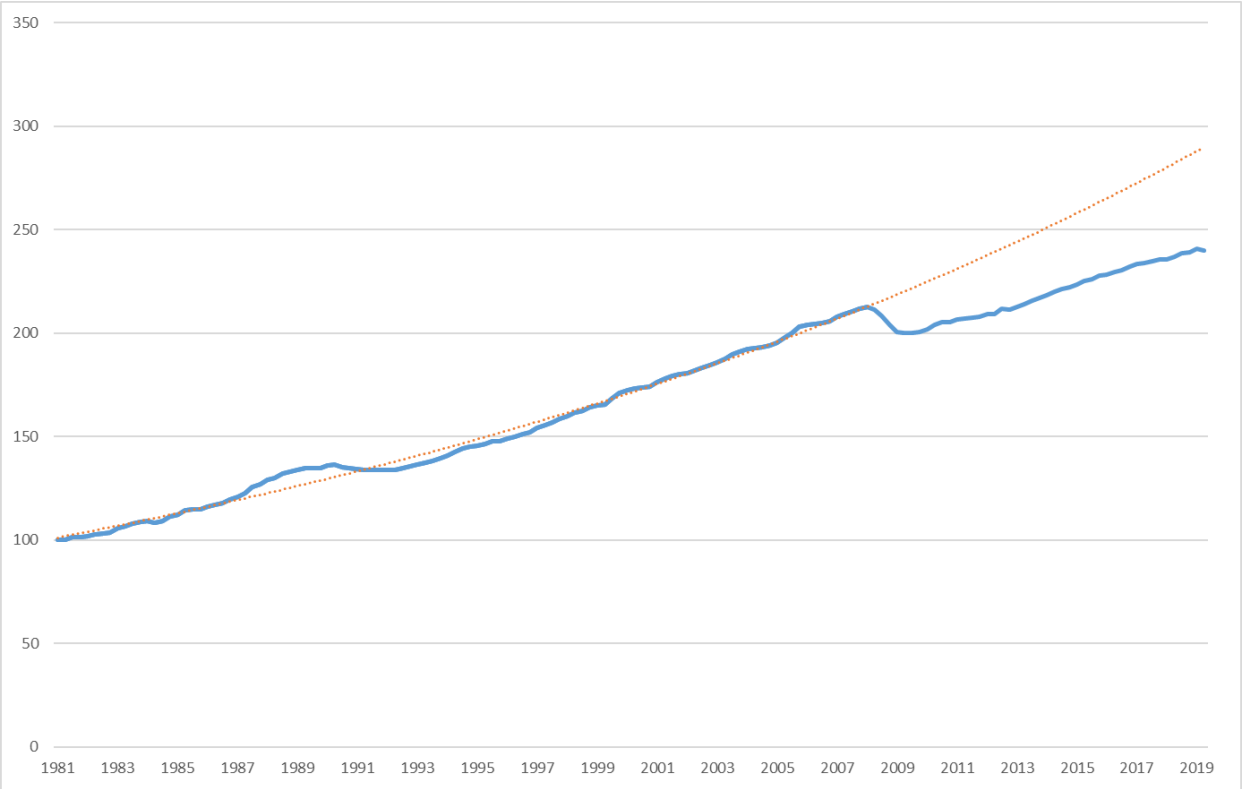
In turn, long-term economic growth depends on improvements in productivity – the efficiency with which outputs are produced from inputs. Productivity improvements derive from innovation in the broad sense – from new or better ways of producing existing goods and services and from the production of new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

The UK growth slowdown

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

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

Figure 3: UK real GDP, actual and pre-recession trend (1981=100)



Source: ONS, Welsh Government

The prolonged slowdown in growth is unprecedented in modern economic history – annual productivity growth has averaged around 2% per year over at least the last century and probably since the industrial revolution[3].

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

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

[3] Measurement issues make a definitive assessment problematic.

The reasons for the slowdown in productivity growth, and particularly the explanation for the UK's particularly poor performance since the recession, remain unclear and open to dispute. In part, the UK's unusually poor performance may be the counterpart to its strong labour market performance, with high employment reflecting a flexible labour market and consequently reduced pressure on firms to invest and innovate. In addition, as the Bank of England has noted, Brexit-related uncertainty has reduced business investment below what would otherwise have been expected, and this will have impacted on productivity growth.

The UK government's policy of fiscal consolidation ("austerity") is also likely to have been a contributory factor, with some arguing that that the policy was excessively restrictive and/or mistimed.

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

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

Prospects for a recovery in productivity growth

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

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

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

In addition, of course, automation in the past has *not* led to a reduction in job numbers, as increased demand (driven in part by higher incomes) has led to the creation of new jobs which have more than offset the jobs that have been lost. However, this may not be true in the future and the more general implications of new

technologies merit much careful study, for example as undertaken as part of the Welsh Government's digital innovation review[4].

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

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

Welsh economic performance over the longer term

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

However, over the period between 2010 and 2017 (the most recent available year), the gap in GVA per head between Wales and the UK has narrowed – something achieved by only one other UK country or region (the West Midlands)[5].

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

Welsh economic performance since devolution

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

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

Compared to many other countries, the UK is more spatially unbalanced, with London and greater South East dominant to a greater extent than leading regions in

[4] https://gov.wales/review-digital-innovation-final-report
[5] London however has continued to pull further ahead over this period.

many other countries. This reflects a complex mix of historical and geographical factors, but UK Government policies, for example on infrastructure investment and on the structure of taxation and the distribution of spending, are also likely to have important effects.

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

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

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

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

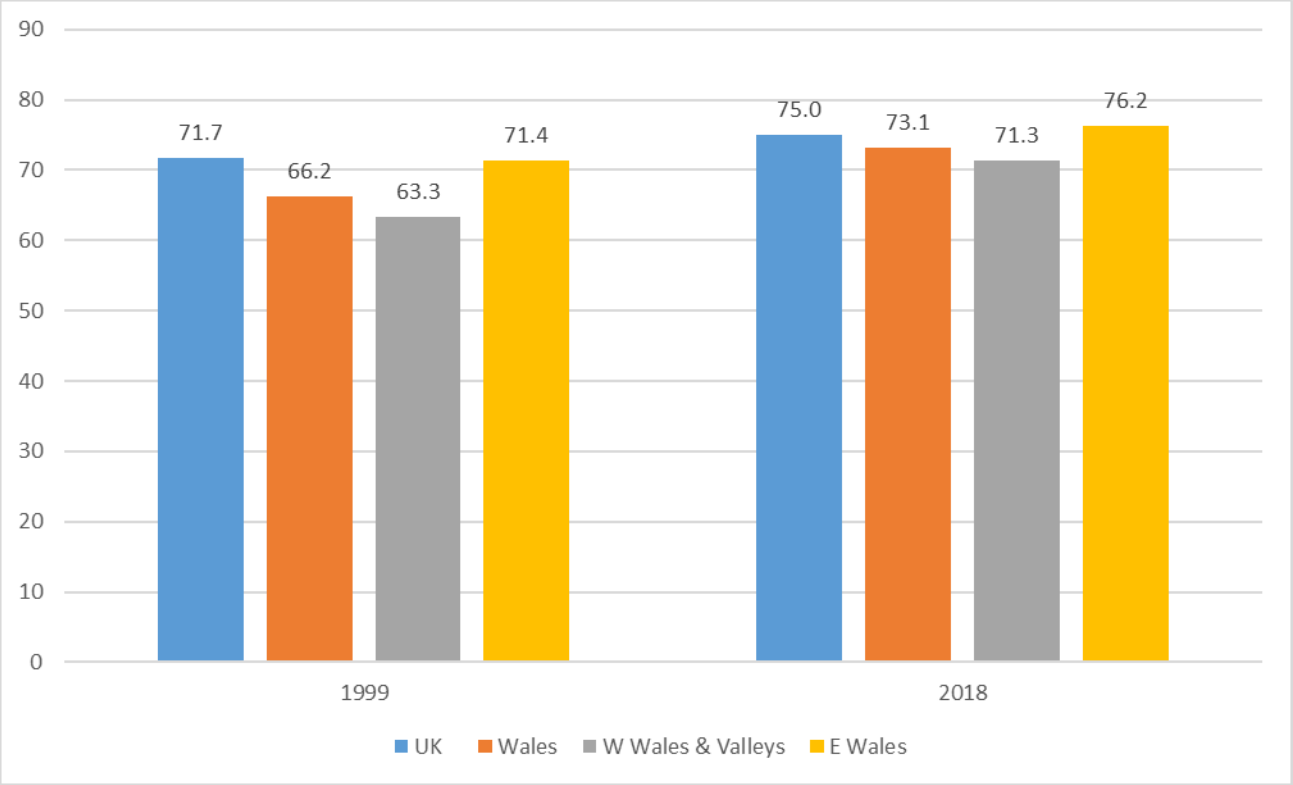
https://gov.wales/welsh-economy-numbers-dashboard

Over the period since devolution, Wales has demonstrated a relatively strong performance on employment, unemployment and inactivity, but less so on productivity and pay (which are closely related). This has resulted in a situation where Wales is one of the lowest performing 12 UK countries and regions on pay and on productivity[6].

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

[6] In the latest, data Wales ranks bottom on both pay and productivity. However, in respect of both productivity and hourly pay, it should be noted that the figures for Wales are very similar to those for the East Midlands and Northern Ireland, and the data is somewhat volatile on an annual basis.

Figure 4: Employment rate, Wales and UK 1999 and 2018



Source: Welsh Government
Note: Data for year ending December 2018

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

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

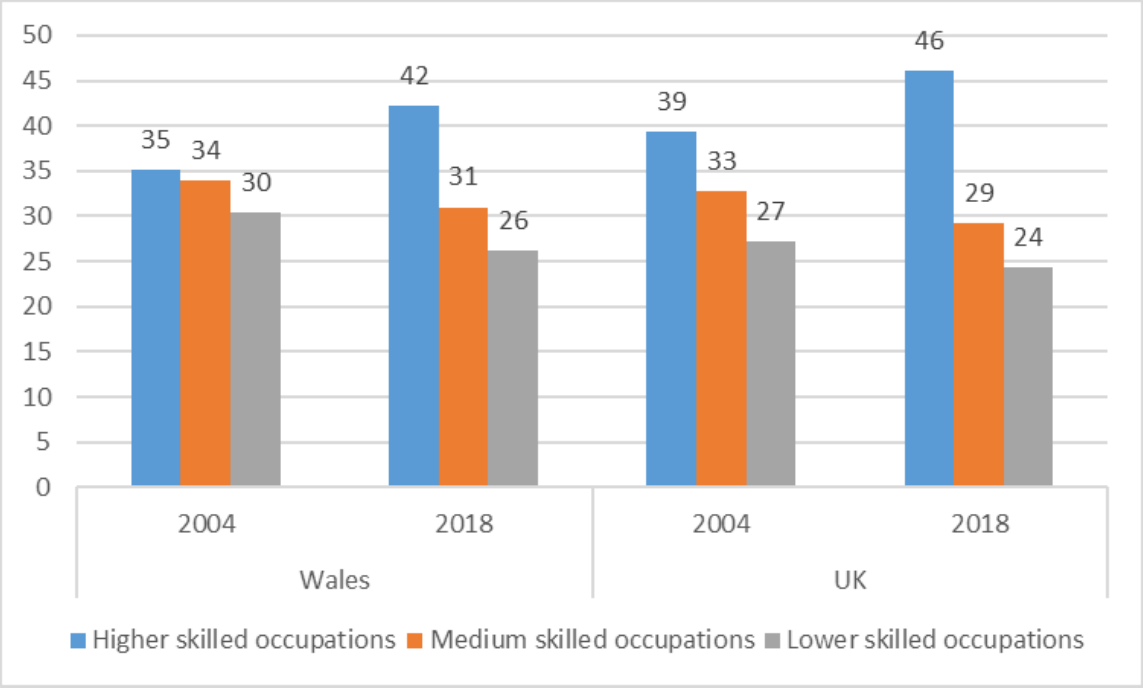
These labour market improvements have been driven by a marked improvement in the skills profile of the population in Wales since devolution. The proportion of working-age people with no qualifications has more than halved since 1999, whilst over the same period, the proportion educated to NVQ4 and above has increased from around one-in-five people to more than one-in-three.

The change in composition of employment in Wales has reflected this improved skill profile, with the largest growth being in the most highly skilled occupations, although the share of such occupations remains lower than that for the UK as a whole – see figure 5.

Skill levels are of course only one indicator of the quality of jobs. Other indicators, for example, those recommended by the Fair Work Commission[7], are also relevant. However, the lack of time series for these other indicators does not permit the assessment of changes in these aspects of work quality over the long run.

Data on the proportion of people in employment who are on permanent contracts (or on temporary contracts and not seeking permanent employment) and who earn more than two thirds of the UK median wage is available from 2013. It shows that whilst the proportion in Wales is lower in Wales than for the UK as a whole, there has been a gradual increase in the proportion since 2013 for both Wales and the UK.

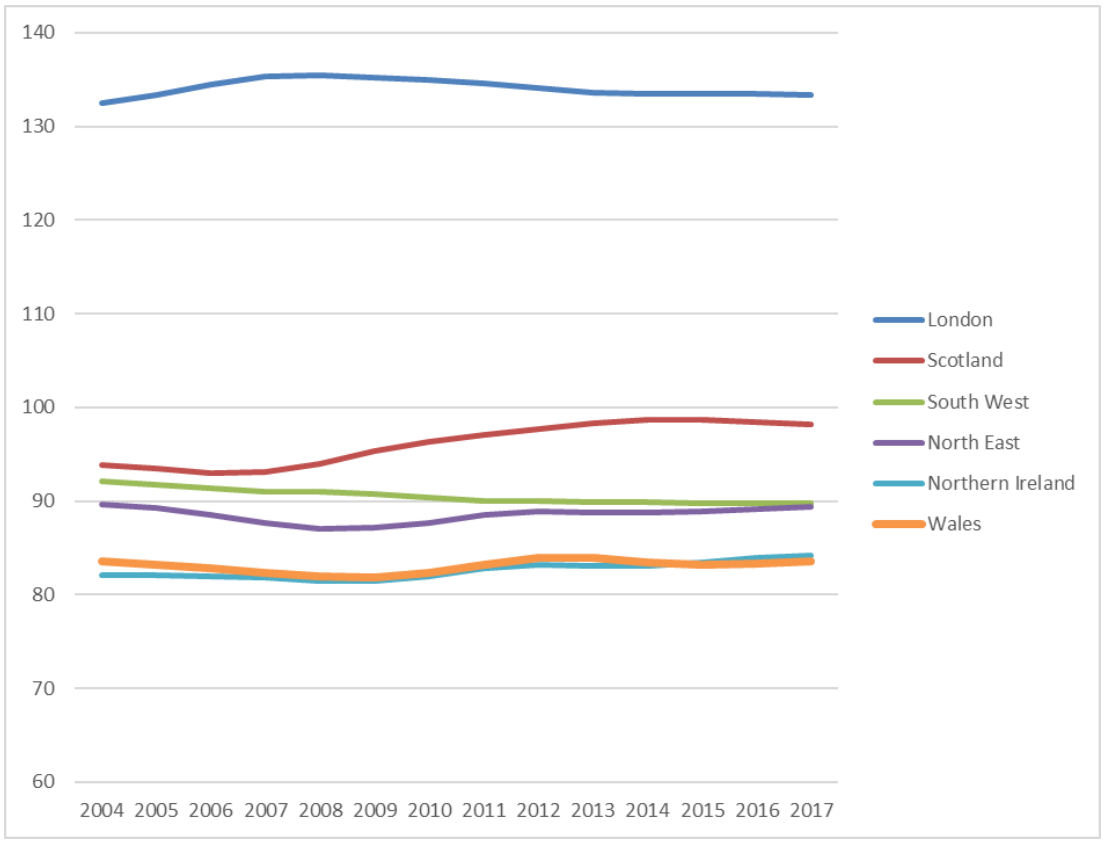
Figure 5: Employment by occupation (%)



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

[7] https://gov.wales/sites/default/files/publications/2019-05/fair-work-wales.pdf

Figure 6: Labour productivity (GVA per hour worked), Wales and selected UK countries and regions (UK=100)



Source: ONS

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

After a period of decline followed by recovery, Welsh relative productivity has stabilised since around 2012. The reasons for this trend are not fully understood but it may be that improvements in the labour market, concentrated in the earlier part of the period, were associated with the entry into employment of people (particularly women) with lower than average skill levels who would previously have been inactive.

Taking the period between 2010 and 2017 (the most recent available year), the gap in GVA per head between Wales and the UK has narrowed – something achieved by only one other UK country or region (the West Midlands)[8].

Prospects for Welsh relative economic performance over the long term

[8] London however has continued to pull further ahead over this period.

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

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

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

Analysis by the ONS and the Welsh Government indicates that relative productivity differences across the UK are *not* strongly influenced by variations in industry mix – productivity differences within industries are much more important[9].

Research does suggests a strong link between productivity across the UK and qualification levels, and, having allowed for this, between productivity in service industries and "economic mass" – that is, with having a smaller share of the population working in sparsely populated areas and a larger share working in more densely-populated centres of economic activity.

The association of productivity (and pay) with economic mass in service industries is driven by a range of factors. These include the greater scope to operate at scale and the better matching of people with jobs that can take place in large centres - facilitated by shorter travel times.

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

While productivity *levels* are related to economic mass, there is no simple relationship between economic mass and *growth*. Figure seven shows the growth in total GVA and in GVA per head for Welsh local authority areas over the period since just before devolution[10]. These figures are not adjusted for inflation, so illustrate the *relative* performance of sub-regions, rather than real increases in GVA[11].

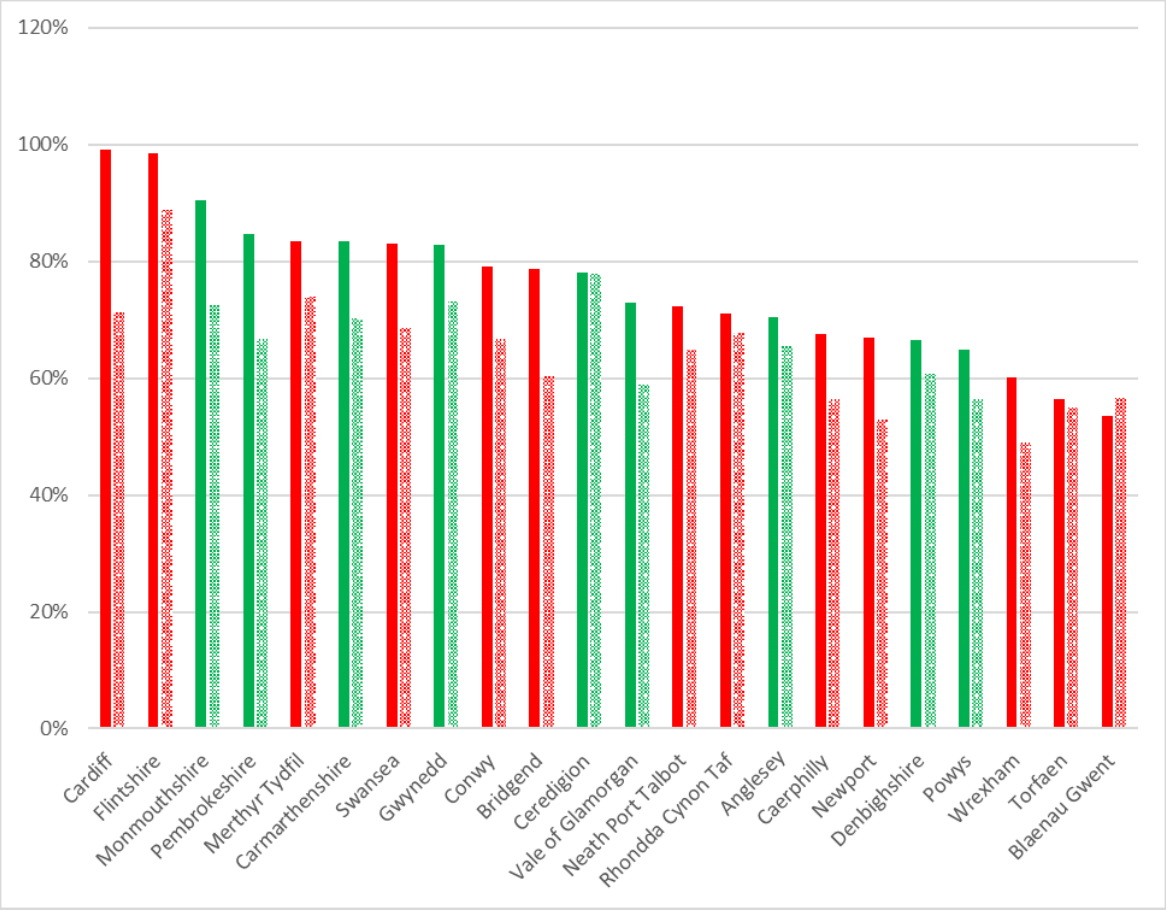
[9] ONS research on the role of industry mix in explaining spatial variations in productivity, and on other relevant factors, is here: https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/labourproductivity/articles/understandingspatiallabourproductivityintheuk/2019-05-03

[10] Averages are used to reduce volatility in the data, which should in any case be seen as illustrative of broad patterns rather than definitive of the position in individual sub-regions.

[11] It should be stressed that Figure 7 shows *changes* in GVA. *Levels* of GVA, particularly for sub-regions, are strongly affected by commuting patterns and should be interpreted with great care.

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

Figure 7: Growth in GVA and GVA per head, 1996-98 to 2015-17
(GVA is shown solid colour, GVA per head patterned)



Source: Welsh Government

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

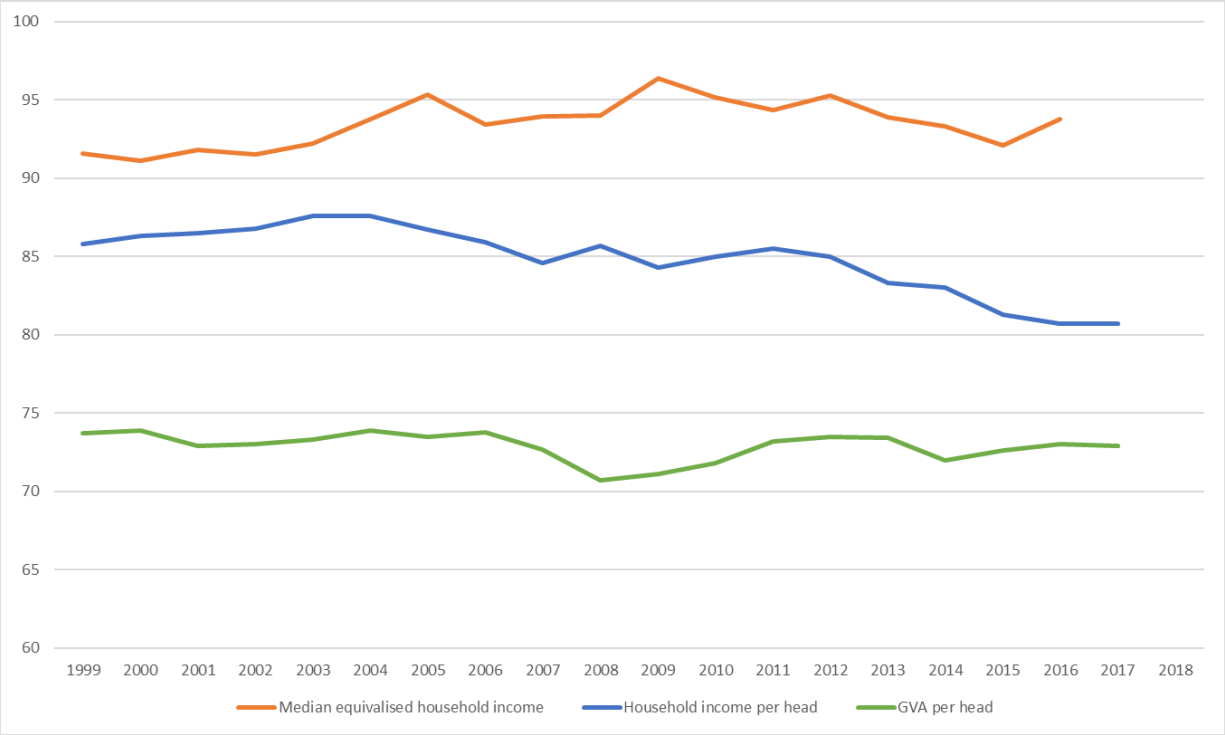
It follows from this that, while Wales' relative performance in terms of *levels* of productivity and pay is disadvantaged by its relative sparsity and lack of economic mass, these factors do not imply that prospective *growth* in productivity and pay need be lower in Wales than elsewhere for this reason.

Previous years' reports have contained further information about geographic differences in economic performance within Wales. Geographical factors are important but typically have their effects over the long term and often indirectly. As the 2017 report showed, people with similar characteristics – most importantly qualifications, but also health status and other factors – have broadly similar chances of being in employment wherever they live in Wales, or indeed across the UK.

Living standards in Wales reflect not just income received from economic activity but also transfers under the UK tax and benefits system and public services - in Wales, provided mainly by the Welsh Government.

Figure eight shows two different measures of the income available for Welsh households to spend after paying taxes and receiving benefits expressed relative to the UK as a whole. GVA per head is included for comparative purposes.

Figure 8: Indicators of average income in Wales, UK =100



Source: Welsh Government

"Household income per head" is the standard ONS measure of Gross Disposable Household Income (GDHI) expressed per head of total population. "Median Equivalised Household Income" is a measure derived from the Family Resources Survey. It takes account of differences in household composition and reflects the experience of a typical household in the middle of the income distribution. It is also adjusted to take account of differences in housing costs.

As the sample size for Wales in the Family Resources Survey is relatively small it is necessary to express the figures as a moving average, and hence the most recent data shown is for 2016.

It can be seen from the chart that on both measures of income, Wales is closer to the UK average than it is on GVA per head. This is similar to most English regions outside London, and reflects transfers under the UK tax and benefits system. The gap is much smaller (and the recent trend more favourable) for Median Equivalised Household Income, where the most figure for Wales is almost 95% of the UK

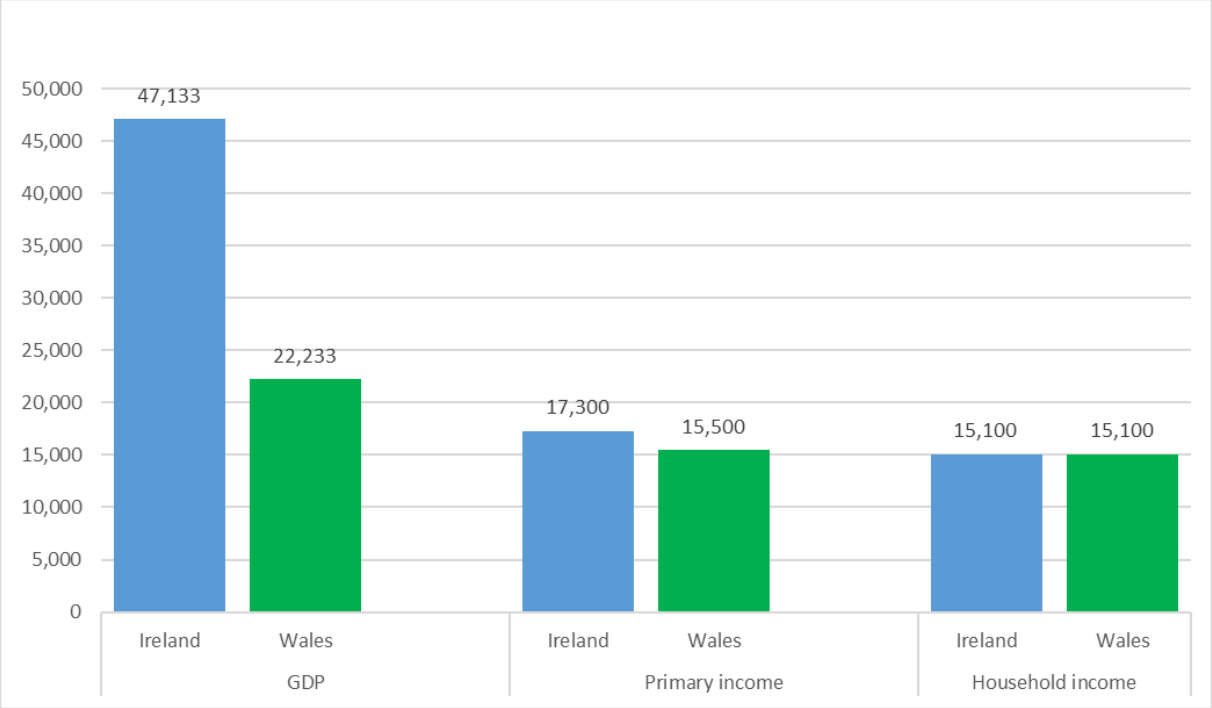
average. This reflects the fact that Wales has fewer households with very high incomes, and means that the living standards of more typical households in Wales are much closer to the UK average than is sometimes appreciated.

Data on average weekly household expenditure on goods and services show a similar pattern.

Average total expenditure in Wales was £470.40 in the financial year ending 2016 to financial year ending 2018; 85% of the UK average of £551.90[12].

The impact of the tax and benefits system is also important in making international comparisons. Figure nine shows a high level comparison of economic indicators for Wales and Ireland.

Figure 9: Economic output and income, Ireland and Wales (at purchasing power standard), 2014-16



Source: Eurostat

Figure eight shows data on GDP per head and on primary income and household income for Ireland and Wales. GDP per head is conceptually similar to GVA – it differs only in the treatment of certain taxes. In broad terms, "primary income" reflects the income from economic activity that is received by residents of an area. Household Income is the measure of gross disposable household income previously described.

[12] Office for National Statistics (2019), Detailed household expenditure by countries and regions. https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/expenditure/datasets/detailedhouseholdexpenditurebycountriesandregionsuktablea35

Data has been average for three years to remove volatility and it is expressed at "purchasing power standard" to adjust for differences in price levels between Ireland and the UK.

It can be seen that after adjusting for incomes received by non-residents (the main reason for primary income being lower than GDP) and for transfers under respective tax and benefits systems, average household incomes in Wales and Ireland are very similar. And this is before taking account of difference in the value of public services provided in kind[13].

UK fiscal context

While the recent one-year spending review for 2020-21 announced some increases in day-to-day spending, analysis by the Office for Budget Responsibility (OBR) indicates that, following an unprecedented decade of real reductions in spending on public services, future fiscal prospects depend crucially on the performance of the wider economy. As noted above, the UK economy has grown only weakly since the recession of 2007, with a particularly lacklustre performance since the EU referendum. Decisions to be made by the incoming UK government about Brexit and on the form it may take will be important influences on future economic performance.

The OBR's longer-term fiscal projections indicate the UK's public finances are fiscally unsustainable, in the sense that meeting their central projections for the demand for public services without tax increases would result in ever-increasing public debt. However, decisions by the incoming UK government about levels of taxation and borrowing will determine the resources available to fund public services over the shorter term.

<u>UK's short-term fiscal prospects</u>

The UK fiscal context is, and will remain, critically important for the public finances in Wales, as Wales receives a large proportion of its public funding in the form of a block grant from the UK government. Even after tax devolution, around 80% of the Welsh Government's Budget will be sourced from the block grant.

The UK has been through a period of unprecedented fiscal retrenchment. In part, this reflects the legacy of the recession, and in particular the failure of the economy

[13] The need to fund public services is the reason for household income (which is measured taxes on income are deducted) being below primary income.

to resume historic rates of growth as described above[14]. It also reflects the choices on spending and taxation made by recent UK governments.

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

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

As the previous UK government cancelled the Budget planned for November, the most recent economic and fiscal forecasts provided by the OBR were released in the spring. It is likely that, with the UK's lackluster growth performance, both economic and fiscal prospects have deteriorated further since then.

The chair of the OBR has observed that it already looks as though the fiscal rules adopted by the previous government would have been breached in 2020-21.

Short run fiscal prospects will be heavily influenced by Brexit, with - depending on the choices make by the incoming UK government - the potential for a further worsening of the public finances. The OBR has estimated that even on relatively benign assumptions, leaving the EU without a trade deal could result in an increase in borrowing, reduction in spending or increase in taxes totalling around £30 billion a year.

The extent to which such fiscal effects would be reflected in changes in spending, and how far the UK government would seek to offset any economic contraction through fiscal means, would be fundamental policy choices with potentially dramatic consequences for the Welsh public finances.

The scope for the UK government to undertake an expansionary fiscal policy will be constrained by the fiscal rules adopted by the new administration which are unknown at the time of writing.

<u>UK's longer-term fiscal prospects</u>

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

Last year, the OBR reviewed the UK's long-run fiscal prospects in its *Fiscal Sustainability Report*[15], in which it projects UK public spending and tax revenues over the period to the 2060s. Spending is projected on the basis of expected demand and is, in this sense, unconstrained by tax revenues, which are projected broadly on the basis of maintaining their historic average share of national income.

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

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

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

In respect of the former, this would imply that public spending would be constrained below the level needed to meet demand pressures. In respect of the latter, it should be noted that tax revenues, as a share of national income, are currently broadly in line with the historic average. The OBR's forecasts indicated that current receipts (mainly tax revenues) were expected to peak at 36.8% of GDP in 2020-21 – this would be the highest level since 1986-87[16]. These figures will of course need to be reviewed in the light of the incoming UK government's fiscal plans.

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

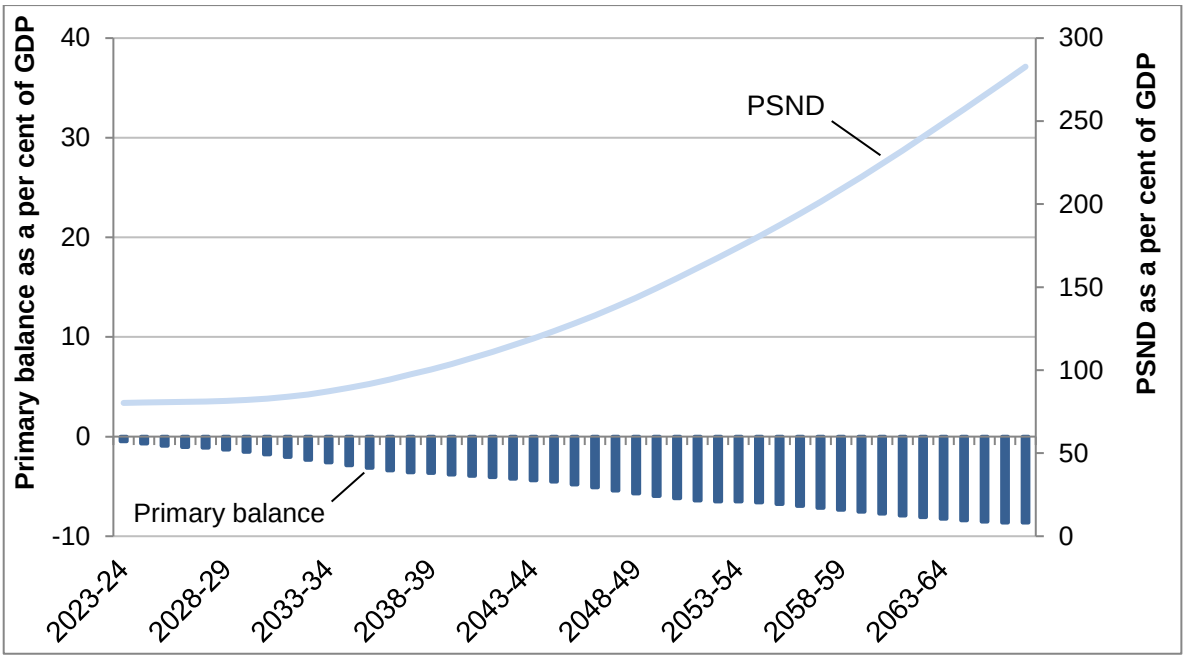
Recent demographic statistics from the ONS suggests the historic increase in life expectancy across the UK may have stalled in recent years. A similar slowdown has been seen in many other developed countries, although to a lesser degree. It is too soon to determine whether this slowdown represents a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

---

[15] https://obr.uk/report/fiscal-sustainability-report/

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

Figure 10: Baseline projections of the primary balance and PSND



Source: OBR

Welsh fiscal prospects

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

The position over the medium term – to 2022-23 – will therefore depend on the approach of the incoming UK government to Brexit, and the fiscal choices it makes in the next multi-year spending review.

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

Welsh fiscal context

In common with all parts of the UK outside London, the South East and the East of England[17], public spending in Wales is higher than tax revenue – in other words, Wales has a negative fiscal balance. This is unsurprising in a fiscal union in which

17 https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/articles/countryandregionalpublicsectorfinances/financialyearending2018

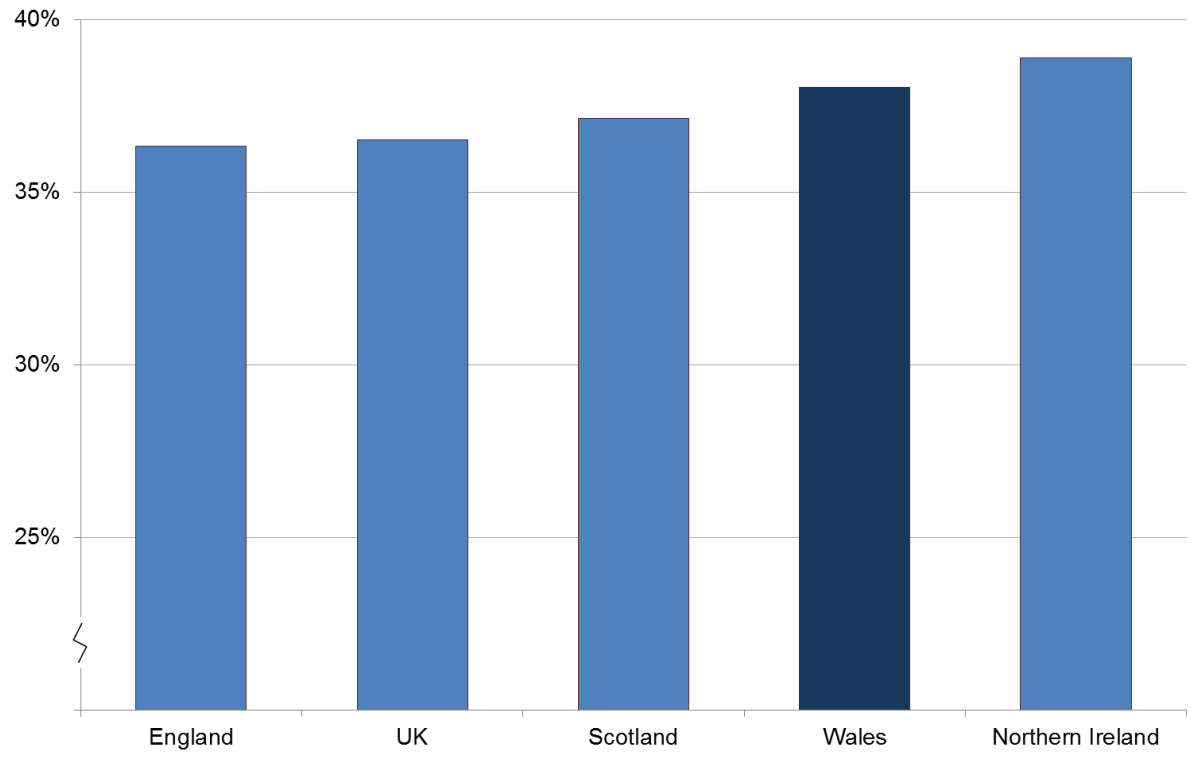
some taxes are progressive and there is some redistribution in favour of people with lower levels of income.

Of course, the UK as a whole has a negative fiscal balance and borrows to address the revenue shortfall. However, when expressed as a share of GVA, the negative fiscal balance for Wales is around 20 per cent higher than the equivalent figure for the UK as a whole. This is equivalent to around £12 billion or public spending per head in Wales of about £4,000.

In the most recent year for which data are available – 2017-18 – ONS figures shows that total receipts (overwhelmingly taxes) derived from Wales were around £27bn. Total public expenditure undertaken either in Wales or on behalf of Welsh citizens exceeded this by nearly £14bn.

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

Figure 11: Tax revenues as a percentage of GDP in 2017-18



Source: ONS and Welsh Government

Out of total public expenditure in Wales in 2017-18, nearly 90% was “identifiable” – that is, directly benefiting the residents or enterprises in Wales. Around 10% was non-identifiable – that is, spent on behalf of the UK as a whole, such as interest payments on public debt, international aid and military spending.

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

Welsh medium-term fiscal prospects – 2020-21 to 2024-25

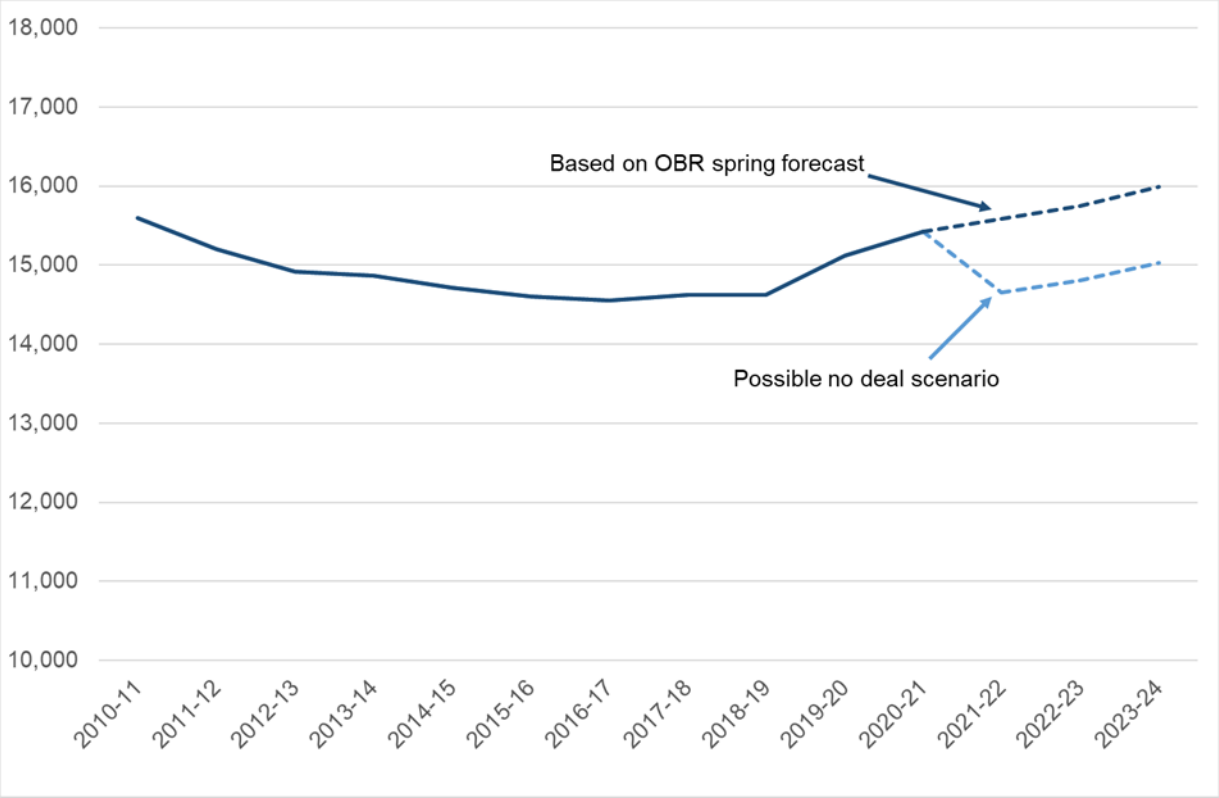
In September 2019, the UK Government published a one-year spending review covering the year 2020-21. Beyond that, much will depend on the approach of the incoming UK government to Brexit and its wider economic and fiscal policies.

At the time of writing these policies have not been determined. Figure twelve therefore sets out two, **purely illustrative,** scenarios for resource spending.

Under the "OBR spring forecast" scenario it is assumed that spending evolves in line with the projection in the spring forecast, but adjusted (upwards) to reflect the one year spending review.

Under the "no trade deal" scenario it simply assumed that spending is reduced in line with the contraction of GDP assumed under the Bank of England's worst case assessment for leaving the EU without a deal. Clearly, the UK government could choose to respond differently in that eventuality.

Figure 12: Medium-term projection for Welsh Government resource budget in real terms (£m, 2018-19 prices)



Source: Welsh Government

Welsh longer-term fiscal prospects – 2024-25 onwards

The longer-term projections use the medium-term scenario based on the OBR spring forecast as set out above as a starting point. Three scenarios are then considered for the period to 2030-31 (see figure thirteen).

Scenario one: OBR “demand-based” spending projections

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

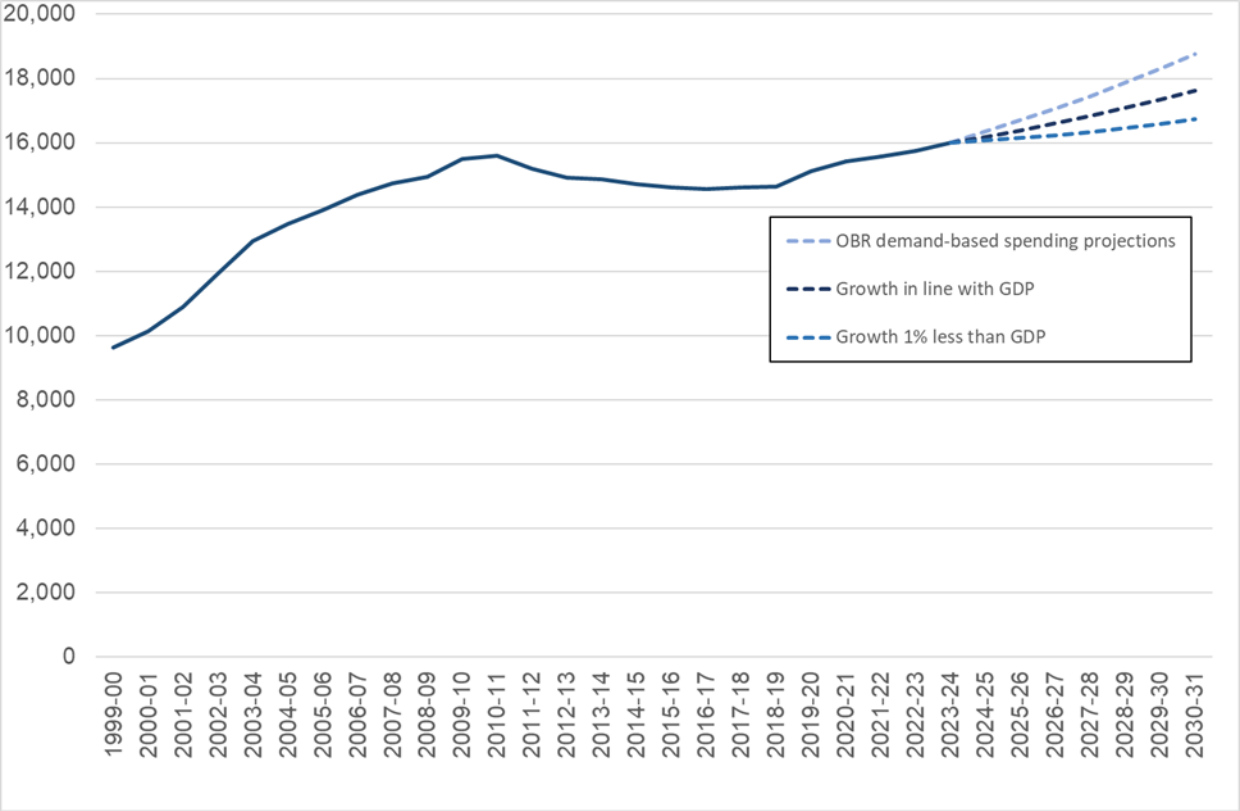
Scenario two: Growth in line with GDP

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

Scenario three: Growth one percentage point less than GDP

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

Figure 13: Long-term projections for Welsh Government day to day spending (resource budget) in real terms, under three scenarios (£m, £2018-19 prices)



Source: Welsh Government

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

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

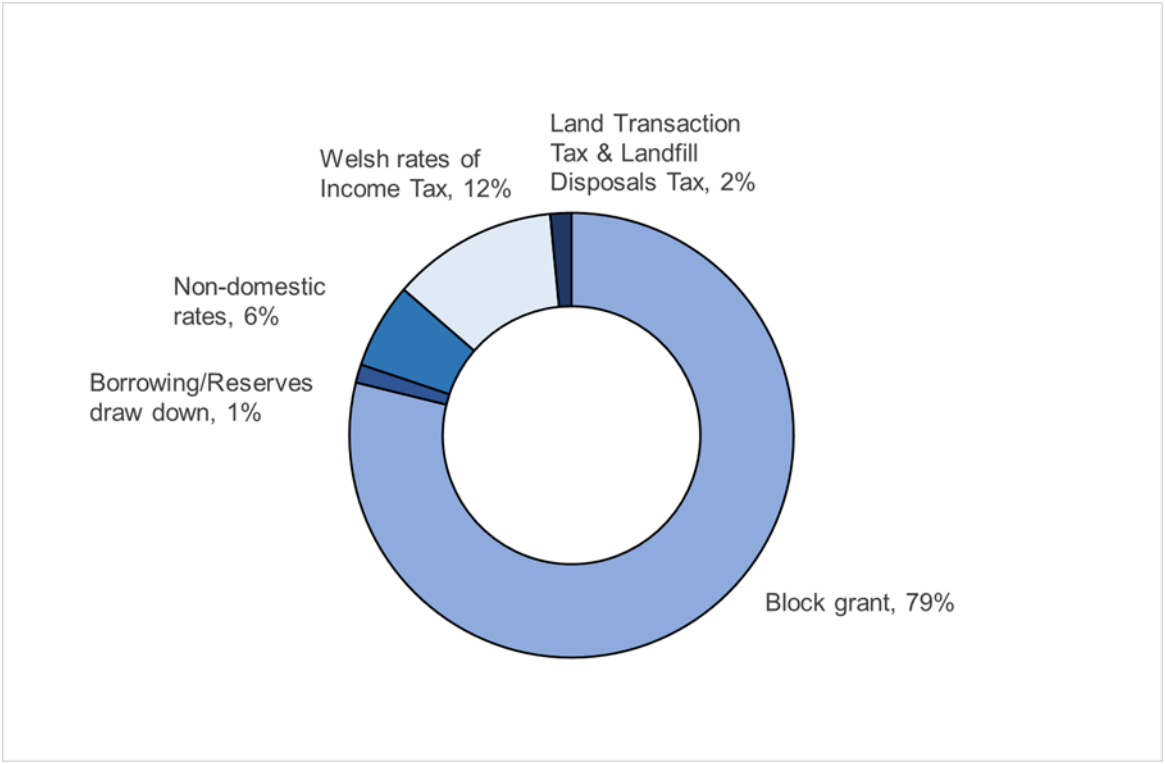
The lower scenario, in which the UK Government reduces public sector debt, would see the Welsh Government resource budget growing at a subdued rate by historical standards. By the end of the next decade it would be less than 10% higher than 20 years earlier.

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

Over the recent past there have been a number of announcements by the previous UK Government and by opposition parties about proposed increases in public spending in specific policy areas. Until there is a UK budget and full three year spending review (possibly next spring), the practical implications of these announcements for public spending are impossible to assess.

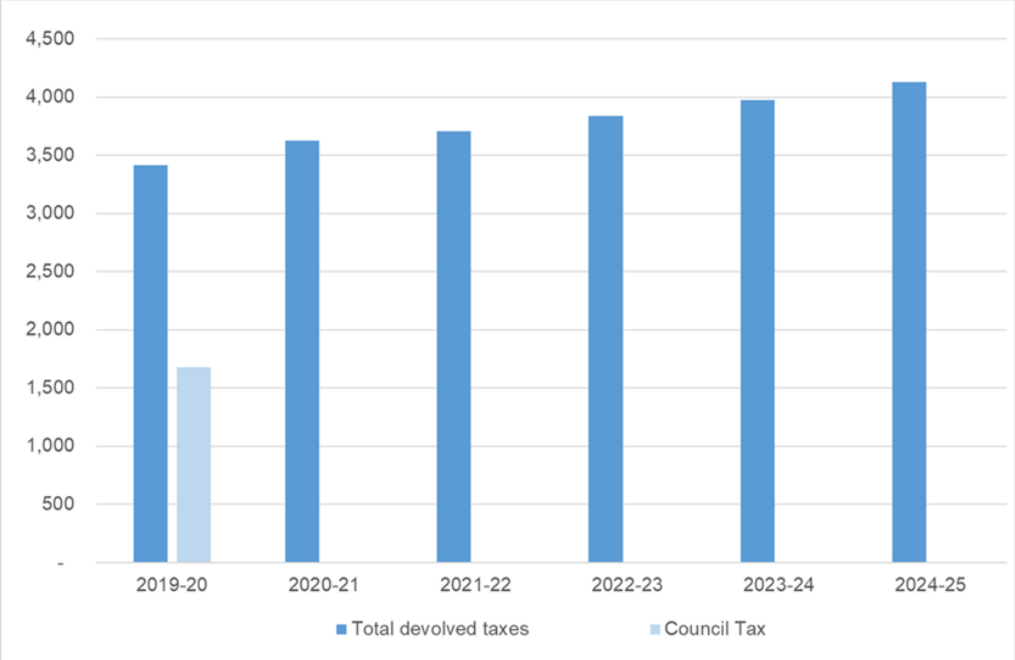
As a result of tax devolution, only around 80% of Welsh Government funding is now derived from the block grant (Figure 14). More funding from tax revenues creates additional uncertainty and links funding to some UK Government taxes.

Figure 14: Financing of Welsh Government draft Budget 2020-21



The forecast trend in total devolved tax revenues is shown in figure fifteen. Revenue raised from Council Tax is also shown for comparison; council tax revenues are not forecast beyond the current year as they are subject to local decisions.

Figure 15: Forecast devolved tax revenues, £m



"Demand" for public services in Wales

The OBR *Fiscal Sustainability Report* published in 2018 systematically explores longer-run demand pressures on public spending across the UK resulting from *changes* in the factors that drive demand and in the factors that increase costs.

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

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

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

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

One consequence of the fact that demographic change is common to Wales and the UK as a whole is that, while Wales currently has a higher share of older people in its

population, the projected *growth* in the number of older people in Wales is quite similar to that across the UK as a whole – indeed, Welsh growth is somewhat lower over the long term, where the projections are particularly uncertain (see figure sixteen).

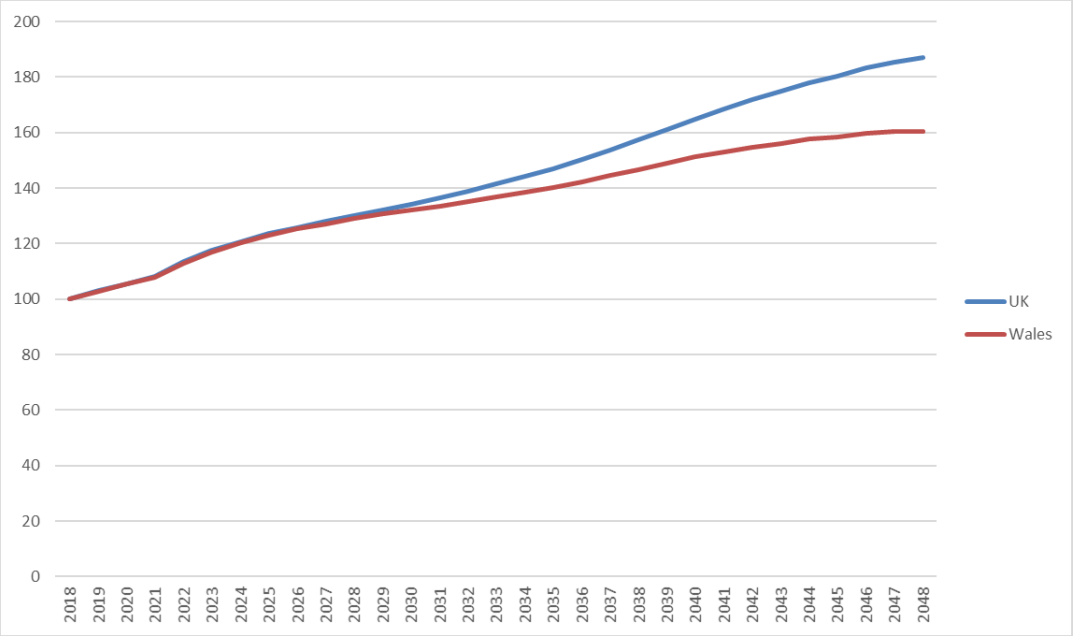
So, other things equal, the *change* in demand should also be similar in Wales and the UK as whole. It follows that, in so far as increased pressures are funded in England, Wales will receive its population-based share through the block grant.

However, even if the change in the share of older people in the population is similar, having a high share may result in additional cost pressures if the relative costs of meeting the needs of this sector of the population rises, as seems likely. Indeed, the OBR notes that the rising costs of medical treatment is probably the largest long run fiscal risk.

In addition, the UK and Welsh governments may well have differing views about the extent to which pressures should be funded.

Wales may also face greater pressures resulting from the fact that it has a higher share of the population receiving low incomes than the UK as a whole, with a higher incidence of relative poverty amongst working age adults and pensioners. As reductions in welfare spending imposed by the UK government take effect, this may be expected to increase the demands placed on devolved public services by people who experience additional disadvantage.

Figure 16: Over-75 population growth (compared to 2018)



Source: ONS 2018-based principal projections

UK fiscal risks

Every two years the OBR publishes a review of the risks facing the UK's public finances over the medium and longer terms in its Fiscal Risks Report. This report considers in greater depth the risks and uncertainties discussed in the Fiscal Sustainability Report.

Much of this analysis also applies to Wales, in part because of the shared socio-economic context and in part because of the continuing importance of the block grant.

In the OBR's recently published Fiscal Risks Report[18] a range of major risks are considered. Key conclusions comprise:

- The biggest and most frequent fiscal risks in peacetime relate to the underperformance of the economy. These risks include both discrete recessions (which have occurred on average around once every ten years) and slow underlying productivity growth.
- The OBR undertook a specific "stress test" of a "no-deal" Brexit, under assumptions that hey considered "relatively benign" (for example in terms of border disruption). This added around £30 billion a year to borrowing from 2020-21 onwards. They noted that a more disruptive or disorderly Brexit could hit the public finances much harder.
- There are long term pressures on revenues from some tax bases, from trends in smoking, drinking, vehicle fuel use and the digitisation of economic activity.
- In respect of cost pressures, as previously noted, over the long term the biggest arise from **non-demographic** cost pressures in health and social care, and second to this, from the impact of an ageing population on them and on the state pension.

Fiscal implications and risks of climate change

The OBR Fiscal Risks report also considers climate change. The OBR notes that in a world in which global warming proceeds as envisaged under the Paris agreement and temperatures are stabilised at 1.5 degrees Celsius above pre-industrial levels, the direct fiscal effects of adaptation and mitigation currently appear relatively modest.

It should be noted that at present achieving this 1.5 degrees target appears unlikely. Only two countries worldwide currently have plans that meet the 1.5 degree target. The UKCCC's report for parliament on the UK's progress, published in July notes domestic "actions to date have fallen short of what is needed for the previous targets and well short of those required for the net-zero target" and the current "global plans give only a 50% chance of meeting 3°C.

[18] https://obr.uk/frr/fiscal-risks-report-july-2019/

Nevertheless, the OBR considers that the cost of adaptation and mitigation measures needed in the UK to meet the 1.5 degree target would probably not be as large as those related to ageing or the cost pressures in healthcare and the effects of extreme weather are not thought likely to be on the same scale as a major recession (although they may be more frequent).

This assessment is based in part on work recently done by the UK Committee on Climate Change (CCC) to inform its assessment that the cost of the UK achieving its recommended target of net zero carbon emissions in 2050 would probably be in the range of one to two per cent of GDP[19] (in the context of an economy with a long run rate of growth of two per cent *each year*).

Purely for illustration of orders of magnitude, in today's terms, in Wales this cost estimate would equate to perhaps £600 million to £1.2 billion per annum. These costs would be borne cross the economy as whole. The CCC does not consider it possible at this stage to attribute the costs to sectors, though it seems likely that a considerable portion would borne by consumers through higher costs for energy and certain "energy intensive" goods. It therefore seems reasonable to assume that the direct costs to government would represent only a modest fraction of the whole economy cost. The implications for the public finances therefore appear limited compared to other risks.

Although the net costs appear manageable, it is important not to underestimate the associated levels of policy "effort" need to deliver the required level of structural change, particularly in respect of energy generation and heating, where there may be big changes to the temporal distribution of cash-flows as annual fuel costs are replaced with "upfront" capital investment.

The OBR does also note that if global mitigation efforts fail, and temperatures reach four degrees Celsius above the pre-industrial levels, the risks posed by conflict, mass migration and catastrophic weather events could be severe. They state that the apparently relatively benign fiscal outcomes may "simply reflect the difficulty we all have in foreseeing the full systematic consequences of significant global warming".

The adverse international consequences may be particularly important as modelling by the IMF[20] suggests that the direct adverse effects of further climate change on countries at relatively high latitude such as the UK could be relatively modest. However, very major adverse effects would be felt by the large numbers of poor

[19] The estimate is based on the "resource cost" – broadly, the cost assuming that there was no shift away from activities which increased in cost and that there were no co-benefits. The consequence is that the estimate is probably best regarded as an upper bound on the true economy costs of mitigation.

[20] See chapter 3: https://www.imf.org/en/Publications/WEO/Issues/2017/09/19/world-economic-outlook-october-2017

people living in countries nearer to the equator, and particularly low lying countries such as Bangladesh.

One area where the direct effects on the UK and Wales could be material, and not taken into account in the IMF analysis, is on the risk of flooding. However, annual expenditure on flood prevention in Wales is currently around £50 million, so even a large increase would appear manageable when considered in the wider fiscal context. The CCC recommend that "it is prudent to plan adaptation strategies for a scenario of 4°C". The Environment Agency estimate the cost of upgrading the UK's flood defences to deal with a four degrees increase would require an a 66% increase on current spend. Assuming the same increase would be required in Wales this would equate to around £35 million per year (less than a fifth of one percent of the Welsh Government's budget).

The Welsh tax base

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

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

These protections do not alter the fact that the Welsh Government's spending power will be affected by the performance of the tax base in Wales relative to the rest of the UK. Last year's report considered some scenarios to illustrate the potential scale of the effects,

The Wales Centre for Public Policy (WCPP) report *Tax Risks and Opportunities in Wales*[21] published last highlighted some of the risks associated with the current Welsh tax base[22]:

- Proportionately fewer high earners (for a range of reasons, including the level and quality of jobs, related to qualification levels in the workforce);
- Lower property prices and rental values;

[21] https://www.wcpp.org.uk/publication/the-welsh-tax-base-risks-and-opportunities-after-fiscal-devolution/

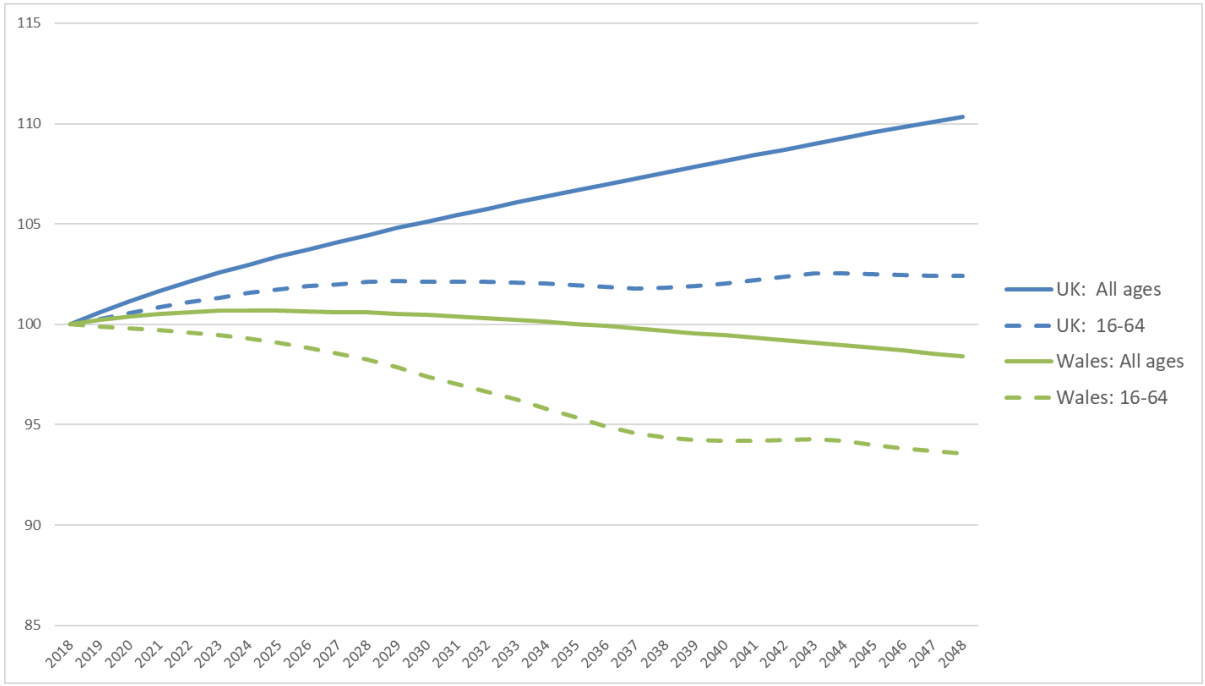
[22] In addition to the scale of the tax base, the efficiency of taxes and the rates at which they are set are obviously crucial and complex issues but are not discussed further in this report.

- Proportionately fewer high-value properties (and a lesser dependency on more valuable properties for tax revenue);
- A larger proportion of the population outside the workforce (relatively larger numbers of older people and, despite improvements over the period since devolution, higher levels of inactivity in the working age population).

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

ONS population projections[23] point to a specific risk to the future Welsh tax base, with "working age"[24] population forecast to grow more slowly than in England – see figure seventeen. Of course, and perhaps even more importantly, this also has broader implications for future Welsh relative economic performance and for social outcomes.

Figure 17: Growth in population from 2018



Source: ONS 2018 based principal projections

If slower growth in the working-age population in Wales feeds directly through to slower growth in devolved revenues, and, as shown in last years' report, the impact

[23] Which are however highly uncertain, not least due to their sensitivity to migration – and particularly migration that is internal to the UK.
[24] A fixed age cohort is shown to remove the effect of changes in state retirement age on the definition of working age.

on the Welsh Government budget could be around £150m a year by the end of the next decade.

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

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

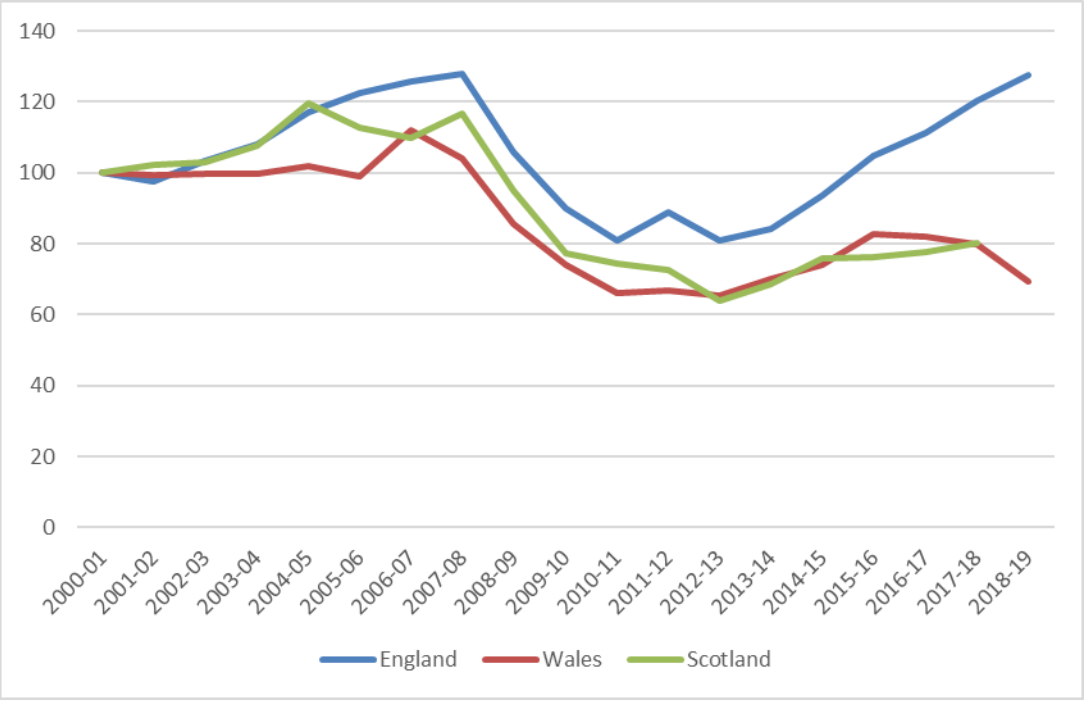
This report does not consider the potential policy responses which would raise a host of issues. However, in principle, there could be a range of options to address differential growth in the working-age population, particularly as many areas of Wales are potentially very attractive places for people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

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

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

The available data on new dwelling completions also suggest that in recent years housing supply in Wales has fallen both behind England and below the levels seen in Welsh prior to the recession of 2008 - see figure eighteen.

Figure 18: New dwellings – completions (2000-01=100)



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