Llywodraeth Cymru
Welsh Government

Welsh Budget 2022: Chief Economist's report

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Purpose and context

- This report reviews recent economic developments and the economic and fiscal prospects facing Wales. It does not cover Welsh Government policy.
- Wales is deeply embedded in the wider UK economy, and over the short-term outcomes in Wales are mainly driven by factors which are common to the UK as a whole.

Current economic conditions and short-term prospects

- At the time of writing, Wales and the UK appear to be entering a recession, following a period during which living standards have already fallen for four successive quarters.
- The Office for Budget Responsibility (OBR) expects the recession will persist through most of next year. Output or GDP is expected to decrease by two per cent.
- Across the UK, average household incomes are expected to decrease by 4.3 per cent in 2022-23 and by 2.8 per cent in the following year. The cumulative two-year decrease of more than 7per cent would be unprecedented. These declines would compound an extraordinarily poor income performance dating back to around the time of the financial crisis.
- The OBR expects the rate of unemployment to increase by around one and half percentage points, which in Wales would be equivalent to a figure of around 20,000 to 25,000 more people out of work.
- Inflation as measured by the consumer price index is expected to remain above 10 per cent through the first half of next year. By the end of 2023, price increases should be down to around 4.0 per cent and a year later be below zero with the price level continuing to decrease until mid-2026.
- The UK economy is entering recession in a weaker position than any other G7 economy as all other G7 economies have recovered their pre-pandemic levels of national income and employment.
- A key factor holding back the UK economy is the increasing numbers of working age people who are economically inactive.
- Given lower income levels in Wales, an incidence of poverty that is higher than in some other parts of the UK, and houses which are on average less energy efficient, people in Wales are likely to be particularly badly affected by the prospective recession and by the reductions in real incomes.
- There is a high degree of uncertainty around economic forecasts. The Bank of England has projected a deeper recession, and a larger increase in unemployment, than the OBR. On the other hand, if the war in Ukraine were to end more quickly than currently anticipated, economic conditions could rapidly improve.

Longer term economic challenges and opportunities

- The longer-term economic challenges and opportunities facing Wales are largely unchanged but have been exacerbated by the cost-of-living crisis and the pandemic.
- A key long run challenge remains relatively weak productivity, the key long run driver of sustainable increases in pay, prosperity and the tax base.
- Challenges also remain in the labour market: employment opportunities are restricted for many disadvantaged groups, particularly the disabled, those with long term health conditions, and people with low skill levels.
- A continuing concern is that the effects of the disruption to the education of children and young people caused by the pandemic will have lasting effects on the prospects of those from disadvantaged backgrounds.
- Employment creation has been unevenly distributed across Wales.
- The rapid growth of remote working presents both a new challenge and an opportunity.
- Welsh population has been growing more slowly than in all English regions. With the number of deaths exceeding the number of births over recent years, due principally to a low fertility rate, in-migration has prevented overall population decline.
- Population change varies across Wales, with a number of local authority areas experiencing a decline in population over recent years.
- Demographic changes poses a number of challenges and some opportunities.

Fiscal prospects

- Following the Autumn Statement, tax as a share of UK GDP is forecast to increase to its highest level since 1947. Large real terms spending cuts have been "pencilled in" for the next spending review period, likely following the UK general election.
- The OBR has again confirmed that the UK's public finances are on an unsustainable path over the long term, with an aging population and other factors set to increase the demands on public services.
- The recent inflation shock has meant that, even with the additions from the Autumn Statement, the Welsh Government's settlement over the three years of the current spending review period is still worth up to £3bn less in real terms than expected last year.
- Low growth over the remainder of the spending review period combined with constrained public expenditure assumptions beyond that, imply that over the next five years the Welsh Government's budget for day-to-day spending per person is set to grow by less than 0.5 per cent a year in real terms.
- Wales is facing similar demographic pressures to England over the coming years. Whether resources are available to meet those pressures in Wales will depend to a large extent on whether the UK Government funds them appropriately in England.
- The devolved taxes are expected to continue making a positive contribution to Welsh Government finances.
- The large gap between total public sector revenue and expenditure for Wales represents a major transfer to Welsh people through the UK fiscal system.
- This transfer is the main reason for the gap between measures of household income and GDP in Wales and represents a key risk to Welsh living standards.

Purpose and context

This report reviews economic trends and assesses economic and fiscal prospects. It does not present Welsh Government policy.

The report includes material relevant to the Welsh Government's commitments to extend the evidence base on Welsh fiscal prospects and to review options for developing the Welsh tax base. Further analysis will be commissioned in connection with these commitments and to consider the fiscal implications of any recommendations from the Independent Commission on the Constitutional Future of Wales. The results of such further analysis will be reflected in future versions of this report.

This year's report has again been produced during a period of high uncertainty due to the surge in inflation, other disruption as consequence of the war in Ukraine, and the continuing global consequences of the lingering COVID-19 pandemic.

The Office for Budget Responsibility's (OBR's) latest forecasts and the UK Government's Autumn Statement were published on 17 November.

Despite the unavoidable uncertainty, the OBR's forecasts and the UK Government's fiscal plans provide context for assessing Welsh economic and fiscal prospects.

Many of the Welsh Government's policy levers operate most effectively over the medium to long term. This report therefore also reviews important longer run trends and challenges that both pre-date the current crisis and will persist beyond it.

As a result of the pandemic, data collection for statistical surveys was disrupted, and in some cases the resulting statistics are unavailable, unreliable, or not reflective of longer run trends. For these reasons, the data used in this report may not always refer to the most recent periods.

Recent economic developments

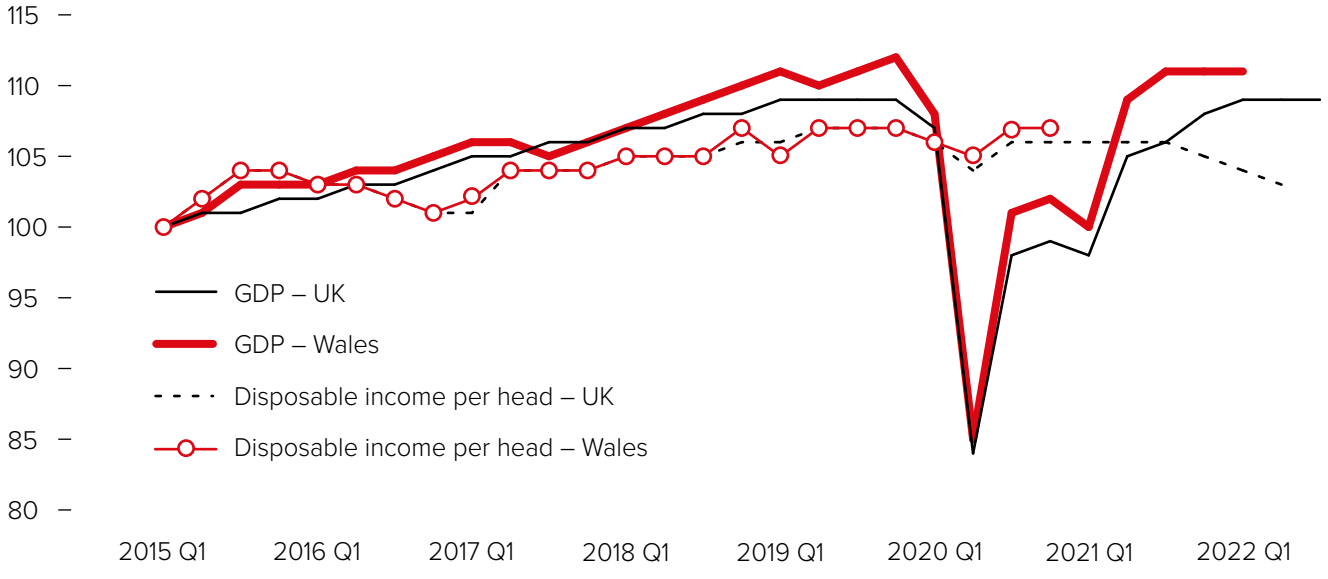
The economy in Wales is deeply embedded in the wider UK economy. In consequence, the short run performance of the economy in Wales is very strongly influenced by developments across the UK – and indeed, beyond[1].

The past few years has been an unusually turbulent period for the economy. This turbulence has largely reflected non-economic factors: the referendum on leaving the EU, the pandemic, and latterly the war in Ukraine.

GDP, inflation and living standards

As in other parts of the UK, the cost-of-living crisis has already had a major adverse impact on living standards in Wales. Chart 1 shows the recent trends in UK GDP (up to the third quarter of 2022) and UK average real income per head (up to the second quarter of 2022). The most recent available, but less timely, data for Wales is also shown.

Chart 1: Change in total GDP and disposable income per head, real terms (2015 Q1 =100)



Source: ONS
Note: GDP data for Wales is experimental. Real disposable income per head for Wales is approximate annual data.

1 This close relationship is confirmed by several charts in this report and the OBR has acknowledged that over recent years, and when expressed on a per head basis, the short to medium term trend in GDP in Wales has been indistinguishable from that for the UK - although there is some random variation.

By the second quarter of 2022, UK GDP had partially recovered from the pandemic, almost regaining the level attained in 2019, before contracting in the third quarter. However, had the 2019 level been regained, that would of course still have represented three years of lost growth.

The UK is now the only G7 economy not to have surpassed pre-COVID levels of GDP and employment.

The less timely, experimental, data for Welsh GDP, and the data for Welsh disposable income, indicate that Wales may have recovered from the depths of the pandemic somewhat more quickly than the UK as a whole. However, this data is volatile, and subject to revision.

The sharp increase in inflation over the last year has eroded living standards, such that, by the second quarter of 2022, average incomes across the UK had fallen for four successive quarters.

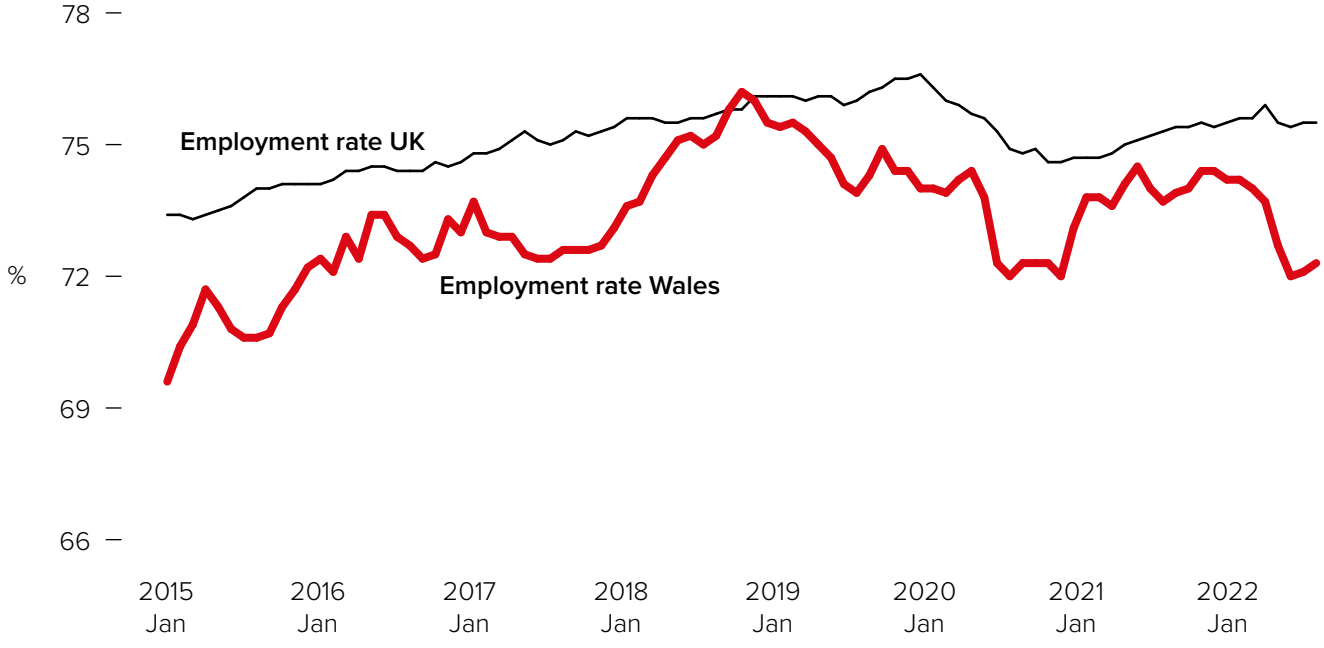
The close correlation between measures of income for Wales and the UK indicates that the same will almost certainly have also occurred in Wales.

People on low incomes have been even more adversely affected than average, as energy and food prices, responsible for a large share of the overall increase in inflation, account for a disproportionate share of their budgets.

Employment and the labour market

The most timely and reliable data that is available for Wales is for the labour market. The overall performance of the labour market is best summarised by the trend in the employment rate, as shown in Chart 2. The data shown covers the period to August-September 2022.

Chart 2: Employment rates, Wales and the UK



Source: ONS

The labour market has so far performed better than might have been expected, given the large reduction in GDP seen over the last few years, with unemployment remaining low.

Less positively, inflation has exceeded average pay increases, resulting in real pay reductions, particularly for public sector employees.

In addition, there has been a marked increase in economic inactivity. This is in part reflected in a rise in the incidence of long-term illness, particularly affecting older age groups within the working age population. In contrast, comparable economies have higher employment and lower inactivity as compared with pre-pandemic positions.

It appears that more people are leaving the labour market for reasons other than ill health, and then becoming ill, rather than leaving the labour market primarily because of illness. However, in the relevant survey, people can only record one reason for inactivity, so it may be that some people leaving the labour market for another reason nevertheless have an underlying illness. If this illness becomes more severe over time it may become the primary reason cited for inactivity.

Although the increase in inactivity is mostly attributable to older age groups, inactivity due to ill health has also increased amongst some younger age groups, and this is a further cause for concern.

The increase in inactivity appears to have been greater in Wales than the UK as a whole, and it is this that has driven the recent divergence in employment rates shown in the chart. A greater increase in inactivity in Wales might be expected, as the Welsh population is older than the UK average. However, the data for Wales is volatile, and it is as yet unclear to what extent the divergence represents a real difference between Wales and the UK.

Despite these recent indications of weakening, the performance of the labour market in Wales compares well with the rest of the UK on an historical basis. As noted in previous reports[2], recent performance contrasts with the period before devolution, when the employment rate in Wales was typically five to six percentage points lower than the UK (reflecting a much higher level of economic inactivity in Wales).

Looking forward, a deterioration in labour market conditions across the UK is in prospect, as consumers and businesses retrench in response to the reduction in real incomes.

Even within a generally strong labour market, disadvantaged groups under-perform. These groups include people with low skill levels, disabled people and those with long term health conditions, women with young children, and members of certain minority groups. All such groups are liable to suffer disproportionately as labour market conditions deteriorate.

Prospects for the labour market in Wales are discussed more fully below.

Welsh international trade

International exports provide an important market for Welsh firms, whilst imports provide inputs to businesses and goods for consumers, typically keeping prices down and increasing consumer choice.

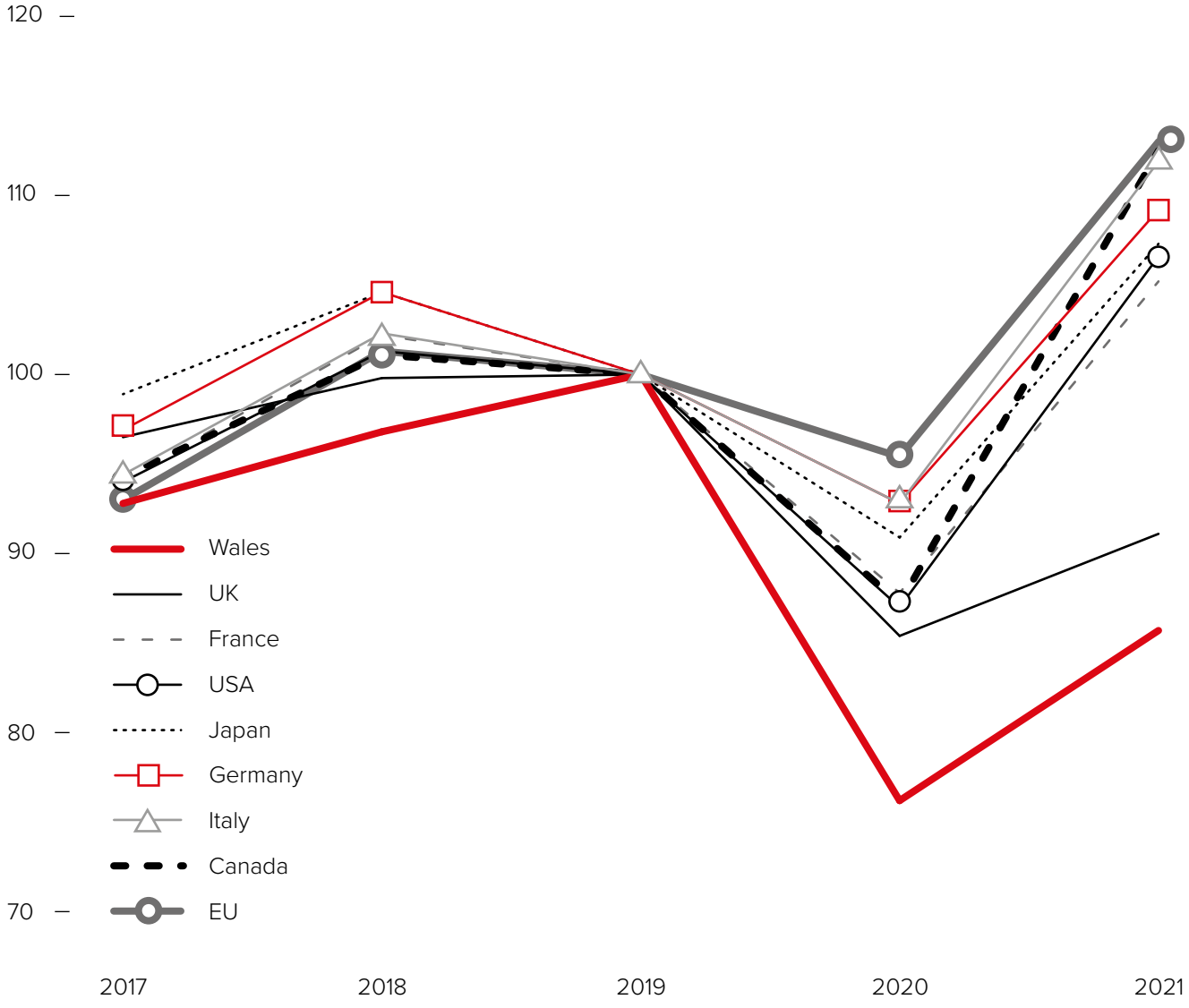
Between 2016 and 2020, goods exports on average accounted for a higher proportion of GDP for Wales than any other part of the UK. This implies Wales may be more exposed to economic shocks from changes in trading relationships than elsewhere in the UK.

2 **chief-economists-report-2020.pdf (gov.wales)**

Recent years have proven to be particularly volatile for global trade, and even more so for the UK, with the changes observed due to the UK's exit from the EU being compounded by volatility from the COVID-19 pandemic.

More recently both UK and Welsh trade have started to recover. However, the recovery for both UK and Wales has been at a slower rate than other G7 countries (who had all exceeded their pre-pandemic levels of exports by 2021). See Chart 3.

Chart 3: Wales, EU and G7 countries, total goods exports (2019=100)



Source: Welsh Government analysis of UN Comtrade data

Whilst a recovery of goods exports is positive news, it should be noted that Welsh goods exports appear to continue to be much lower than would have likely been the case in the absence of recent events. It is however not possible to determine the precise scale of the impact or disentangle the impact of the UK's exit from the EU from that of the pandemic. However, it appears likely that EU exit is playing a significant role.

It also is important also to consider other global economic events, and particularly the war in Ukraine, and how these are affecting the value of trade, especially with inflationary pressures pushing up the price of products. This issue is particularly prevalent for the latest two quarters of data, with the value of petroleum exports from Wales increasing sharply whilst the volume remains broadly constant.

This effect on the value of exports presents challenges in interpreting Welsh trade performance as it shows a post-pandemic recovery. However, at the time of writing it appears that the observed recovery is likely to be driven by inflationary pressures, and to a lesser extent the value of the pound, affecting the value rather than volume of trade. This may mean that the recovery of Welsh exports shown in the chart presents an overly optimistic picture.

The EU continues to be an important market for Welsh goods exports, with the majority (58 per cent) of Welsh goods exports heading there according to latest data[3]. However, this importance has been decreasing over recent years from 61 per cent in 2019. Whilst for Wales, the importance of the EU market has weakened, the opposite is true for both Northern Ireland and Scotland who now export a higher proportion of their exports to the EU than previously.

This Welsh shift away from the EU market for Wales is not unexpected given the change in trading terms with the EU following the end of the transition period. The re-structuring of supply chains, coupled with the increasing focus towards non-EU markets, particularly as the UK Government secures trade deals with countries including Australia and New Zealand (with many more in negotiation), could partly explain this, however more data is needed before conclusions can be drawn, particularly in view of the experience in Scotland.

3 Year ending Q2, 2022.

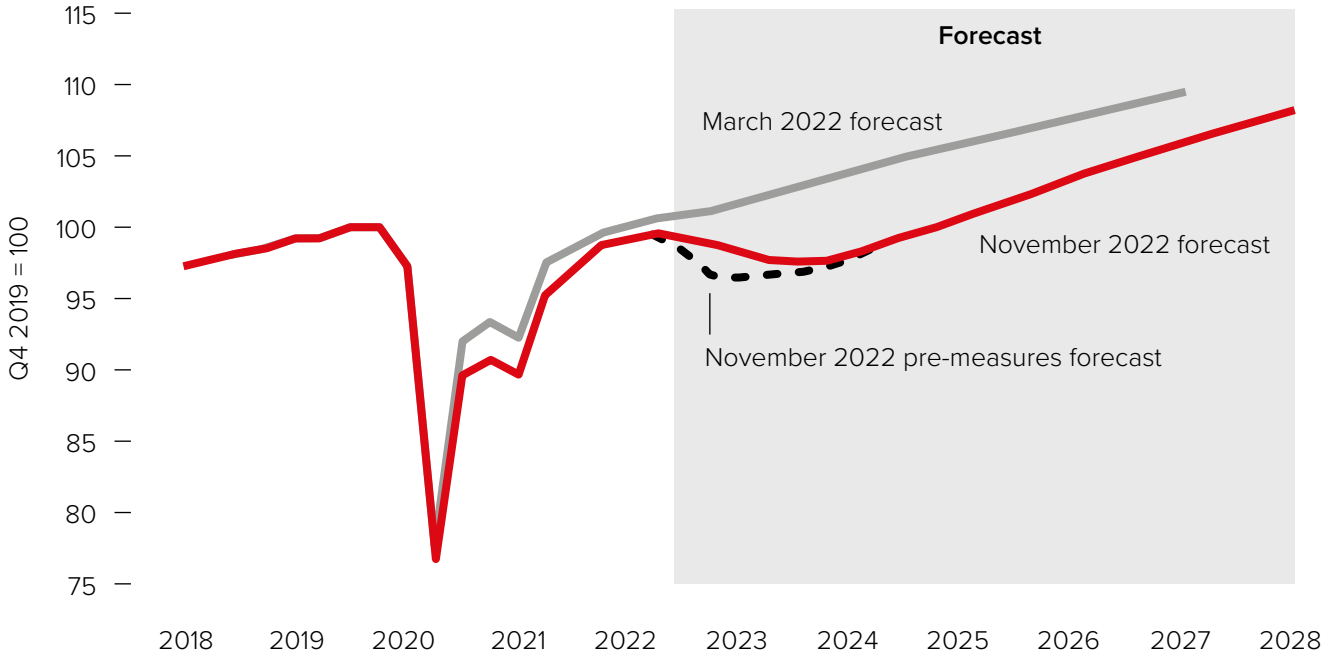
Shorter term economic prospects

UK output and labour market

As already noted, Wales is deeply embedded in the wider UK economy and Welsh economic prospects are heavily dependent on expectations for the UK.

In its latest Economic and Fiscal Outlook, published on 17 November, the Office for Budget Responsibility (OBR) expects inflation to result in a continuing squeeze on real incomes. This, along with a rise in interest rates, and fall in house prices all weigh on consumption and investment. In turn, the OBR expects these pressures to tip the economy into a recession lasting just over a year, from the third quarter of 2022, with a peak-to-trough fall in GDP of 2 per cent. See Chart 4.

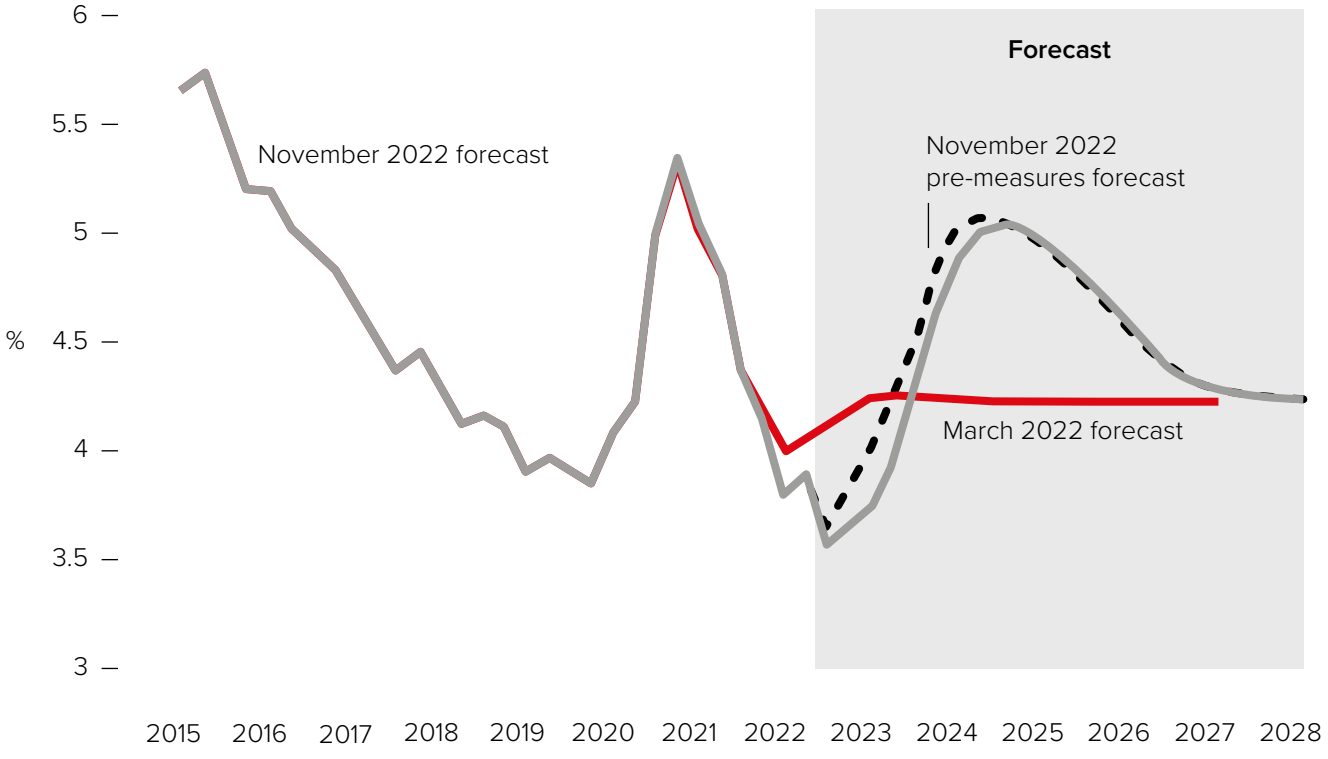
Chart 4: Real GDP outturn and OBR forecast (UK)



Source: ONS, OBR

The OBR expects the unemployment rate to rise to a peak of 4.9 per cent in the third quarter of 2024 and then fall back over the period to 2027. See Chart 5.

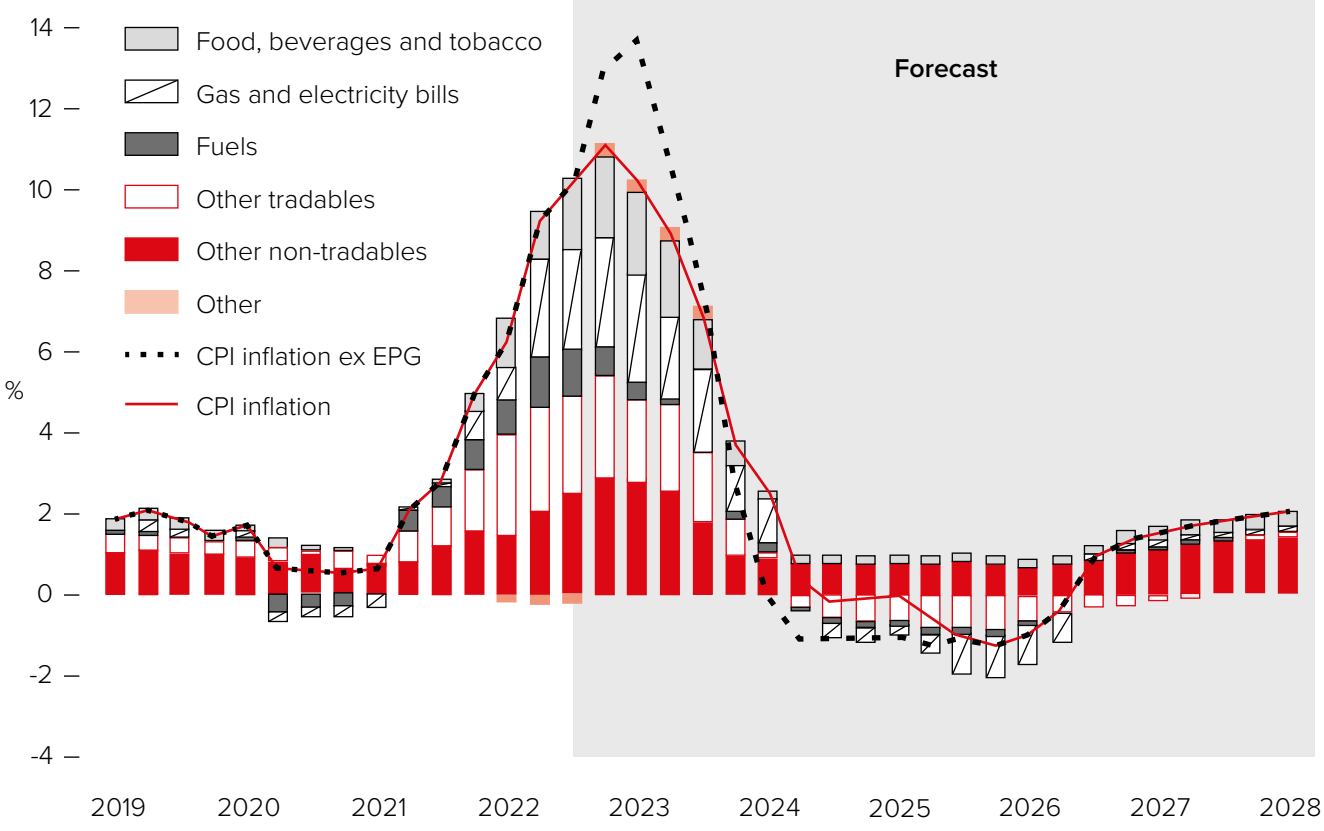
Chart 5: Unemployment rate outturn and OBR forecast (UK)



Source: ONS, OBR

Alongside the increase in unemployment, the OBR now forecasts a smaller labour force than had expected pre-pandemic, with a particularly large increase in inactivity among older age groups. The OBR judges that many of these people are unlikely to re-enter the labour market. The OBR expects inflation to peak at a 40-year high of 11.1 per cent in the fourth quarter of 2022. Food and energy prices are key drivers. See Chart 6.

Chart 6: Inflation outturn and OBR near-term forecast, showing contributing factors (UK)



Source: ONS, OBR

The inflation peak in 2022 would have been even higher, at 13.6 per cent, without the reduction in utility prices that results from the Energy Price Guarantee (EPG). The EPG increase from £2,500 to £3,000 in April 2023 is expected to add one percentage point to quarterly CPI inflation in the second quarter of 2023. On an annual basis, CPI inflation is expected to fall back from 9.1 per cent in 2022 to 7.4 per cent in 2023. Inflation is then expected to fall further, dipping below zero for eight quarters from mid-2024 before recovering towards the two per cent target in 2027.

Household incomes are expected to fall by 4.3 per cent in 2022-23, which would be the largest since ONS records began in 1956-57. This would be followed by the second largest fall in 2023–24 at 2.8 per cent. It would be only the third time since 1956–57 that income per person has fallen for two consecutive years – the last time this happened was in the aftermath of the global financial crisis.

Prior to the publication of the OBR forecast, the Bank of England had, on 3rd November, also published its latest economic forecast. The Bank forecast a more severe and longer lasting recession than the OBR, with a slower recovery.

The principal reasons for the differences between the forecasts of the OBR and the Bank include the OBR's expectation that consumer spending will be maintained at a higher level than expected by the Bank. This reflects the OBR's judgement that households will be able and willing to run down savings accumulated during the course of the pandemic. In addition, the OBR assumes a higher level of in-migration than Bank, and that the recovery in productivity following the recession will be stronger.

At the time of writing, the OBR's forecast was closer to the average of independent forecasts than was the Bank's forecast.

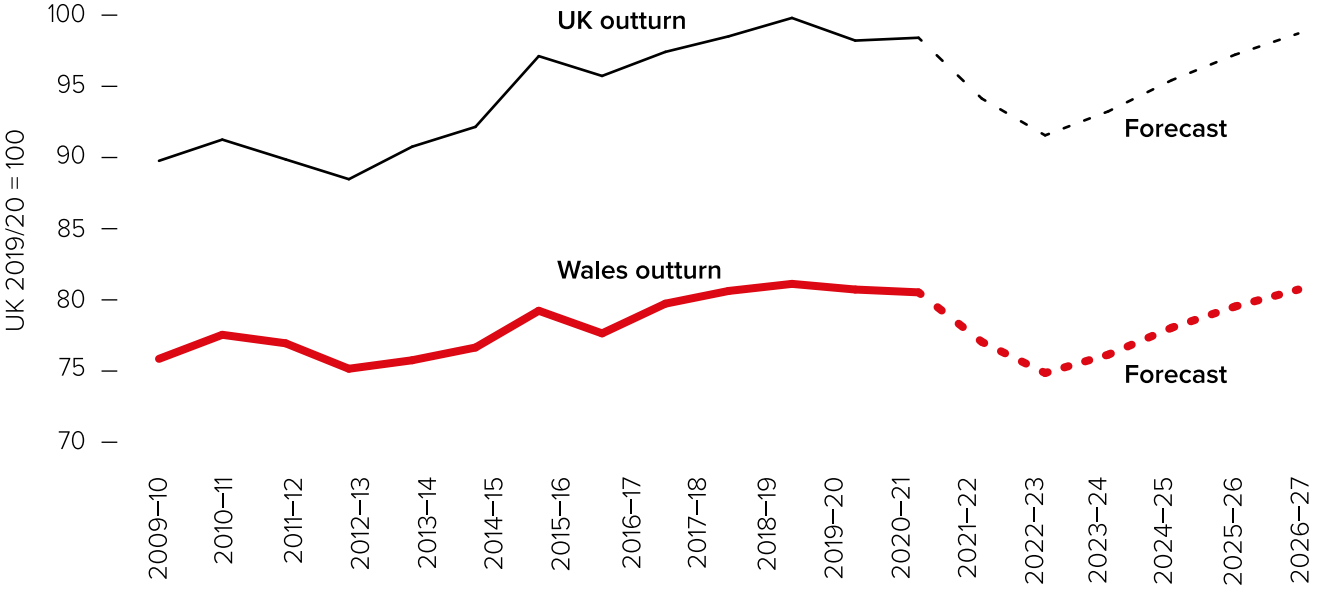
Both the OBR and the Bank of England base their forecasts on market expectations of interest rate changes. The Bank has stated that it does not believe that interest rates will in fact need to increase to the extent expected by the markets. If this is the case, the recession may be less severe than currently forecast.

Implications for Wales

In general, the OBR's assessment of near-term prospects for the UK is also applicable to Wales.

Chart 7 shows outturn and projections of UK and Welsh living standards, as measured by average (mean) real income per head. The projection for Wales should be regarded as illustrative because it assumes that the historic relationship between incomes in Wales and the UK continue into the future.

Chart 7: Average income per head, UK and Wales: outturn and projection UK 2019/20 = 100



Source: OBR, Welsh Government calculations
Note: Measure is average (mean) real disposable household income per head.

As with the UK as a whole, incomes are projected to fall by over four per cent in 2022-23. That will be followed by a fall of nearly three per in 2023–24. Incomes are then projected to recover, with incomes regaining the level of 2019–20 only by 2027–28. This represents eight years of lost growth in incomes and follows a long period during which real incomes have grown only very sluggishly in historic terms. (The long run trend discussed further below.)

The projected reduction in real incomes is unprecedented, and much worse than experience in the years following the financial crisis.

Given lower income levels in Wales, an incidence of poverty that is higher than in some other parts of the UK, and houses which are on average less energy efficient, it appears likely that people in Wales will be particularly badly affected.

People in Wales are more reliant on benefits than the UK average. Even though working age benefits will be uprated by inflation for 2023-24, and some additional payments were announced in the Autumn Statement, the IFS has found that this will still leave the real value of benefits on course to be 6 per cent below their pre-pandemic levels, equivalent to almost £500 per year for the average out-of-work claimant.

Pressure on people's incomes will result in lower spending, with additional adverse effects on the pace of the recovery and on local employment in areas with large numbers of people on low incomes.

The OBR forecasts an increase in unemployment is of around one and half percentage points, which in Wales would be equivalent to a figure of around 20,000 to 25,000 people. If the Bank of England's more pessimistic forecast were to prove accurate the increase in unemployment could be higher – perhaps up to around 40,000 people.

In view of higher levels of vulnerability in Wales, the outcome could be even worse.

The continuing tight squeeze on living standards comes on top of a protracted period, dating back to around the time of the financial crisis in 2008, during which the growth in living standards in Wales, as across the rest of the UK, has been exceptionally slow. Very weak productivity growth has been the key factor explaining the longer-term trend and this is discussed further below.

Welsh living standards over the longer term

This section reviews longer term trends in living standards in Wales, comparing Wales with the rest of the UK and beyond.

Background

As this report considers mainly economy developments and prospects, the focus is on material living standards as measured by household income. But as the cost-of-living crisis and the pandemic has of course emphasised, other aspects of well-being are crucially important, with some indictors of mental well-being, for example, showing marked deterioration at various stages of the pandemic.

The Welsh Government's annual Well-being of Wales Report[4] reviews recent trends as they have affected well-being in Wales more holistically, as required by the Future Generations Act, and last year's Future Trends Report[5] provides an updated assessment of the implications of the long run trends facing Wales for the goals set in the Act. This broader perspective is not therefore duplicated in the present report.

Information on household incomes in Wales is available from two sources. One is the Family Resources Survey (FRS), which provides key results for both mean and median household income and for poverty levels.

In the past, the FRS sample size for Wales has been small, meaning that data needs to be averaged across several years (hence producing results that are not timely) and that detailed analysis is often precluded. The Welsh Government has therefore funded a boost to the FRS in Wales in order to improve our ability to analyse changes in living standards in Wales, and particularly to assess how such changes affect various population groups, including those with low levels of income.

The other source of information on income is the ONS Regional Accounts, which provides results for average (mean) household income, but where results are based in part of the apportionment of high-level data in the national accounts to local areas. The Regional Accounts data also includes some income which is "notional" rather than actual, most importantly the value of housing services deemed to be received by owner occupiers.

As the 2020 report demonstrated[6], there is typically far more variation in living standards within areas than between them, with incomes being most strongly influenced by individual and household characteristics, and particularly by levels of qualification and health status.

4 **Wellbeing of Wales: 2022 | GOV.WALES**
5 **Future Trends, National Indicators and National Milestones: Consolidated plan for 2021 [HTML] | GOV.WALES**
6 **chief-economists-report-2020.pdf (gov.wales)**

For example, in Wales people in the tenth of the population with the highest incomes have average income levels that are around six times higher than the tenth of the population with the lowest incomes. By contrast, the average income in the local authority in Wales with the highest level of income is only around 50 per cent higher than in the local authority with the lowest level of income.

These considerations also point to the critical importance of the wider UK tax and benefits system in mitigating variation in living standards, and hence to the important consequences of policy choices made by the UK government in these areas.

The extent of redistribution under the UK tax and benefits system directly affects people's incomes, but there are also indirect effects on the level of local economic output as a result of the impact on consumer spending.

Trend in average incomes

When a comparison is made between Wales and the UK based on measures of people's average incomes the gap is considerably smaller than when a comparison is based on GDP or GVA per head. The gap is narrower mainly because of the large transfers made through the UK fiscal system. It is also narrower because net out-commuting from Wales results in Welsh people earning incomes from economic activity that does not take place within Wales.

Average incomes can be measured using either the median or the mean. Median household income is defined as the income of the household that, when households are ranked by income, is in the centre of the distribution. It can therefore be regarded as a reflecting the income of a "typical" household and is widely regarded as the most representative single measure of material living standards for the population as a whole.

Chart 8 shows longer run trends in median household income for Wales and the UK in real terms, mainly covering the period prior to the COVID pandemic[7].

Despite annual variation, the trends for Wales and UK are strongly associated, as would be expected given the largely common economic and fiscal context.

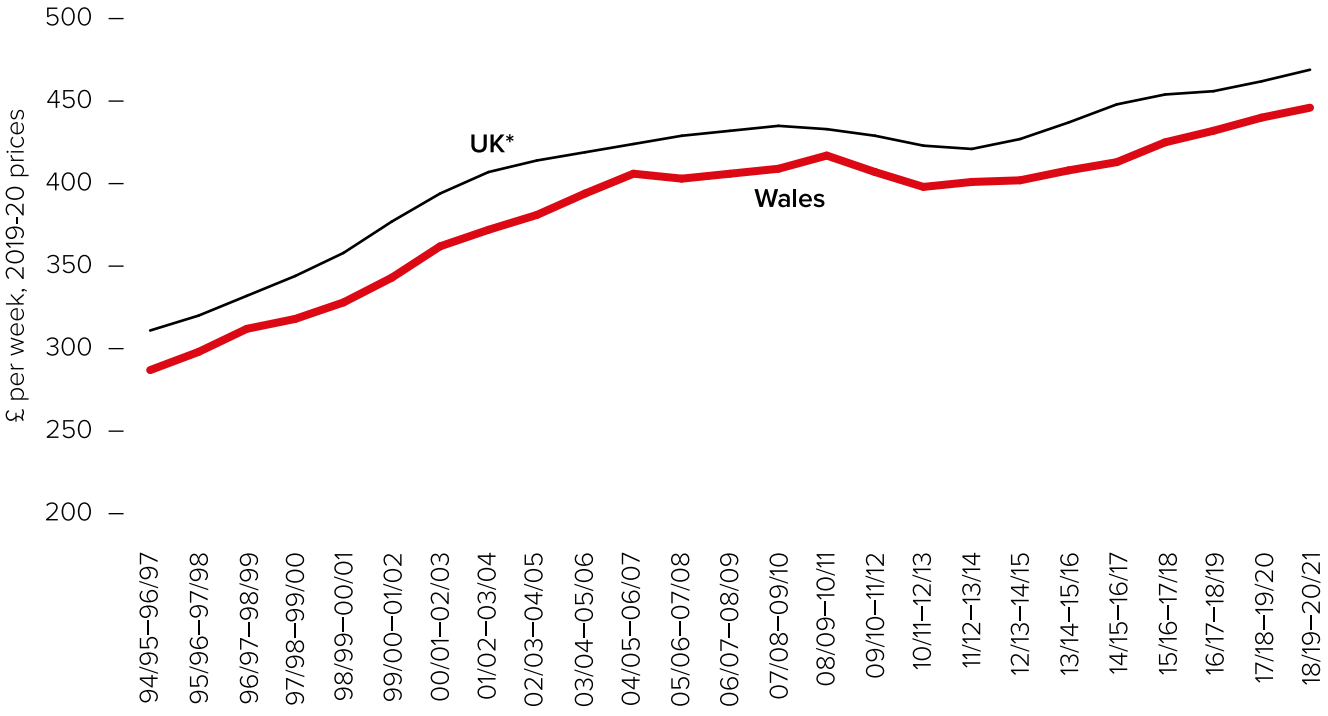
The data in the chart shows that, over the whole period, median incomes in both Wales and UK have grown by around 1.8 per cent per year, after allowing for inflation. However, this obscures a sharp change in trend.

Growth in real incomes slowed markedly from around the time of the financial crisis in 2008. From this point, on average the growth in incomes was under one per cent each year. Prior to this, the rate of growth was higher – at well over two per cent per year over the previous decade.

If incomes had continued to grow at the rate experienced prior to the financial crisis, real incomes – and living standards – would now be around 30 per cent higher than they are.

7 The pandemic impacted on the size and composition of the underlying survey sample in 2020-21, so DWP recommend that users exercise additional caution when interpreting changes observed in this period.

Chart 8: Median household income (£ per week, 2019/20 prices)



Source: Family Resources Survey
*GB for the years prior to 2002/03
Notes: Data is equivalised to ensure results reflect similar household composition and shown after housing costs.

The prolonged period of slow growth in incomes and living standards over the period since the financial crisis is unprecedented in modern times, and largely reflects slow growth in productivity, the ultimate driver of living standards[8].

While Chart 8 shows that trends in median incomes in Wales and the UK are broadly similar, Wales has nevertheless converged somewhat with the UK since the mid-1990s. Median Welsh household income in the most recent period was just under five per cent below that for the UK as whole, with the figure for Wales higher than for several English regions[9]. In the mid 1990's the gap was around seven per cent.

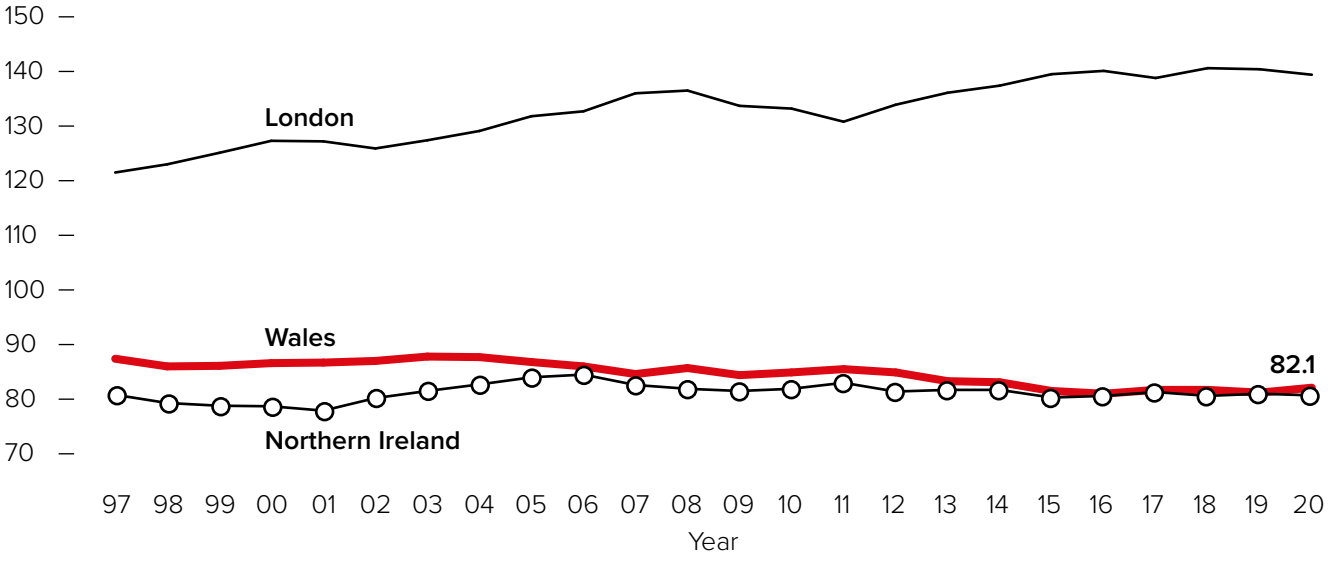
The alternative source of information on household incomes in Wales, the ONS Regional Accounts, shows a larger gap between incomes in Wales and the UK. The income measure used is Gross Domestic Household Income (GDHI). It is a measure of mean, rather than median, income.

Chart 9 shows GDHI per head in Wales and other UK countries and regions, compared to the UK.

8 The underlying weakness of productivity growth over the most recent years is somewhat masked in the chart as the growth in incomes has been partly driven by a recovery in employment rates, something which obviously has only finite potential.

9 While this figure adjusts for differences in housing costs, it does not take account of other differences in the cost of living. Previous analysis by the ONS suggests that if such differences were taken into account, it might reduce the gap by up to around 2 percentage points.

Chart 9: Gross Domestic Household Income, UK =100



Source: ONS

For the most recent available period, 2020, GDHI per head in Wales was the third lowest amongst UK countries and regions, but a little higher than the North-east of England and Northern Ireland. GDHI per head in Wales was 82.1 per cent of the figure for the UK – or, in other words, 17.9 per cent below the UK figure.

The much larger gap between Wales and the UK when the comparison is made based on measures of mean rather than median income reflects in part the relatively small share of the population with high incomes in Wales. This small share is, of course, reflected in the calculation of the mean but not of the median income.

The data in Chart 9 indicates that, in contrast to the measure of median household income, the gap between Wales and UK on GDHI has widened over the longer term[10]. The underlying data (not shown) also indicates that the gap between Wales and the UK excluding London has widened, albeit to a lesser extent, so a stronger relative growth in incomes in London can only be a part of the explanation for the overall widening.

Examination of the underlying data indicates that two factors appear to have been important in explaining the divergence in trends between Welsh relative median household income and Welsh relative GDHI. The first is the distribution of the growth of pay, with faster growth in pay for those who are already highly paid in other parts of the UK. The second is slower growth in rental income in Wales. Both of these are reflected in GDHI but not in median income. This issue was explored more fully in last year's report.

Welsh living standards in an international context

It is possible to compare Welsh living standards, as reflected in household income, with other similar sized countries and regions. Table 1 presents data from the OECD, showing "equivalised" household income at purchasing power parity[11]. The table shows Wales and the regions identified as its closest peers when regions are ranked by income levels[12].

10 A measure of mean income is also available from the FRS, alongside the measure of median income. The gap with the UK shown on this measure is quite volatile, but with little sign of any trend closing of the gap.

11 Equivalisation adjusts the data to ensure comparability across different household sizes, and comparisons at purchasing power parity take account of differences in the cost of living.

12 The data shown is for 2019, before the impact of the pandemic, the impact of which has complicated more recent comparisons.

Table 1: Household income per head ($), 2019

Netherlands: Gronigen	22,488
Spain: La Rioja	22,477
France: Corsica	22,458
Spain: Asturias	22,302
Sweden: East Middle	22,277
Spain: Balearic Islands	22,197
Sweden: Upper Norrland	22,175
UK: Northern Ireland	22,073
Denmark: Zealand	22,065
France: Hauts-de-France	22,030
Wales	**22,002**
Finland: Western Finland	21,966
Sweden: Småland with Islands	21,939
Sweden: Central Norrland	21,863
Finland: Eastern and Northern	21,861
North East England	21,781
Sweden: North Middle	21,780
Spain: Castile and León	21,729
Denmark: Central Jutland	21,691
Spain: Cantabria	21,684
Denmark: Northern Jutland	21,427
Ireland	21,409

Source: OECD

The data shows that average living standards in Wales are similar to those in a number of other regions in Western Europe, and higher than in the republic of Ireland.

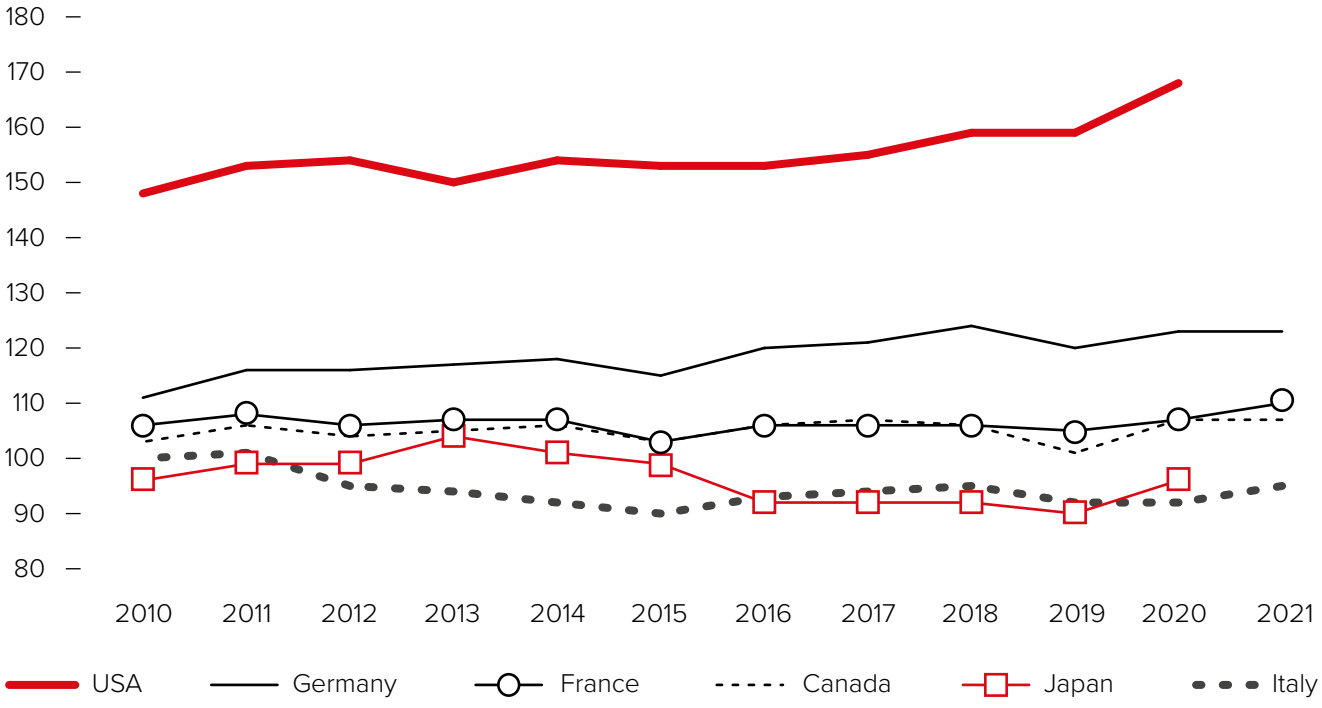
The latter result may be surprising, given Ireland's strong performance on GDP-based indicators. However, such indicators are widely recognised to be particularly misleading in the case of Ireland, partly because they reflect profits recorded in Ireland rather than incomes received by Irish residents.

Disposable income does not take account of government services provided in kind, such as health services in the UK. Eurostat and the OECD recommend that international comparisons

should be made based on Actual Individual Consumption (AIC), which does take account of such services. However, AIC is not available for Wales or at the regional level for other countries. Results at the state level indicate that UK tends to perform more favourably when compared on AIC than on disposable income, and the same would almost certainly therefore be true for Wales[13].

While slow growth in incomes has been seen across developed countries over the period since around the time of the financial crisis, the UK (and therefore also Wales) has fared less well than may comparator countries. Chart 10 shows trends in household incomes for G7 countries expressed relative to incomes in the UK.

Chart 10: Household income per head, UK=100



Source: OECD[14]
Note: Chart shows relative household disposable income, included social transfers provided in kind (such as health services in the UK), per head at current prices and purchasing power parity.

Slow growth in the UK has meant that living standards have fallen further below those in several comparator countries. The OECD data in the chart shows that disposable household income per head in the UK in 2010 was 90 per cent of the level in Germany and 95 per cent of the level in France. By 2021, these figures had fallen to 81 per cent and 91 per cent respectively.

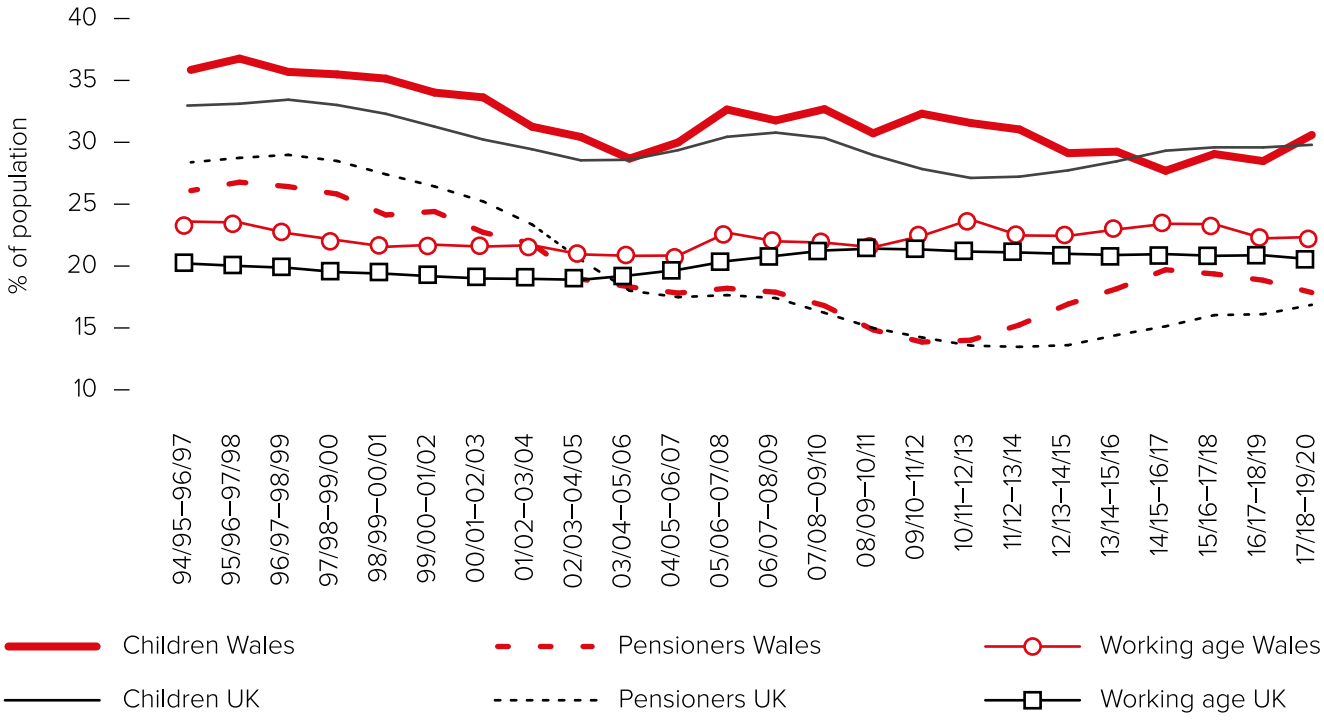
13 The ONS most recent comparison of UK living standards on the basis of AIC was for the year 2020: **Actual individual consumption per head in the UK - Office for National Statistics**
14 **Household accounts - Household disposable income - OECD Data**

Poverty

Alongside trends in the average level of income, trends in the distribution of income are central to the assessment of changes in the level of material well-being.

Chart 11 shows trends in relative poverty[15] (after allowing for housing costs) in Wales and the UK. Unfortunately, owing to data collection problems attributable to the pandemic, the most recent published data is for the three-year period 2017–18 to 2019–20.

Chart 11: Relative poverty Wales and UK, after housing costs (% of population)



Source: DWP

The chart does not show sustained trend changes in poverty rates in Wales over the last decade or so (although there are some indications of a recent increase in child poverty), following a decade in which poverty fell.

The latest available data shows poverty rates that are currently higher for children, and lower for pensioners, when compared with working age adults. It also shows that poverty rates in Wales are mostly quite close to the UK average.

The highest poverty rates in the UK are generally in London, with several other UK regions also having higher rates than Wales, depending on the age group under consideration.

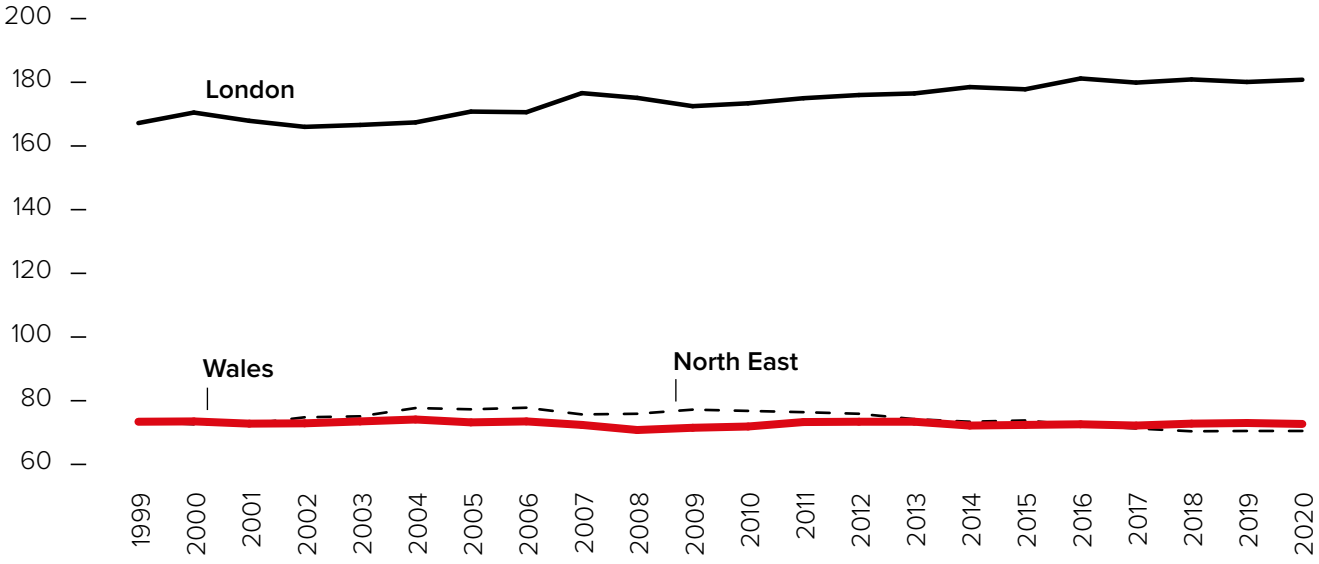
Forecasts by the IFS, the Resolution Foundation and others suggest that changes to the welfare system put in place by the UK Government are likely to lead to increasing poverty levels over coming years.

15 Relative poverty is defined as income below 60 per cent of that received by the median UK household. So poverty would increase if incomes received by households in the lower part of the distribution increased but the increase was less than received by median household. And poverty could fall even if incomes reduced in the lower part of the distribution, provided this reduction was less than that received by the median household.

Trend in GDP/GVA

Despite their limitations as a measure of living standards, and still more of well-being, GDP and GVA[16] remain important as key indicators of the underlying strength of the economy in Wales and therefore of the tax base. The key driver of GDP/GVA over the long run is productivity growth, and it is this which in turn supports higher pay, higher tax revenues and higher overall living standards. Welsh productivity performance is discussed further below. Welsh relative performance on GVA per head in comparison with other UK countries and regions is shown in Chart 12.

Chart 12: GVA per head, UK = 100



Source: ONS

The most recent data for GVA is for 2020, when GVA per head in Wales was 72.7 per cent of the figure for the UK as whole – the second lowest of all UK countries and regions.

Over the last few years, GVA per head in Wales has risen above that in the North-east of England, a reversal of the previous position, when Wales had for many years the lowest GVA per head of all UK countries and regions.

Welsh performance on GVA per head is negatively affected by the presence of net out-commuting (which does not contribute to Welsh GDP but does contribute to Welsh incomes) and by the age structure of the population, with a relatively high share of older people who are less likely to be in work.

London's performance on GVA is a clear outlier, reflecting in part the effect of in-commuting, which adds to London's GVA but not its population. London has improved its relative position over the last twenty years, and as an arithmetic consequence, the relative position of most other UK countries and regions has worsened.

However, Wales's performance on GVA per head relative to the UK shows little trend in recent years, though it remains somewhat lower than in the period up to the financial crisis of 2008.

16 GDP differs from GVA only through the inclusion of certain taxes and subsidies. Welsh relative performance levels and trends for GDP and GVA are very similar, and the concepts can be regarded as interchangeable for current purposes.

Spatial variation in incomes and living standards

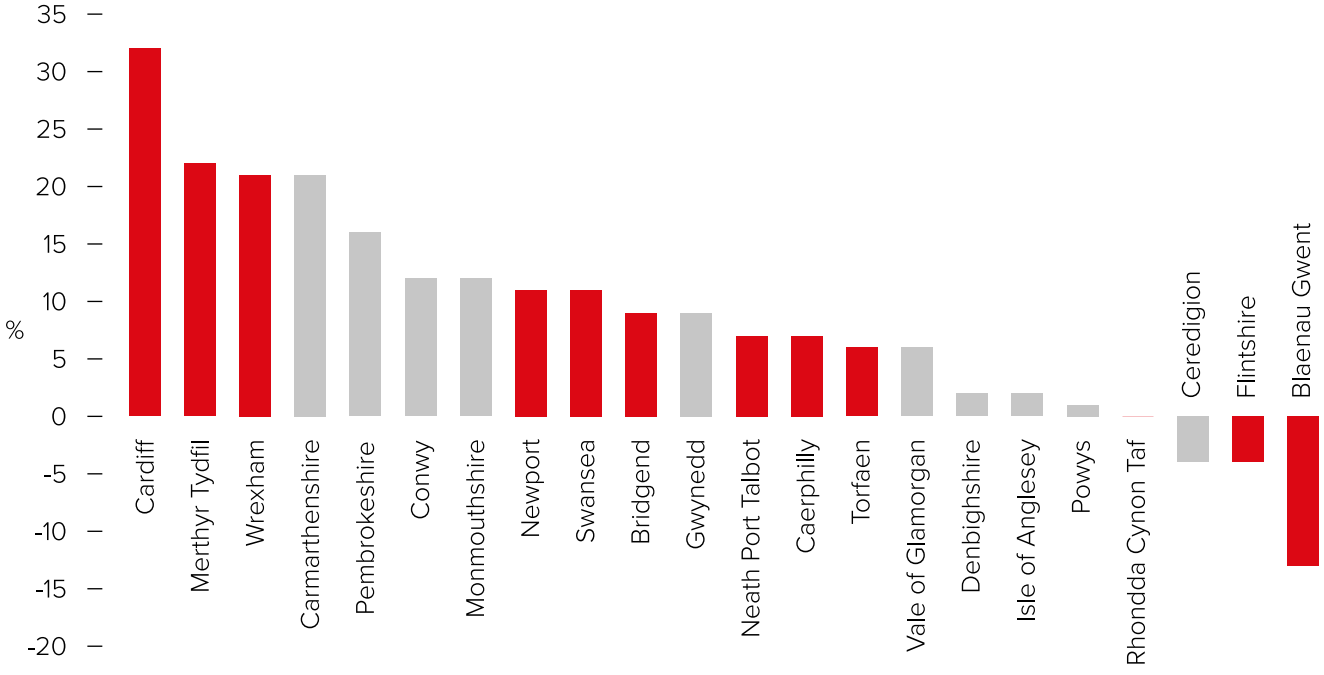
Income levels and living standards of course vary across Wales. As discussed above, the difference in incomes between people and households is much greater than the average difference across areas. And as shown in last year's report, and contrary to some presumptions, on most indicators, the spatial variation in economic outcomes across Wales has been tending to decrease in recent years, rather than the reverse.

Caution is needed in interpreting GDP/GVA per head at the local level, as the figures are heavily influenced by commuting patterns and may not therefore reflect local living standards. Some areas, particularly in the more rural parts of Wales, which have below average GVA per head have incomes levels that are above average.

While local authority areas have, if anything, converged over time in terms of incomes per person and employment rates, these indicators do not necessarily reflect the relative strength of local economies. Local economies can grow more quickly or more slowly without this necessarily translating into effects on the average resident, as the growth can be reflected in changes in commuting and/or migration.

The differential economic growth of Welsh local authority areas is illustrated by the data in Chart 13, which shows changes in the number of jobs in each area. Data for period after 2019 has not been included as it has been affected by the pandemic in ways that may obscure underlying trends.

Chart 13: Change in total jobs 2002–04 to 2017–19 (%)



Source: Welsh Government
Note: Local authority areas with a large rural element shown in grey.

Chart 13 shows that, while the largest growth in jobs has been in Cardiff, beyond this there is no clear geographical pattern across Wales.

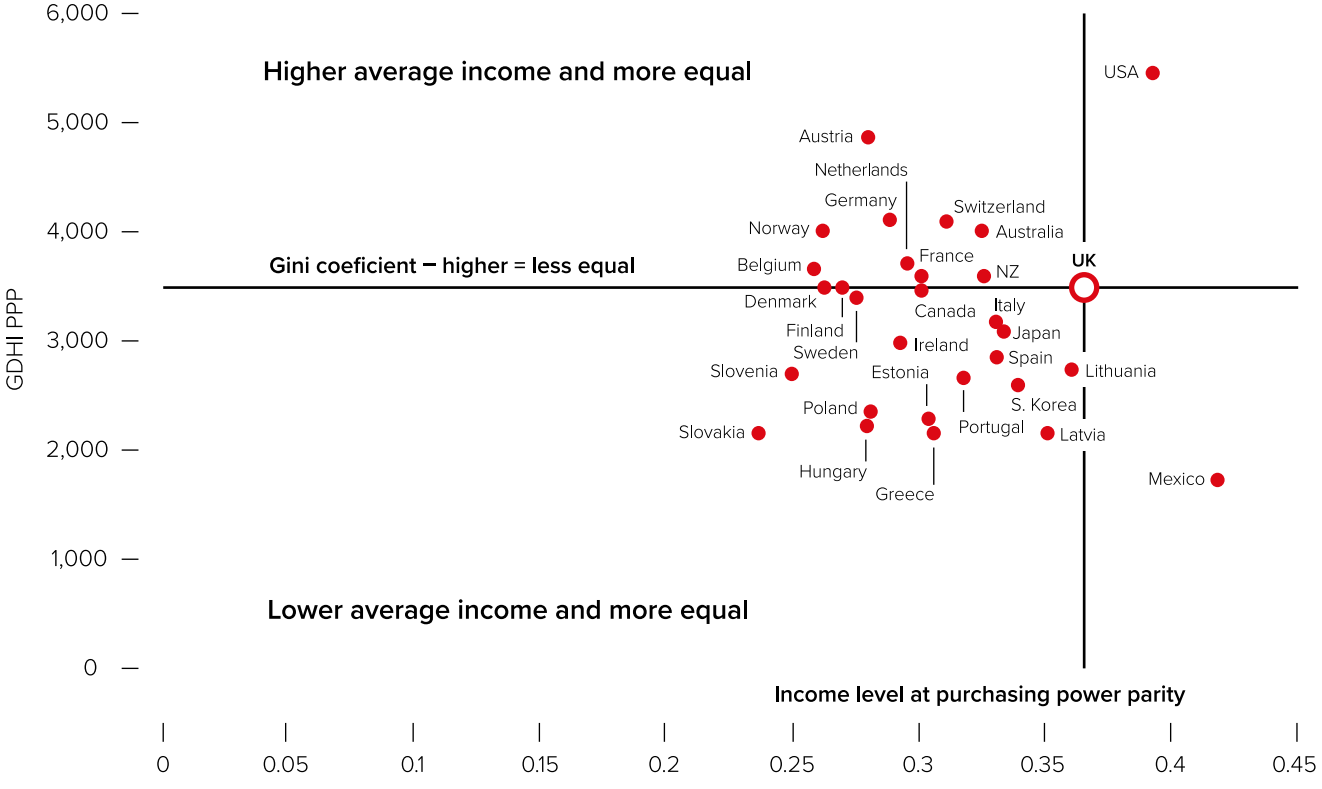
Longer term challenges and opportunities

UK context

The UK Government has laid much emphasis on the need to improve the underlying growth performance of the UK economy, with the distribution of income being accorded less priority.

However, international comparisons show scope for UK to be both more equal and more affluent. See chart 14.

Chart 14: Average income and inequality by country, 2019



Source: OECD

The chart shows that only two major OECD countries, the USA and Mexico, have a more unequal distribution of income than the UK. While the USA does have a higher level of average income than the UK, many other developed countries have managed both to grow more than the UK, resulting in a higher level of average income, and are more equal.

Analysis by the OECD suggests that the key factors in the UK's poor performance on income inequality are that:

- market incomes – incomes before taxes and benefits – are highly unequal
- the level of cash redistribution in the UK is relatively low[17].

Nevertheless, and as previously noted, redistribution under the UK fiscal system is the key reason why the gap between Wales and the UK is much smaller when the comparison is made based on household incomes than when it is based on GDP/GVA per head. This redistribution is reflected in Wales's large negative fiscal balance (see below).

The policy of the UK Government towards income redistribution is therefore a crucial factor influencing Welsh living standards.

Welsh labour market over the longer term

While the latest data has shown some signs of weakness, the longer run trends for employment in Wales have been positive. As previously noted, the gap in employment rates between Wales and the UK, driven by inactivity more than unemployment, have closed markedly since the period before devolution. In the 1990s the gap was typically five to six percentage points. In recent years the gap has generally been closer to two percent, with unemployment in Wales similar to, and sometimes below, that for the UK during much of the recent past.

Of course, as across the rest of the UK, employment rates remain low for disadvantaged groups, particularly those with low levels of qualification, disabled people, people with longer ill health, and certain minority groups.

It is to be hoped that recent weakness in the labour market, and particularly the increases in inactivity, in both Wales and the UK, are a temporary consequence of recent economic circumstances.

However, the longer-term adverse effects of EU exit identified by the OBR are likely to be felt particularly in Wales, with its' higher-than-average dependence on manufacturing and exposure to EU markets.

In addition, previous analysis by the IFS[18] indicated that, within Wales it is – unsurprisingly – those areas that are most dependent on manufacturing that are at greatest risk.

There are also concerns about the consequences for the future labour market outcomes facing young people that may result from the disruption to their education that occurred during the pandemic. By their nature, these potential scars may take a long time to appear in lower incomes and employment. The risk is that this will result in a further widening of inequalities over the long term.

The pandemic has of course accelerated the trend to "remote" economic activity, particularly remote working, and this is discussed further below.

17 See for example: **Income redistribution | Government at a Glance 2021 | OECD iLibrary (oecd-ilibrary.org)**
18 **Brexit and labour market inequalities: potential spatial and occupational impacts - Institute For Fiscal Studies - IFS**

Productivity in Wales

Productivity – the amount of output produced for each hour worked – is the main driver of living standards over the long run. Increases in real wages can only be sustained if they result from improved productivity.

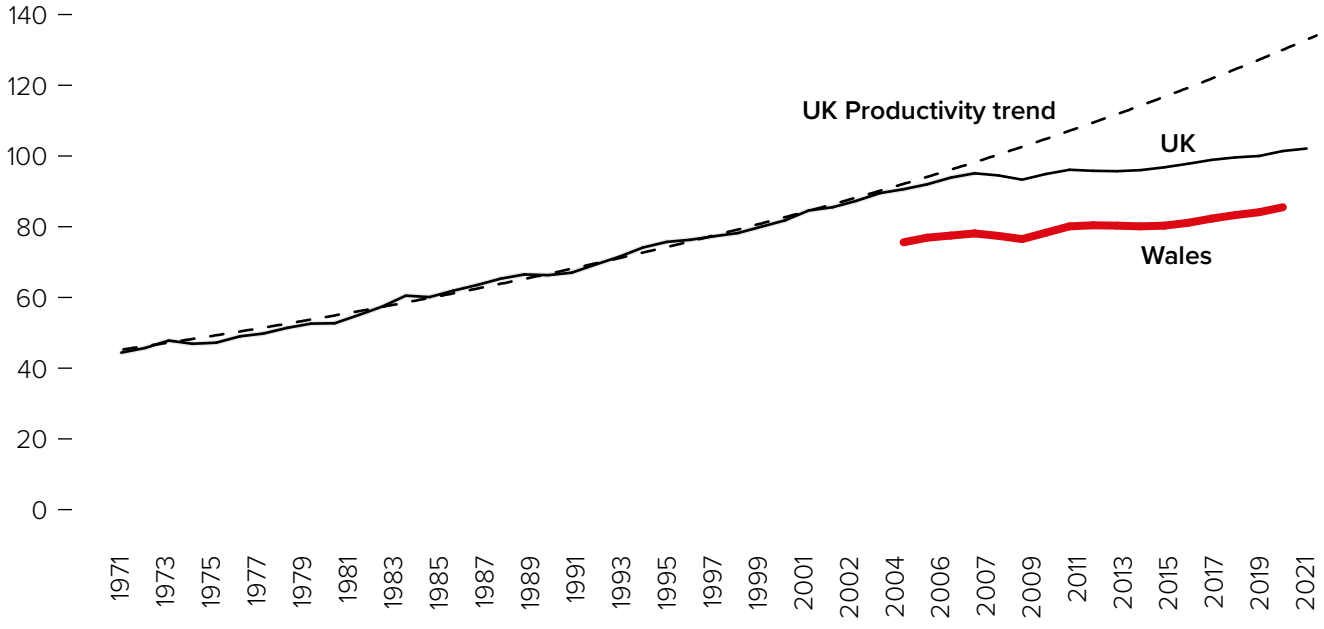
In turn, productivity improvements are driven mainly by innovation, defined in a broad way – the development of new or better goods and services and increases in the efficiency with which goods and services are produced[19]. In many areas, it is the speed and effectiveness of the absorption and application of innovations developed elsewhere that is crucial, rather than the process of invention.

In principle, increasing productivity allows higher living standards without any increase in the use of inputs or pollution, or in the consumption of natural resources. In practice the extent to which pollution occurs and nature resources are consumed will depend on the policies put in place to limit such effects.

Productivity is also a key driver of the size of the tax base and hence of the level of resources available for funding public services.

Prior to a time around the financial crisis of 2008, productivity across the UK, including Wales, grew by a little over two per cent each year on average. Since then, the rate of productivity growth has fallen, averaging well under one per cent per year – see Chart 15.

Chart 15: Labour productivity (output per hour worked, 2019=100)



Source: ONS and Welsh Government

19 The factors driving productivity and innovation in the UK context are reviewed here **LSEGC-2017-report.pdf**, **Stagnation nation - The Inquiry (resolutionfoundation.org)**, and **Productivity-in-the-UK-Evidence-Review.pdf (niesr.ac.uk)**

The rate of increase in productivity prior to the time around the financial crisis supported a doubling of real incomes over the 40 years from the mid-1970s. If that rate of productivity growth had continued it could have generated real incomes around 30 per cent higher than currently experienced and provided the resources to support more and better public services.

The reasons for the relatively poor rate of productivity growth experienced by the UK (including Wales) since around 2008 are only partially understood. It is a feature that has been shared by many other developed countries, albeit generally to a lesser extent than the UK.

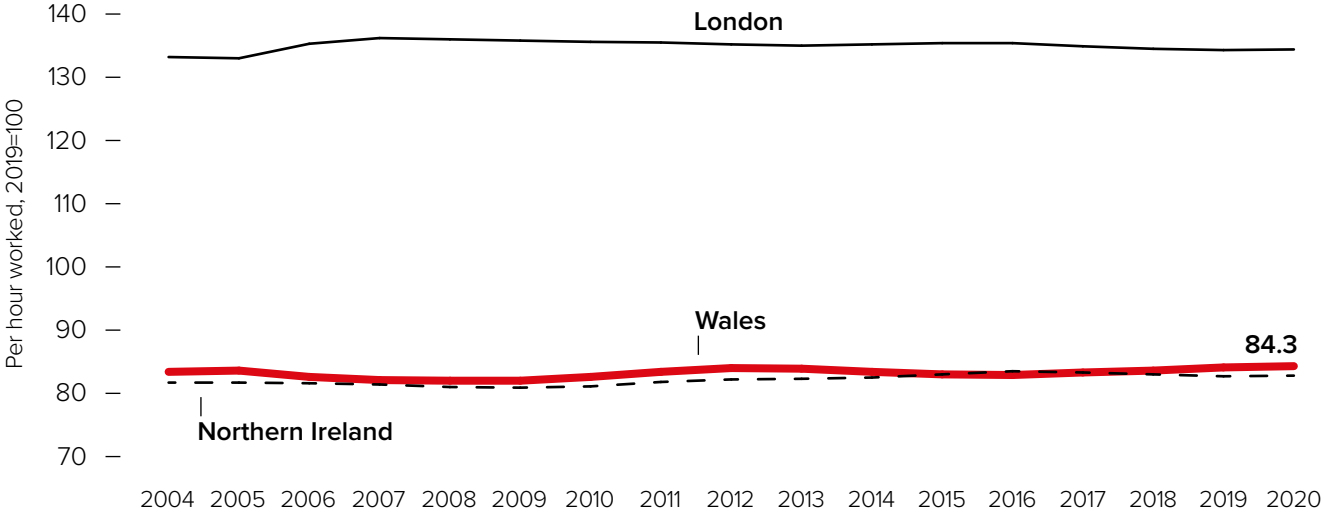
One potential explanation for the experience that is shared across countries is that the rate of innovation may have slowed. Another, more hopeful, possibility is that a range of new technologies are in the process of being adopted, but with a "penalty" that reflects transitional costs and frictions and is therefore temporary.

However, as just noted, over recent years the UK's productivity performance has been particularly poor. One factor that may have played a role the low level of business investment in the UK. This long-term problem may have been exacerbated over the last decade, first by the presence of a large financial sector suffering from a "hangover" from the financial crisis, then by the imposition of stringent "austerity" measures by the UK Government and finally by the uncertainty associated with both the EU referendum and the transition to a new trading relationship with the EU.

Until recently, a relatively low level of research and development (R&D) in the UK had been identified as potential explanation of the UK's weak productivity performance. However, the ONS has made very large upward revisions to its estimates of R&D spending, such that the UK now appears to have a level of spending which is close to the average for the OECD.

Levels of productivity in Wales are relatively low, even in the UK context: amongst UK countries and regions: hourly labour productivity is only lower in Northern Ireland (see Chart 16).

Chart 16: Labour productivity: GVA per hour worked (UK=100)



Source: ONS

In contrast to Wales's – broadly – good performance on employment, the gap in labour productivity between Wales and the UK is little changed since the time of devolution. However, the gap widened in the years prior to around 2008 but has narrowed since. Progress in the most recent few years for which data is available has been reasonably encouraging.

Many of the factors explaining the relatively weak Welsh labour productivity performance are reasonably well understood and have been discussed in previous reports.

First, low Welsh labour productivity levels are not explained by the mix of industries in Wales. Furthermore, labour productivity in manufacturing, which accounts for a larger share of the economy in Wales than the rest of the UK, compares reasonably well. Hence the deficiency lies mainly in the (much larger) service sector.

Research indicates that, in general, skills and qualification are by far the most important drivers of productivity. The Welsh workforce has qualification levels that, while similar to (or even a little above) those in parts of England are below those for southern England and Scotland.

Wales has probably also experienced some productivity penalty from its dispersed settlement pattern, and particularly from the absence of a very large and dynamic conurbation (such as Manchester). Such conurbations can support jobs with high productivity and pay, especially in the tradeable service sector.

Research by the OECD shows that a successful tradeable services sector in turn provides a strong basis to support businesses providing locally consumed services.

Parts of Wales are also hampered by their relative peripherality and consequent limited connectivity.

There may also be issues arising from a lack of indigenous large firms; from weak management skills; and, perhaps from limitations in the access to finance.

Labour productivity is only a partial measure of productivity as it does not take account of the level of capital employed and can therefore be a misleading indicator of the relative efficiency with which inputs are used. Total factor productivity (TFP) by contrast assesses productivity by considering all inputs. However, measuring TFP is challenging, and official estimates have only recently become available at the sub-UK level.

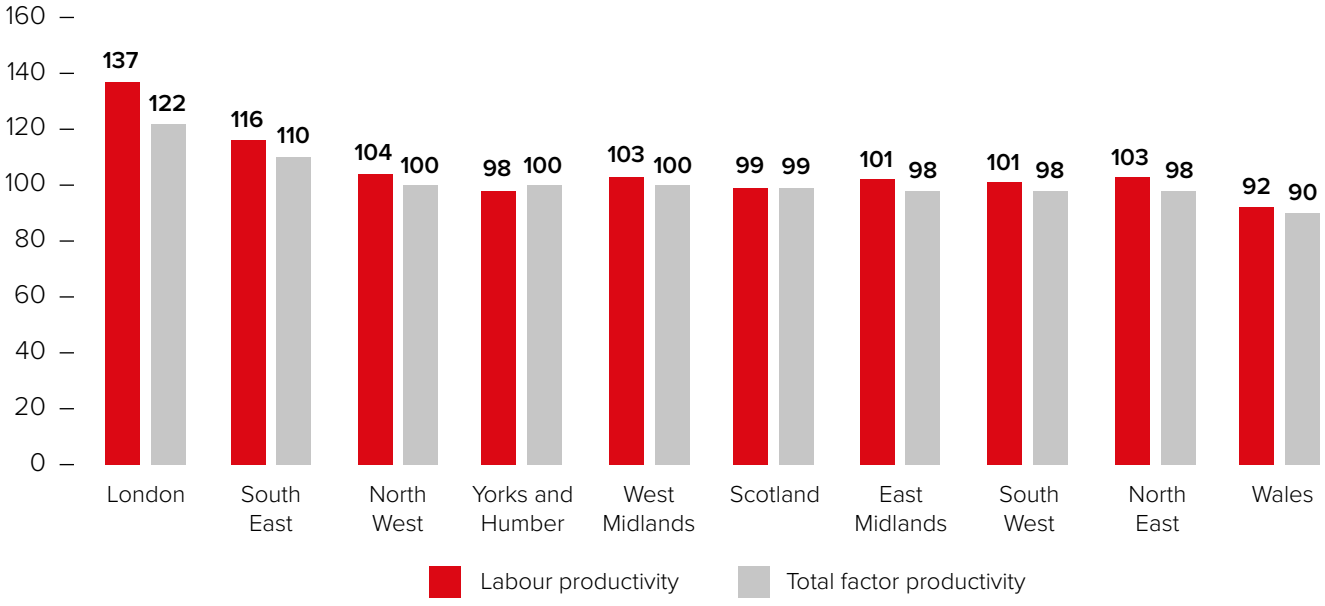
In August 2022 ONS released experimental statistics which cover both labour productivity and total factor productivity[20]. The ONS has also performed statistical analysis to explore how far various factors explain differences in productivity across business establishments. These factors are those that have been identified in previous research as being associated with higher productivity, and include being foreign owned, being an international trader, being located in the Greater South-east of England, using IT more intensively and using advertising and market research services more intensively.

The ONS analysis confirmed that all these factors are correlated with higher labour productivity, although the relationships with TFP were generally weaker and in some cases absent.

Even after adjusting for differences in the factors associated with productivity at the GB level, both labour productivity and TFP were found to be lower in Wales than in other GB countries and regions – and the gaps were both quite large and similar for labour productivity and TFP. See Chart 17.

20 **Estimates of total factor productivity from the Annual Business Survey, Great Britain: 1998 to 2019 - Office for National Statistics (ons.gov.uk)**

Chart 17: Labour Productivity and Total Factor Productivity (2003 – 2019), UK =100



Source: ONS

The chart shows the average results from different elements within the analysis undertaken by the ONS and should be treated as illustrative rather than definitive.

Recent academic research[21] has confirmed the finding of relatively weak Welsh TFP performance and has also confirmed the ONS finding that a significant residual gap remains even after adjusting for differences in the plant-level factors that prior research indicates influence productivity (again including plant size and age, ownership structure and engagement in international trade). This may suggest that the more "structural" factors, such as agglomeration, accessibility, and perhaps skill levels, are important in explaining the Welsh productivity gap.

Remote working

As discussed in last year's report, the pandemic has accelerated the trend to "remote" economic activity, particularly remote working, with many employers stating that they intend to move permanently to a model of hybrid working.

The scale of the lasting change is currently unclear, but the effects could be profound.

Increases in remote working may bring opportunities for people with valuable skills who, for reasons perhaps of disability or geographic remoteness, were not in employment pre-pandemic. It may help to attract people to, and retain people in, areas that have struggled to create jobs.

An increase in remote working could also risk widening inequalities. On the one hand, there may be a loss of employment for lower paid people in locally consumed services and, on the other hand, gains in the well-being of people working remotely may accrue to people who are typically in better paid jobs.

New research indicates that a shift is underway, with some economic activity, and jobs, in sectors providing services to employees reducing in dense urban areas and increasing in some suburban areas[22].

21 **The geographical dimension of productivity in Great Britain, 2011–18: the sources of the London prod (tandfonline.com)**
22 **Remote working and the new geography of local service spending | CEPR**

Implications for housing demand, commercial property (including offices) and transport use are not yet clear, although international evidence suggests there have already been some negative effects on the value of office property[23].

Welsh demography

The size and structure of the Welsh population has important economic and fiscal implications.

There is some, but not wholly conclusive, evidence that an aging of the population is associated with slower growth in productivity. A larger share of older people will place greater burdens, and impose higher costs, on some public services. And an aging population will also affect the tax base, with impacts depending on how labour market participation and income levels vary with age.

In Wales, population determines the annual allocation of additional funds to the Welsh Government block grant under the Barnett formula. Lower relative Welsh population growth will result in lower levels of additional resources than otherwise. At the same time, lower population growth will result in lower levels of demand for some public services. And, as the "base" of the block grant is rolled over from the previous year, the smaller the population the greater the level of spending per head. This population effect on relative funding tends to counteract the impact of the Barnett squeeze. The latter occurs because the rate of growth generated by the Barnett formula is lower than for comparable spending in England.

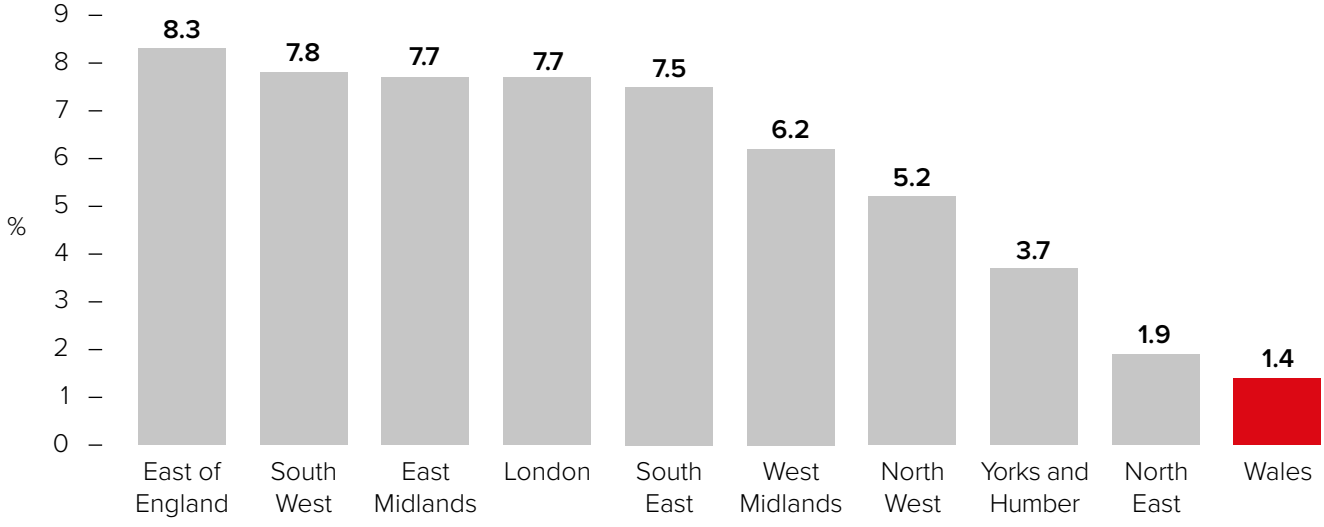
In addition, the size of the Welsh population will influence the level of revenues generated by devolved Welsh taxes.

More broadly, reductions in the numbers, and/or share, of younger age groups could affect the vitality, and perhaps the even economic viability, of areas that are particularly affected, with the potential for a downward spiral if places come to be perceived as unattractive as residential locations.

The recently released population data from the 2021 Census provides additional insights into recent Welsh demographic trends and prospects.

These data showed that over the previous ten years, population growth in Wales had been smaller than in any English region. See chart 18.

Chart 18: Population change 2011 to 2021, %



Source: Census

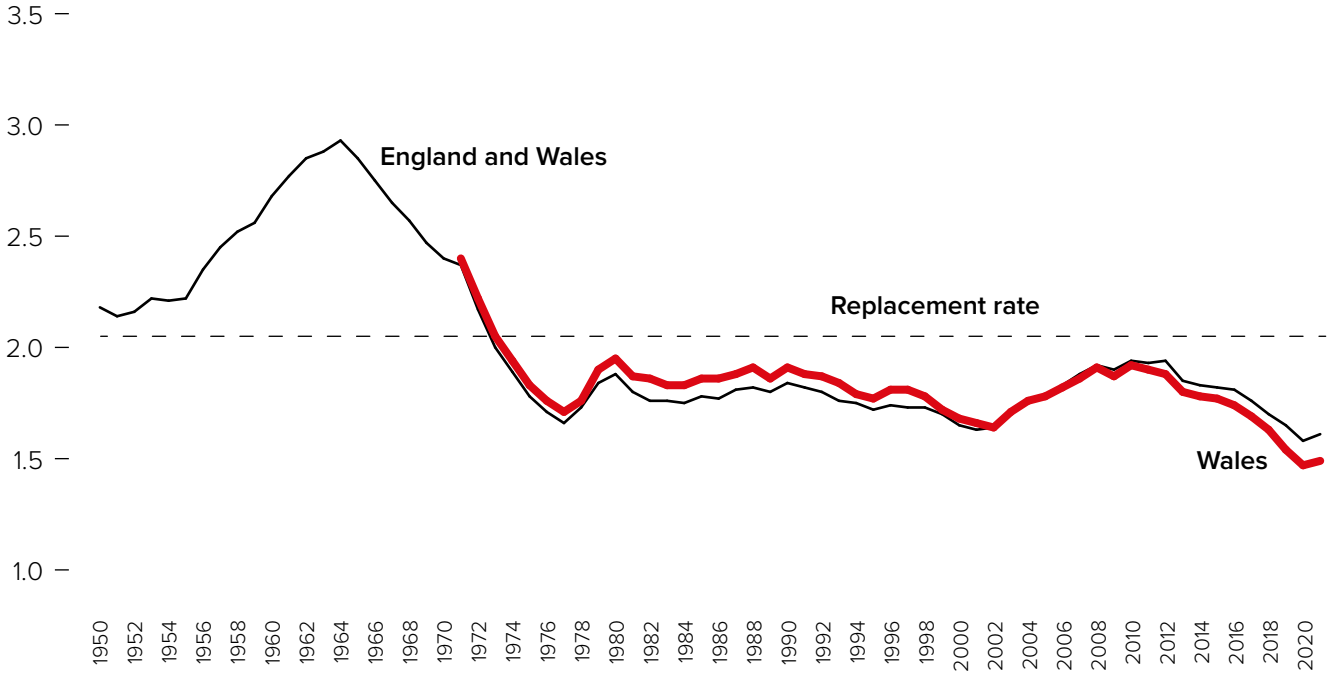
23 See for example: **Working from home and corporate real estate | CEPR**

The Census confirmed that Wales has a higher share of the population aged 65 and over than any other UK country or region, apart from the South-west of England.

In Wales, as in other UK countries and regions, the share of the population aged 65 and over has increased since the previous Census in 2011. Over the same time period, the share of the population aged 16–64 has fallen in Wales, as it has across the UK as a whole.

As in many other developed countries, the fertility rate in Wales has been well below the replacement rate for many years – and over recent years has been below that for England. See Chart 19.

Chart 19: Fertility rate



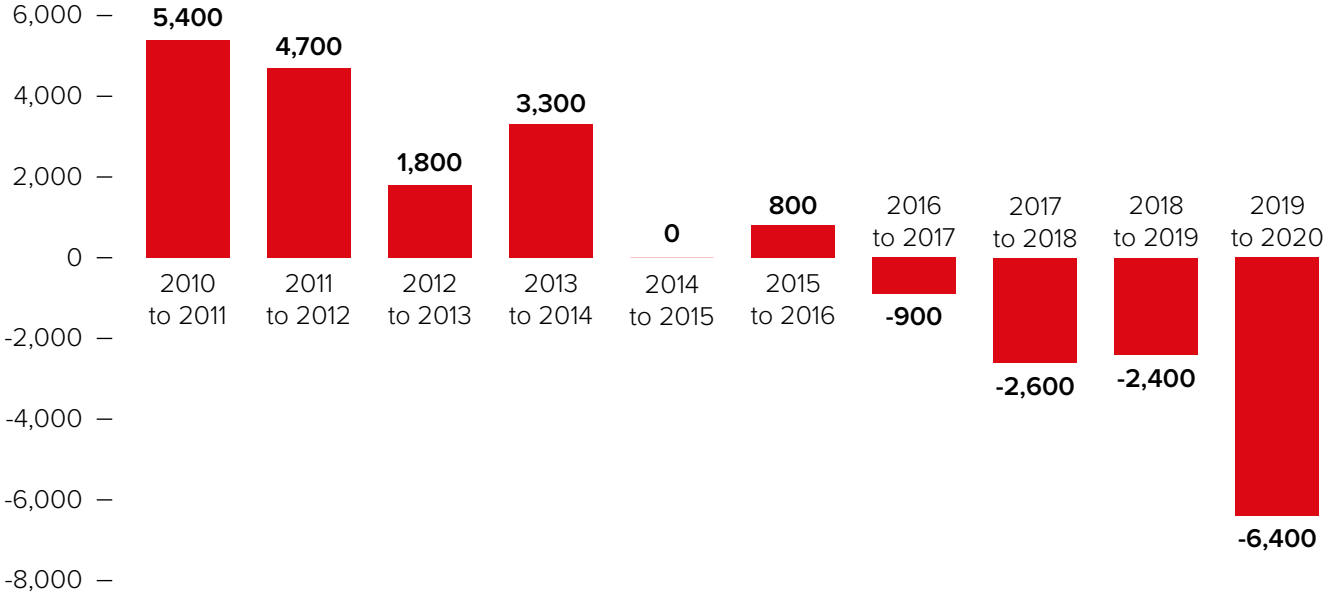
Source: ONS

Over the long run, there has been a large increase in life expectancy in Wales, although the rate of improvement has greatly reduced over the last decade.

This pattern is also observed across the rest of the UK, and most other developed countries, although the extent of the recent levelling off may be particularly marked in the UK.

The overall size of the population in Wales reflects the balance of fertility, mortality, and migration. Over the recent past, the number of births in Wales has been lower than the number of deaths, and there may be some trend developing – see chart 20.

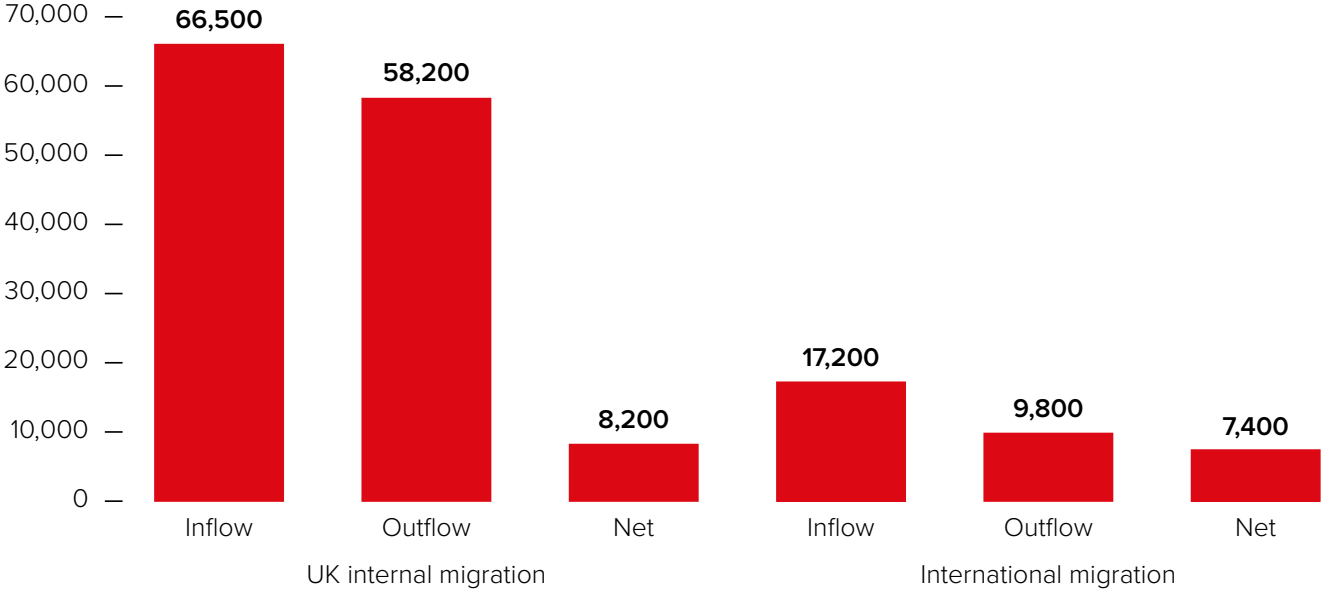
Chart 20: Excess of births over deaths, Wales



Source: ONS Mid-year population estimates.
Note: Rounded numbers.

Also, over recent years, net migration (from both other parts of the UK and other countries) has been positive, more than offsetting natural population decline and thereby resulting in an overall increase in the Welsh population. See chart 21.

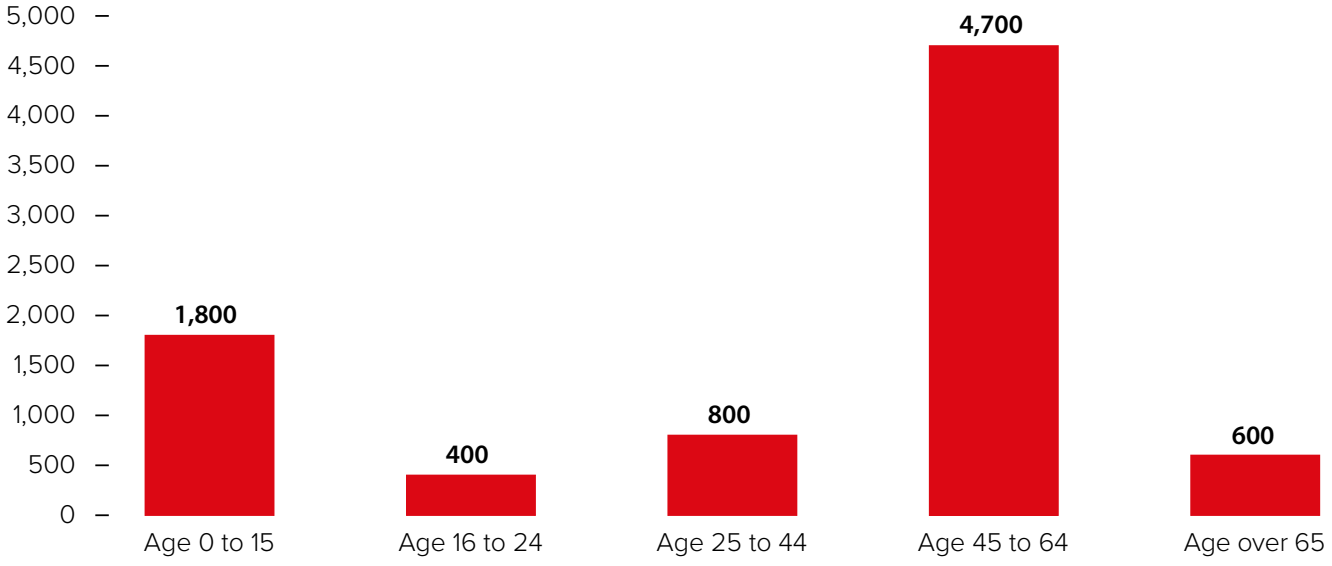
Chart 21: Welsh net migration, annual average, 2015/16-2019/20



Source: ONS Migration statistics.
Note: Rounded numbers.

An age breakdown of migrants is only available for internal migration. Chart 22 shows that over recent years Wales has gained population in both younger and older age groups from migration between Wales and the rest of the UK.

Chart 22: Welsh net internal migration by age group



Source: ONS Migration Statistics
Note: Rounded numbers.
Positive figure for age 16-24 is driven by high in-migration for the single year 2019/20. For most other recent years net migration for this age group has been a small negative figure.

Population projections are inherently uncertain, and for Wales will be very sensitive to assumptions about future migration patterns, which are unpredictable. However, if fertility rates remain similar to current levels, a failure to maintain in-migration levels will inevitably result in long run population decline.

The latest official population projections are based on population estimates for 2020. Census results have since been released which show that the 2020 estimates were significantly above the actual numbers as revealed by the census. The absolute numbers set out in the projections are therefore subject to some doubt. However, the projections remain useful in providing an indication of the potential change in population composition.

Broadly, the projections indicate that, over the period to 2040, there will be a growing share of older age groups, a gradual decline in the age group aged 16–64, and a sharper decline in those aged 0–15.

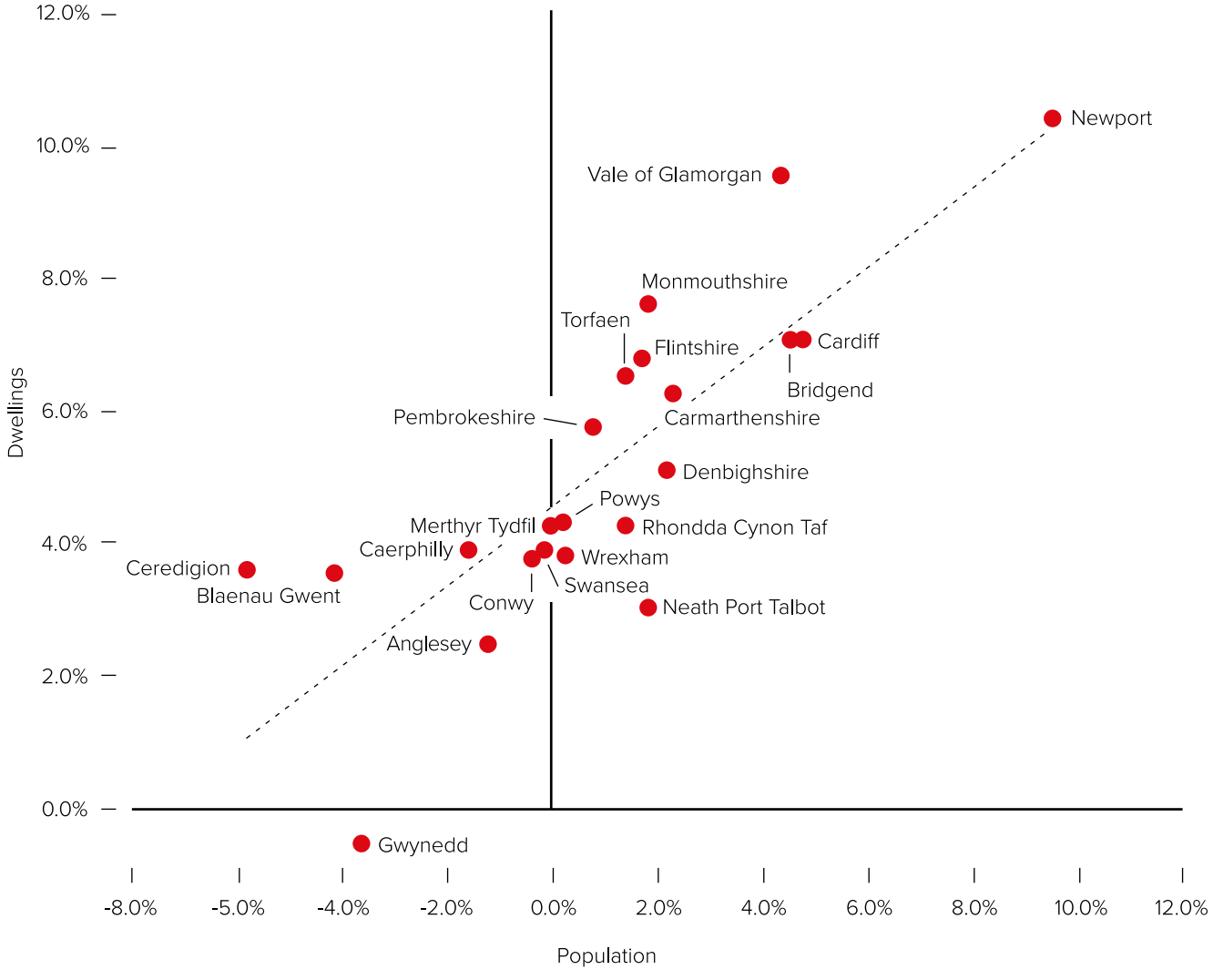
These trends are similar to those projected for other parts of the UK, albeit from a base in which Wales has a higher share of older people than most other parts of the UK.

Comparisons of data from the most recent census with the previous census results in 2011 show marked differences in the rate of population change across Wales.

Between 2011 and 2021, population decreased in north-west Wales – in the local authority areas of Gwynedd, Anglesey, Conwy and Ceredigion. It has also deceased in Blaenau Gwent, Caerphilly and Swansea. Population was little changed in Merthyr, Powys and Wrexham. Population increased in other local authority areas, and particularly those that are more "accessible", including towards the eastern end of the M4 corridor in Wales, and especially Newport.

Chart 23 shows that, unsurprisingly, population change is associated with the rate of new dwelling construction. While the direction of causation is unclear, and probably runs both ways, the data does offer some support to the view that constructing dwellings can itself promote population growth, at least when this construction takes place in areas with high demand.

Chart 23: Population change and dwelling number increase, 2011 to 2021



Source: Census 2021 and Welsh Government calculations.

While future population trends are, as noted, inevitably uncertain, it does appear reasonable to draw some tentative conclusions:

- There is a real possibility of sustained population decline, particularly for the working age population and for children, with an associated risk to prosperity and the tax base.
- The elderly will account for an increasing share of the population.
- There will be an increasing reliance on in-migration to maintain population – but as many other countries will also have declining populations, and perhaps increasing levels of affluence, migration rates may fall.
- Population movements within the UK may be affected by the increasing prevalence of "remote" economic activity and the associated impacts (e.g., on property prices), but in ways currently hard to assess.

The broader implications of such changes are also hard to assess. One benefit could be a reduction in the environmental pressures associated with population. Other implications could include:

- Increasing cost pressures in the public sector. This may be particularly relevant in social care as, evidence suggests health costs more related to last period of life, rather than chronological age, and that health costs are driven more by other factors than demography. It is also not clear that Wales faces high fiscal risks from an aging population than other parts of the UK. While Wales does already have a higher share of older people in its population than the UK, the projected changes in share as the population ages into the future are similar.
- The changing patterns of demand for goods and services associated with aging will affect patterns of employment. (This may particularly impact on some public services, of course, but also on privately provided care services and leisure activities.)
- Demand for some aspects of the education system will change and probably reduce, but lifelong learning may become increasingly important.
- There are potential consequences from population decline in more rural areas for the use of the Welsh language.
- Issues that arise from changing population levels may be particularly concentrated in some local authority areas.
- Family friendly employment policies, childcare provision, and older worker policies are all likely to attract a higher priority.

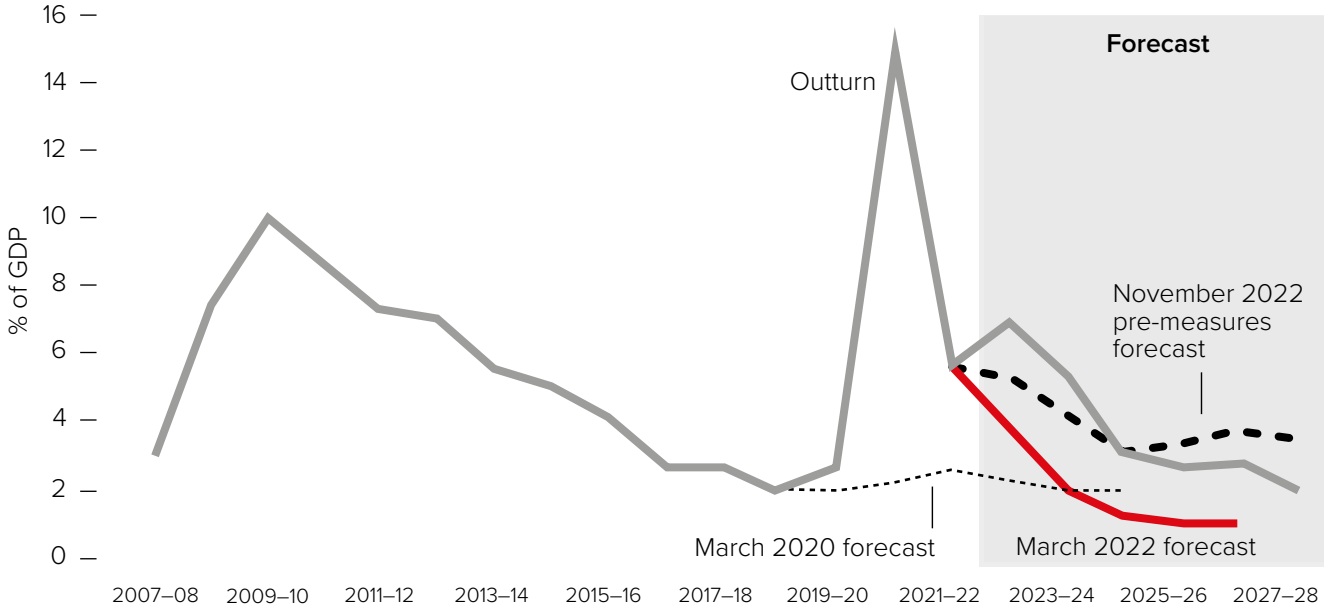
The increasing reliance on in-migration, and the importance of policies that help in attracting and retaining "appropriate" migrants, may have implications for housing policy, and for other policy areas including transport.

Fiscal prospects

UK – Short term fiscal prospects

The OBR's November 2022 forecast for public sector net borrowing is shown in Chart 24.

Chart 24: Forecast for Public Sector Net Borrowing



Source: OBR

The OBR notes that the UK's medium-term fiscal outlook has materially worsened since the March forecast due to a weaker economy, higher interest rates, and higher inflation. Based on policy as it stood in March, government borrowing would have been £108 billion (3.7 per cent of GDP) in 2027–28 and underlying debt would have been rising in every year. Almost two-thirds of the increase in the deficit in 2026–27 would have been due to higher debt interest costs from higher interest rates, with the energy-shock-driven loss of receipts and the inflation-driven rise in welfare spending the other major factors.

The net effect of the new measures set out in the UK Government's Autumn Statement is to increase borrowing relative to the OBR's March forecast by around £64 billion in 2022–23 and £40 billion in 2023–24, reducing the fall in output when the economy is in recession and unemployment rising. Policy decisions, if put into effect by a future UK Government, would then reduce borrowing from 2024–25 onwards – when the economy is recovering and unemployment falling.

Taking forecast and policy changes together, the deficit would rise from 5.7 per cent of GDP in 2021–22 to 7.1 per cent of GDP in 2022–23.

Under the UK Government's plans, borrowing would then fall in 2023–24 to 5.5 per cent of GDP, thanks to previously announced tax rises and scaled-back fiscal support and would continue falling to 2.4 per cent of GDP in 2027–28. The tax burden would rise from 33.1 per cent of GDP in 2019–20 to 37.1 per cent of GDP in 2027-28, 1.0 percentage point higher than forecast in March and its highest sustained level since the Second World War.

Despite very small increases in departmental budgets over the next five years and cuts relative to the figures published in March, total public spending would also rise – from 39.3 per cent of GDP in 2019–20 to 43.4 per cent of GDP in 2027–28 – 2.9 percentage points higher than the OBR predicted in March. This reflects higher debt interest and welfare spending raising cash spending, and the energy-shock-driven smaller economy.

Higher borrowing would push underlying debt (excluding the Bank of England) up sharply, from 84.3 per cent of GDP last year to a 63-year high of 97.6 per cent in 2025–26. Tax rises, spending cuts and a pick-up in GDP growth would then be sufficient for it to fall modestly in 2026–27 and 2027–28.

However, this forecast presumes that a future UK government carries forward the tax rises and very tight spending plans that have been "pencilled in" by the current Chancellor for the next spending review period.

The OBR judged that the UK Government's two legislated fiscal targets – to balance the current budget and get underlying debt falling in 2025–26 – were on course to be missed by a large amount. However, the UK Government announced new, replacement targets: to get borrowing below three per cent of GDP and underlying debt falling in five years' time. The OBR's forecast indicates these new targets will be achieved on the basis of the UK Governments plans – but only quite narrowly.

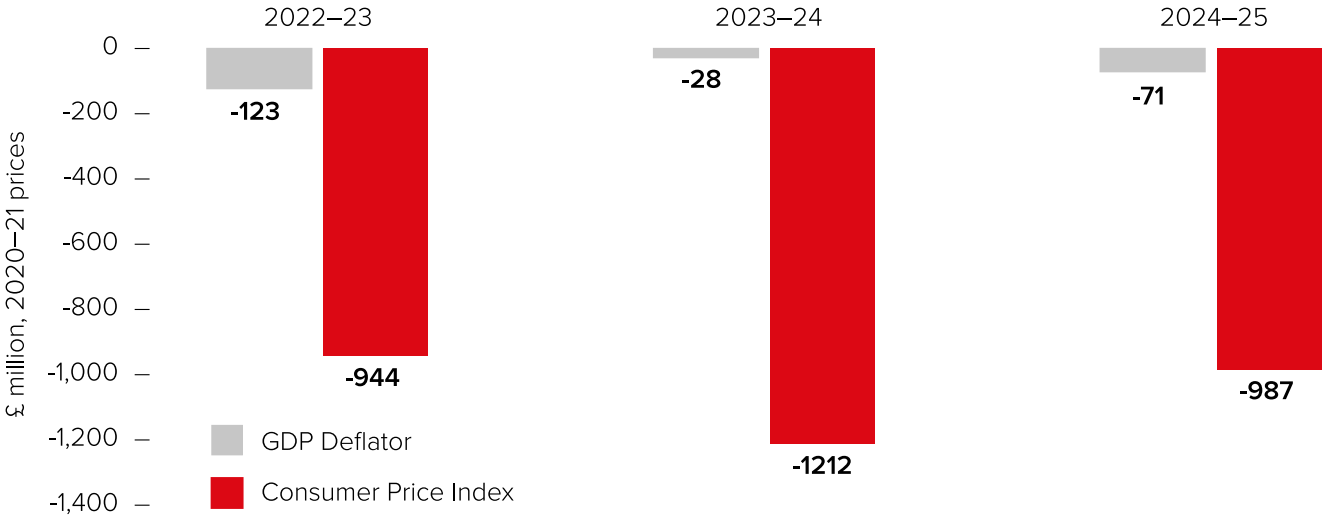
The near tripling of interest rates since March means the share of revenues consumed by debt servicing is expected to rise from under 5 per cent in 2019–20 to 8½ per cent in 2027–28, leaving the public finances more vulnerable to future shocks or swings in market sentiment.

Wales – fiscal prospects over the budget period

The UK Government's Autumn Statement provides some modest additional allocations for the Welsh Government's budget in 2023–24 and 2024–25, over and above the Spending Review settlement. However, because of the inflation shock since last year, even with those additions the Welsh Government's settlement over the 3 years of the spending review period is still worth less in real terms than expected at the time.

The GDP deflator is generally used to account for inflation in analyses of public spending. However, the OBR acknowledges that it may not fully reflect the inflationary shock faced by governments in the UK. The GDP deflator is a broader based measure of price change but does not include changes in the price of imported goods, which are included in the CPI. An alternative assessment is therefore provided by the change in the OBR's CPI inflation forecast since last year. On the basis that the GDP deflator and CPI forecast provide a range, the Welsh Government's settlement over the current spending review period is now worth up to £3bn less than expected last year, and over £1bn less in 2023–24 alone (Chart 25).

Chart 25: Real terms difference in Welsh Government settlement since October 2021 using different inflation measures (£m, 2020–21 prices)

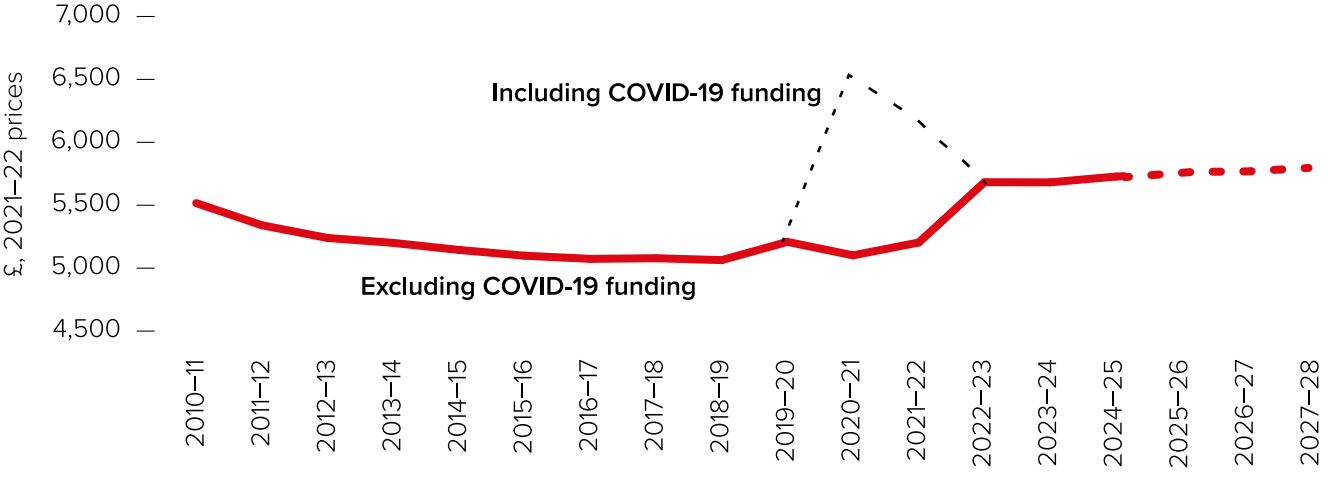


Source: Welsh Government

Having fallen by around 8 per cent in real terms during the last decade, recent increases mean the Welsh Government's budget for day-to-day spending in 2022–23 is around 3 per cent higher per person than in 2010–11, but changes very little over the next two years (Chart 26).

A projection for 2025–26 to 2027–28 is also included in Chart 26, using the assumed growth in overall UK resource DEL from the OBR's November forecast to grow the Welsh Government DEL, together with the devolved tax forecasts from the OBR's Welsh Taxes Outlook published alongside the Welsh Government's draft Budget. This suggests the pattern of low growth will continue. Over the next five years day-to-day spending per person is set to grow by less than 0.5 per cent a year on average in real terms on a like-for-like basis.

Chart 26: Welsh Government Resource Budget in real terms per person (£, 2021–22 prices[24])



Source: Welsh Government

24 Excludes farm funding and IFRS16 changes which are not included in earlier years.

UK – Longer term fiscal prospects

The OBR latest review of the UK's long the run prospects, and the first combined Fiscal Risks and Sustainability Report (FRS), was published in July 2022[25]. As the title suggests, the report reviews the UK's fiscal sustainability over the long run and considers associated risks. The main economic and fiscal projections cover the fifty-year period to 2070–71.

The FRS includes a detailed discussion of two specific fiscal risks: the rise in geopolitical tensions as reflected in the Russian invasion of Ukraine, and the impact of higher energy prices. The report also considers the implications of demographic change for the UK.

The FRS's key conclusion is that UK's fiscal position is unsustainable over the long term without significant tax rises (or reductions in spending obligations).

The OBR concludes that the pandemic (perhaps surprisingly) had little impact on the medium-term fiscal position (with debt marginally higher but the primary balance slightly stronger), thanks in part to the substantial tax rises announced in its wake.

After the report was published, the effect of these rises was partially offset by the tax reductions announced in the September fiscal statement, which were then themselves partially reversed in the Autumn Statement.

The underlying rate of growth is expected to remain much lower than the historical average, at an average of 1.4 per cent over the long run (1.5 per cent underlying productivity growth offset by 0.1 per cent reduction due to a decline in the working age population).

The OBR noted that demographic pressures on the public finances had eased somewhat in the near term thanks to a lower birth rate and slower improvements in life expectancy, reducing age-related spending as a share of GDP. However, lower migration levels result in some offsetting negative fiscal changes.

Overall, in the long run the pressures of an aging population on spending and the loss of existing motoring taxes in a decarbonising economy still leaves public debt on an unsustainable path in the long term, with debt rising as a share of GDP.

The baseline projections show the budget balance worsening progressively over the long term, from a surplus of 0.2 per cent of GDP in 2026–27 to a deficit of 11.2 per cent of GDP in 2071–72. This rise of 11.4 per cent of GDP is equivalent to £287 billion in today's terms. The largest contributions to this rise are: 6.7 per cent of GDP from health spending (thanks to both demographic and non-demographic pressures); 3.0 per cent of GDP from state pensions spending (thanks to demographic pressures and the cost of the triple lock); 1.5 per cent of GDP from the loss of tax revenues (particularly road fuel duties) due to decarbonisation; and 1.1 per cent of GDP from adult social care spending.

In the absence of offsetting policy changes, the baseline projection is for net debt increases from 84 per cent of GDP in 2026-27 to 100 per cent in 2052–53 and then rises rapidly to 267 per cent of GDP by 2071–72.

25 **Fiscal risks and sustainability – July 2022 - Office for Budget Responsibility (obr.uk)**

Bringing debt back to 75 per cent of GDP – the level at which it stabilised in the Government's pre-pandemic March 2020 Budget – would need taxes to rise, spending to fall, or a combination of both, amounting to a 1.5 per cent of GDP additional tightening (£37 billion a year in today's terms) at the beginning of each decade over the next 50 years.

The OBR noted that newly emergent geopolitical and energy challenges add to the wide range of pre-existing risks, any of which could result in even more negative fiscal prospects. These risks include:

- Rising inflation potentially tipping the economy into recession.
- Continued uncertainty about our future trading relationship with the EU.
- A resurgence in COVID cases.
- A changing global climate.
- Rising interest rates.

Factoring in a broad-brush estimate of the asymmetric costs associated with inevitable periodic shocks from these or other causes could push debt up to 100 per cent of GDP by 2047–48 and nearly 320 per cent of GDP in 50 years' time.

Welsh longer-term fiscal prospects

The longer-term projections in Chart 27 use the medium-term outlook illustrated in Chart 26 as a starting point. Three scenarios are then considered for the period from 2027–28 to 2032–33.

Scenario one: OBR "demand-based" spending projections

- Based on the OBR's projections for relevant non-interest, non-benefit spending from the 2022 Fiscal Risks and Sustainability report. UK Government spending relevant to block grant funding grows at around the same rate as GDP for the remainder of this decade and then around 1 per cent a year faster than GDP thereafter. This reflects increased demand from factors such as an ageing population and increases in the real costs of providing health and care. The OBR notes that spending under this scenario would be unsustainable under current taxation policies.

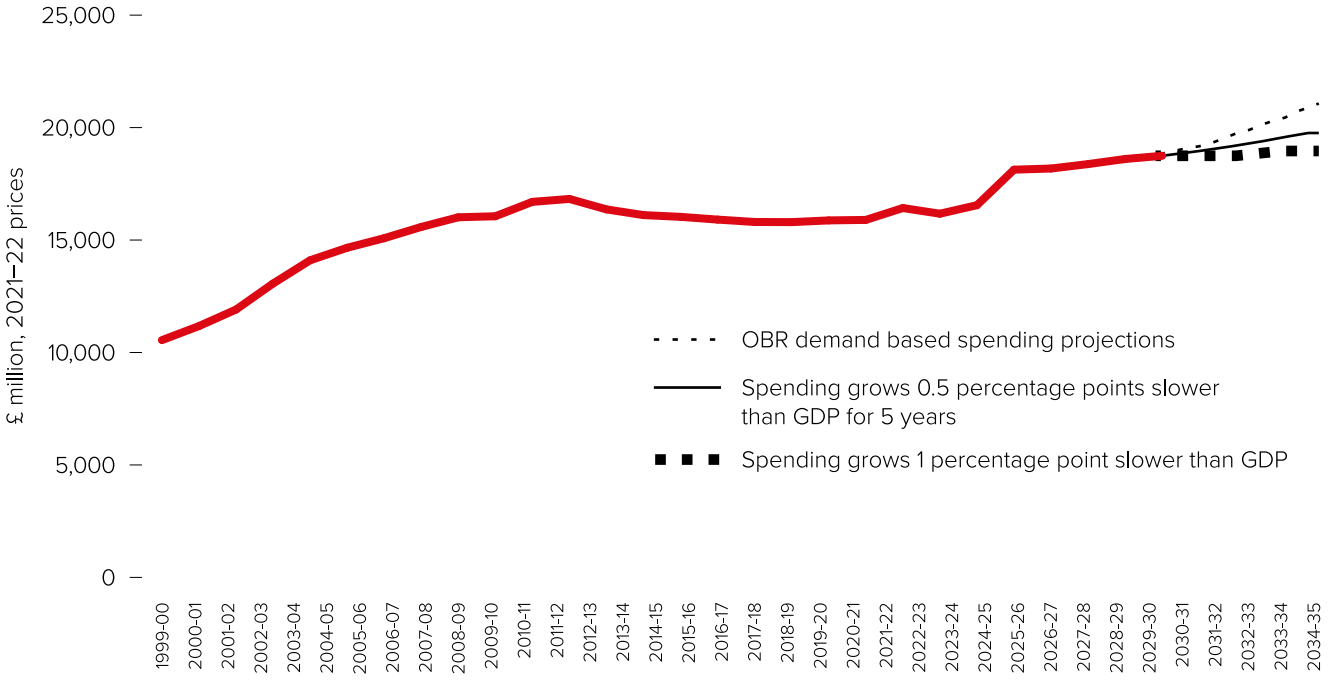
Scenario two: Growth 0.5 per cent below GDP for 5 years then GDP

- UK Government spending relevant to Welsh Government block grant funding for day-to-day spending grows slightly slower than the UK economy until the early 2030s and then at the same rate as the economy. This scenario reflects a situation where the UK Government might want to keep reducing the level of public sector debt as a share of GDP beyond the medium-term forecast horizon, followed by a period of stability.

Scenario three: Growth one percentage point less than GDP

- Relevant UK Government spending grows one percentage point slower than the UK economy. This reflects a scenario where there are demands to reduce debt more rapidly or other elements of UK spending – such as pensions or debt interest – are growing more quickly.

Chart 27: Long-Term Projections for Welsh Government Day to Day Spending (resource budget excluding COVID-19) in real terms, under three scenarios (£m, 2021–22 prices)



Source: Welsh Government

The demand-led scenario has the Welsh Government resource budget growing faster over a sustained period of time than at any time since the 2000s. This scenario is most likely to provide the necessary resources to meet future demand for public services but, given the OBR's conclusion that this level of spending growth is unsustainable without tax increases, it may well be regarded as implausibly optimistic.

The middle scenario suggests the resource budget will grow a little faster than over the next five years, while the lower scenario sees slightly slower growth in the longer term. While these scenarios are perhaps more likely than the first, they would both imply spending per person growing at less than half the average rate since devolution began.

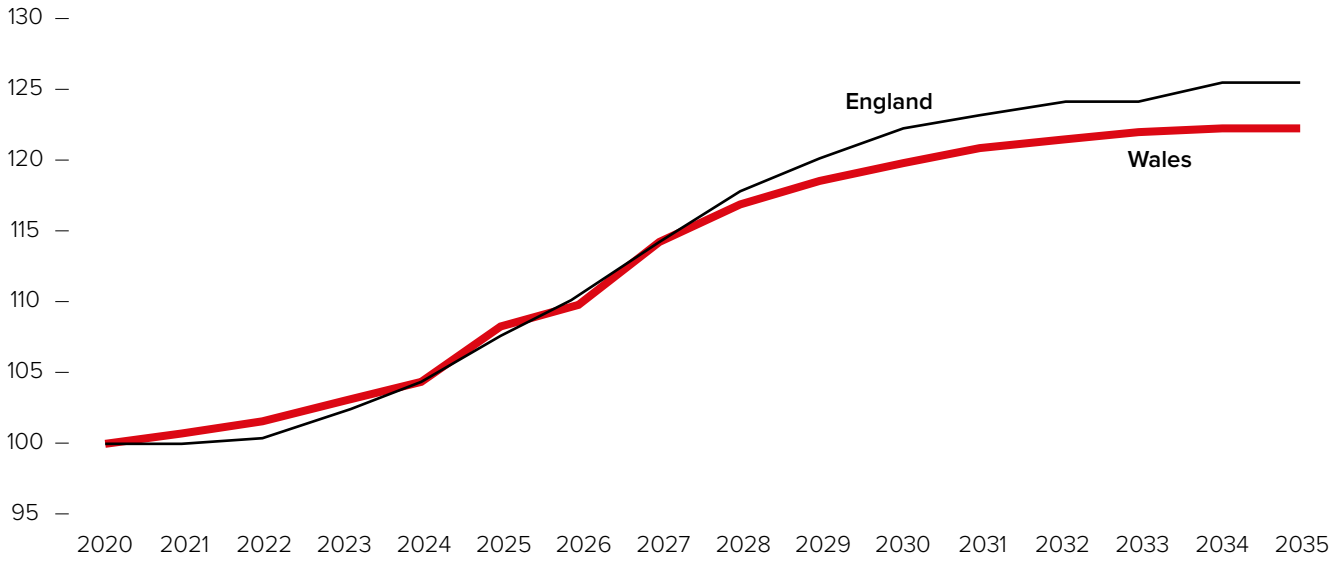
Fiscal sustainability in Wales

There is increasing interest in analysis of the long-term sustainability of devolved fiscal frameworks in the UK. This is a different exercise to the OBR's assessment of fiscal sustainability across the UK as a whole. The operation of the Barnett formula means that devolved budgets depend to a large extent on UK Government decisions about public spending in England. There is therefore a conditional element to any assessment of the sustainability of funding for devolved services in Wales. If the equivalent services in England are adequately funded then, to a large extent, the future adequacy of funding in Wales will depend on whether the demand for those services is growing at a different rate to that in England. The relative performance of the devolved taxes will also have an impact.

This report does not attempt a systematic assessment of either the future relative demand for public services or the capacity for the existing fiscal framework arrangements to cope with that demand. However, it looks at one element to illustrate the point made above.

The increasing population of older people is expected to be a key driver of growing demand for public services across the UK. Wales has a higher proportion of older people than England – part of the reason it has a higher relative need to spend on public services – but it is the growth in that population that will drive change in demand. Chart 28 shows the projected growth in the population with remaining life expectancy of 10 years or less, a group which is likely to generate some of the highest future demand for public services. This population is expected to grow quickly, but at around the same rate in England and Wales until the late 2020s, followed by slightly faster growth in England after that.

Chart 28: Projected population with remaining life expectancy of 10 years or less (2020=100)



Source: Welsh Government based on ONS 2020 based population projections

If the public service needs of this group in England are properly met over the medium to long term, then there is a reasonable chance that the Welsh Government will also have the necessary resources to meet demand under current fiscal framework arrangements. The Barnett formula squeeze will mean growth in spending is somewhat lower in Wales than in England, other things being equal, but there is a mechanism in the Welsh Government's Fiscal Framework Agreement to limit that effect over the medium to long term.

Whether the UK Government will provide adequate funding in England is clearly a major risk. The highly restrained expenditure plans for the remainder of this spending review period and the assumptions for the following three years which underpin the OBR's latest fiscal outlook both suggest that the prospects are poor, at least in the short to medium term. As noted above, it is also the case that the scenario which is most likely to provide the necessary funding in the longer term is also the one that is unsustainable given current taxation levels according to the OBR. Further to this it is worth noting the cumulative pressure on public services across the UK as a result of funding below demand over the last decade or so.

Of course, the Welsh Government can also vary the size of its budgetary envelope via the use of devolved taxation levers. These levers provide valuable flexibility and are covered in more detail in the following section. However, their use to generate very large changes in resources relative to block grant funding could well impact on the tax base in Wales in a way which would raise further sustainability questions.

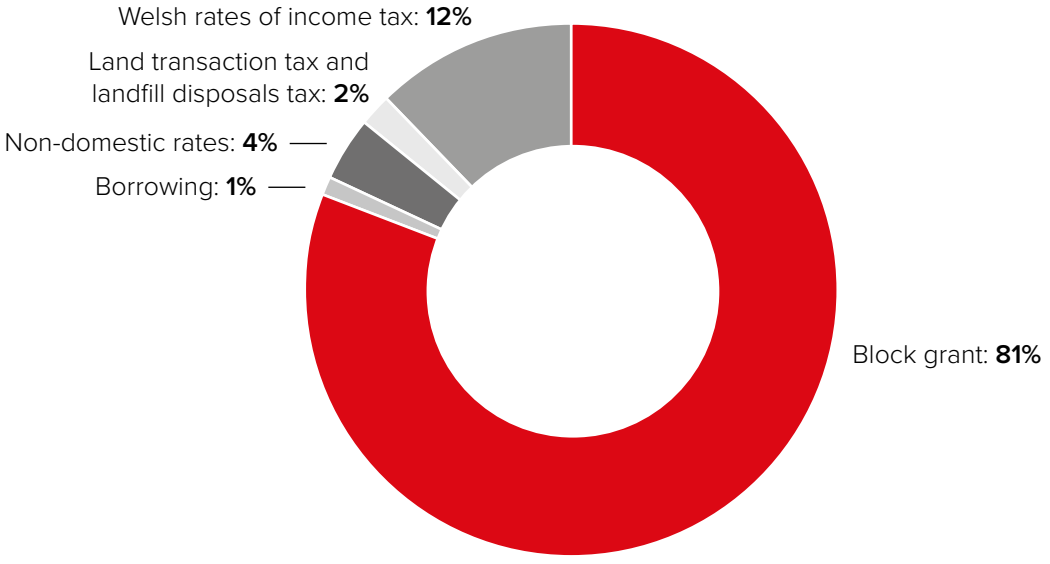
This example provides an insight into one element which impacts on fiscal sustainability in Wales.

However, long run fiscal sustainability is dependent on the balance of all elements which impact on spending needs and tax revenues in future years.

Welsh tax revenues

As a result of tax devolution, around 80 per cent of Welsh Government funding is now derived from the block grant (see Chart 29). Funding from tax revenues is a source of risk in the Welsh Government budget and links funding to the performance of Welsh devolved taxes relative to their UK equivalents.

Chart 29: Financing of Welsh Government Draft Budget 2023-24

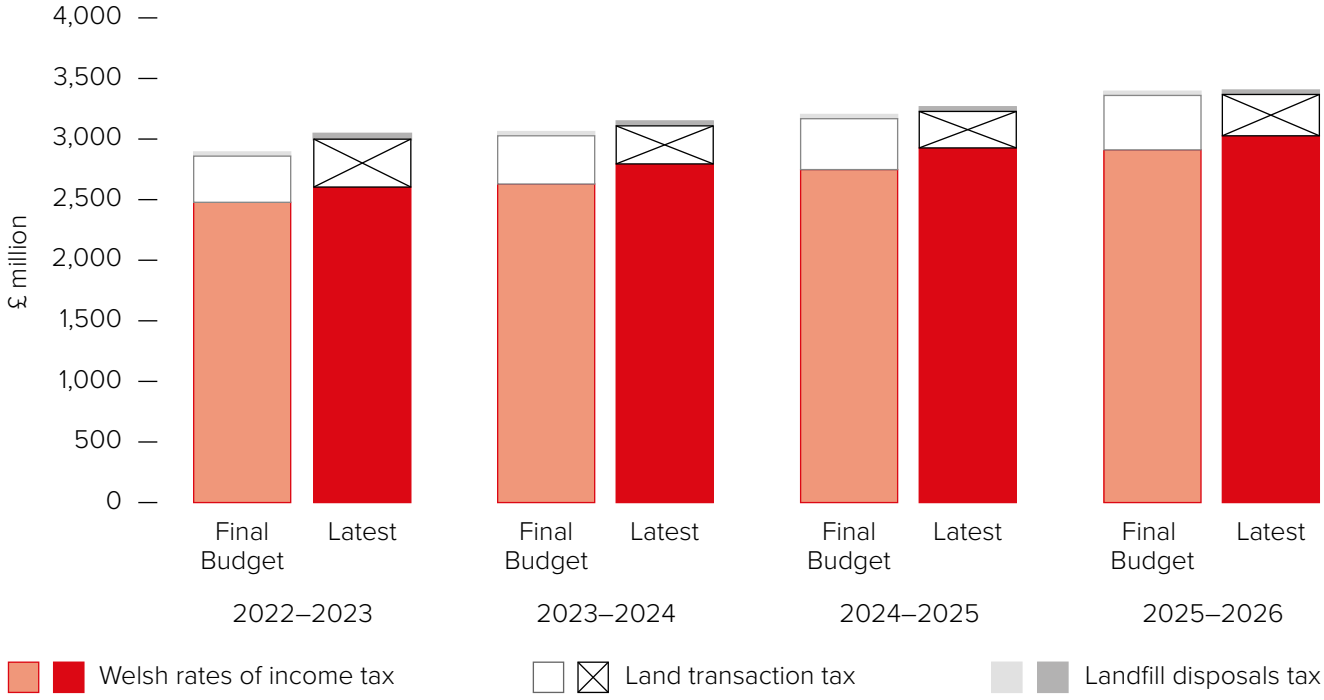


Source: Welsh Government

The OBR's November Economic and Fiscal Outlook included new forecasts for the devolved taxes and for the UK taxes which are used to derive the associated block grant adjustments. Updated revenue forecasts for the fully devolved taxes and further detail is included in the OBR's Welsh Taxes Outlook published alongside the Welsh Government's draft budget.

The latest forecasts show higher revenues from the Welsh rates of income tax compared to those included in the March 2022 final Budget (which reflect the OBR's October 2021 forecast), but lower revenues from land transaction tax (chart 29). The latter is in keeping with the deteriorating outlook for the property market over the next few years. In aggregate, devolved revenues are up a little over the spending review years.

Chart 30: Devolved tax forecasts (£ million)



Source: OBR

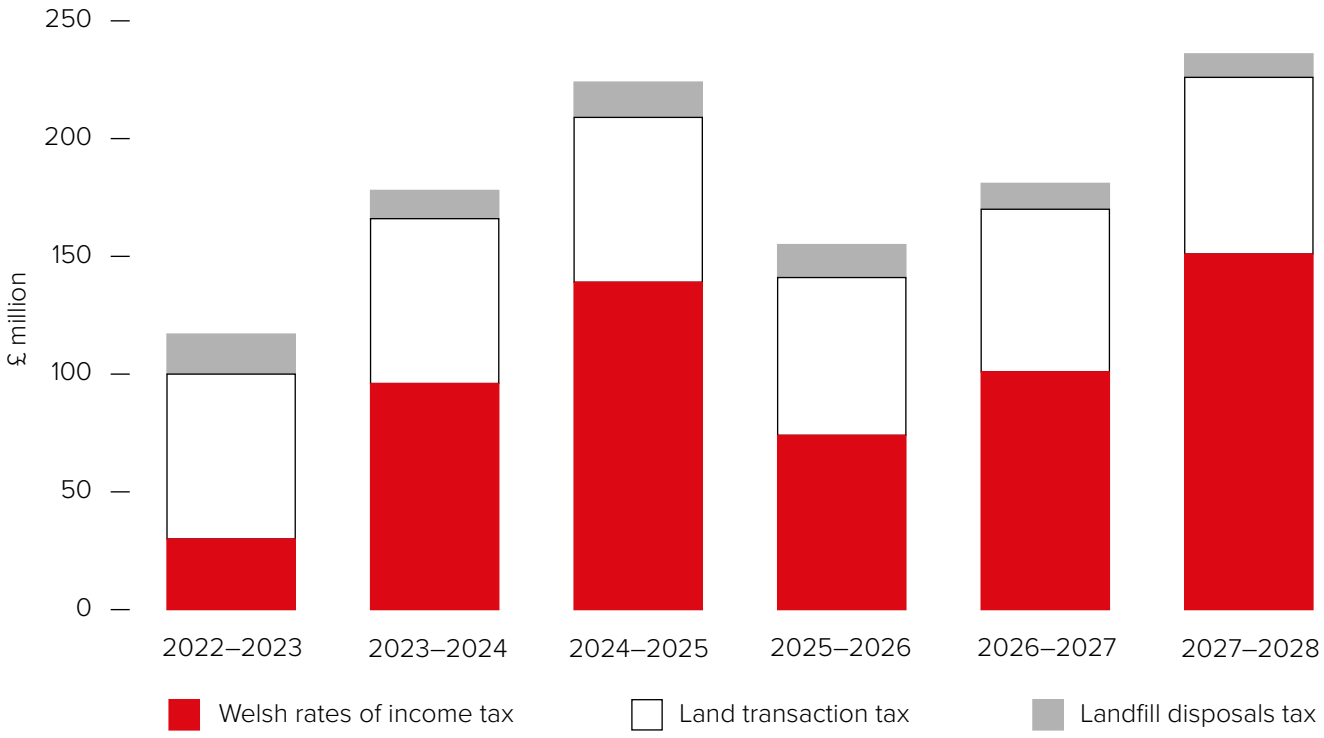
The OBR's forecasts for UK equivalent taxes also affect the Welsh Government's budget via the block grant adjustments.

The net position between the devolved taxes and the associated block grant adjustment is shown in chart 31. Over the years covered by the Welsh Government draft budget, it shows the net impact increasing from £174m in 2023–24 to £221m in 2024–25. The impact falls but remains positive in 2025–26 and rises again over the rest of the forecast period. The pattern is complicated by actual and forecast reconciliation adjustments which have been included in the year they affect the budget rather than the year to which they relate.

The gap between devolved revenues and associated block grant adjustments is driven in part by policy choices, for example land transaction tax has a higher rate on additional properties than the UK Government's stamp duty land tax. In addition, the freeze on the income tax personal allowance has a greater proportional impact on revenues in Wales than elsewhere.

For budget purposes, the WRIT block grant adjustment and the WRIT revenue forecast for 2023–24 are now fixed. There will be a reconciliation adjustment once the outturn data is published. WRIT outturn information for 2020–21 was published this summer. WRIT revenues were £62m higher than the associated block grant adjustment. The forecast included in the 2020–21 budget showed a £13m net difference. A net reconciliation adjustment of +£48m will be applied to the 2023-24 budget and is included in Chart 31.

Chart 31: Net position between devolved tax forecasts and block grant adjustments (£ million)



Source: OBR and WG calculations

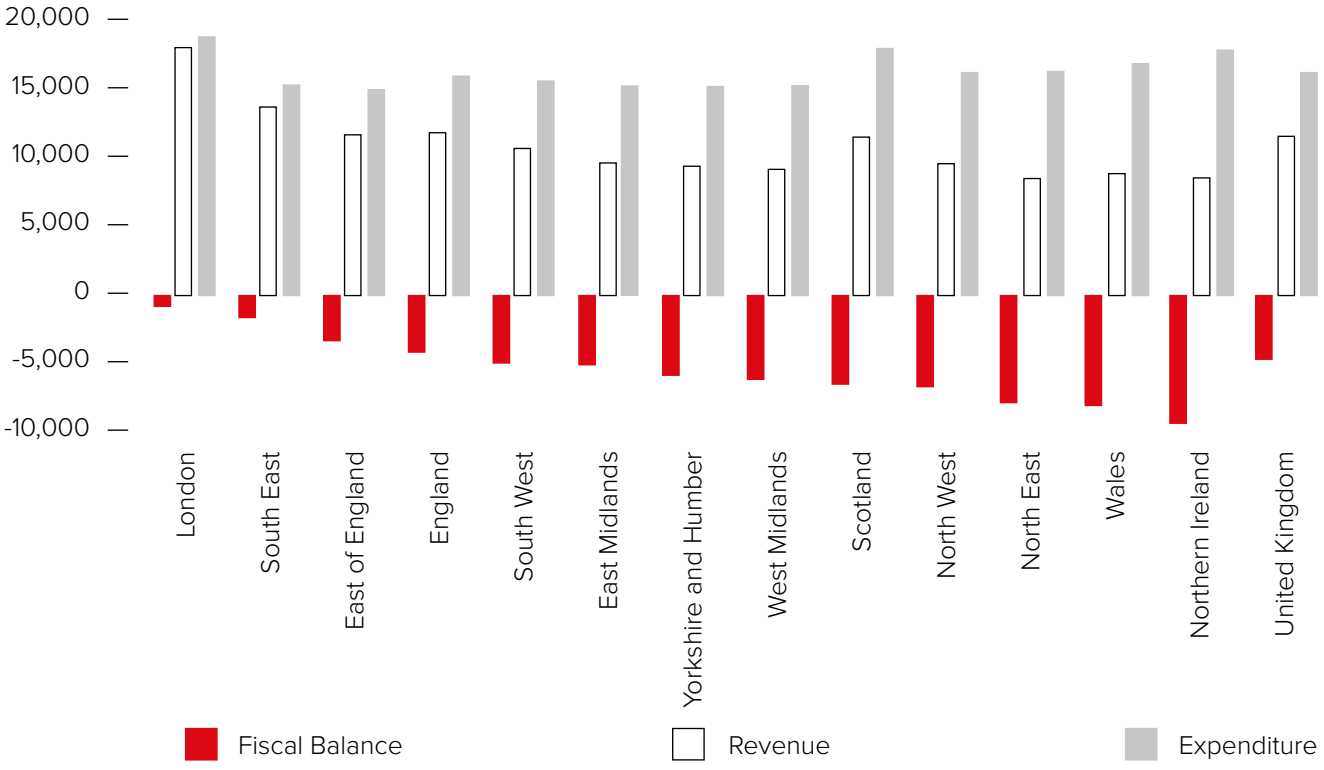
Fiscal balance

Chart 32 shows the fiscal balance for Wales and other UK countries and English regions in 2020–21. A negative balance indicates expenditure higher than revenues. These figures will have been affected by the COVID-19 pandemic and the response to it, with every country and English region recording a negative fiscal balance. However, the relative pattern between different areas remains much the same as in earlier years.

Public expenditure per head is higher in Wales than in most other UK countries and English regions. Generally, the level of expenditure in different areas reflects the relative age structures and other indicators of need. Expenditure per head is higher in Scotland and London for other reasons.

Revenues per head in Wales are below the UK average and similar to those in the North east of England and Northern Ireland. The underlying weakness of the tax base in Wales again reflects demographic factors, but also the relatively small number of high-income earners in Wales, both of which are reflected in Welsh relative performance on GDP.

Chart 32: Fiscal balance per person (£), 2020-21



Source: ONS
Notes: North Sea oil and gas revenues allocated on geographic basis

The larger gap between revenue and expenditure for Wales compared to the UK average represents a major transfer to Welsh people through the UK fiscal system, and this transfer is the main reason for the gap shown between measures of household income and GDP in Wales as discussed above. This reliance on fiscal transfers obviously represents a key risk to Welsh living standards.

As noted above, demographic change further adds to the longer term economic and fiscal risks facing Wales.

Under the current fiscal arrangements, Wales has considerable, but not complete, protection from apparently adverse movements in population – indeed, in some circumstances, such movements could have beneficial effects over the shorter term (as the block grant contains a large base which would be rolled forward, and "shared" across a population that would be smaller than otherwise).

However, under potentially different future fiscal arrangements, a weakness in the tax base resulting from demographic change could be a much greater liability.

While many of the factors determining future population levels are driven by factors that are hard to influence, the increased potential for remote economic activity, including remote working, coupled with the high level of amenity in Wales, provides scope for policies to address relative population decline in Wales. Measures that increase the attractiveness of Wales as location could help to retain and attract people, including returnees.