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# Devolution, independence and Wales' fiscal deficit

Guto Ifan, Cian Siôn and Daniel Wincott

## **Abstract:**

Debate around Wales' place in the United Kingdom has intensified over recent years, with radically differing visions for the union of the Welsh and UK governments emerging alongside growing (though still-minority) support for Welsh independence. This article argues these constitutional debates must be considered alongside Wales' current fiscal position. Wales' estimated fiscal deficit is reflective of long-standing economic underperformance as part of the UK, which we argue is unlikely to be addressed under current economic, fiscal, and constitutional arrangements. On the other hand, it also suggests a difficult economic outlook for an independent Wales, which would require tough fiscal and economic choices to address Wales' apparent balance of payments deficit.

## **Keywords:**

Devolution, Independence, National Deficit, Secession, Wales

## **JEL Classification:**

H62, H77, R50

**Competing interests:**

The authors declare none.

“I think closing the fiscal gap is a proper ambition for any Welsh Government. It would certainly have to be an ambition for a government led by the Member that seeks to take Wales out of the United Kingdom.”

*Mark Drakeford, First Minister of Wales, in reply to Adam Price, Leader of Plaid Cymru*

“The very fact that nine of the 12 countries and regions of the UK are persistently in deficit is an indication of the broken fiscal and economic model. It is a model that simply has not and does not deliver prosperity to Wales and offers no expectation to do so in the future.”

*Plaid Cymru Independence Commission report, September 2020*

## **1. Introduction**

The Welsh Government’s highly visible separate public health response to the Covid-19 pandemic sharpened public awareness of devolution and assessments of the performance of the UK and Welsh governments (Larner 2021). Brexit also exposed constitutional tensions between a UK government seemingly intent on re-centralising powers and being more active in Wales (Wincott et al. forthcoming) and a Welsh Government proposing fundamental reform of pan-UK governance arrangements (Welsh Government 2021a). The Independent Commission on the Constitutional Future of Wales and growing (though still-minority) support for Welsh independence (Griffiths 2021), both exemplify increasing questioning of Wales’ place in the UK.

Here, we present a broad discussion of Wales’ fiscal deficit, as a key part of the political economy of constitutional debates in Wales. Largely a symptom of Wales’ long-standing economic underperformance, this fiscal deficit is unlikely to be addressed given current economic, fiscal, and constitutional arrangements. Fiscal transfers raise relative disposable income and consumption levels in Wales substantially; but unlike, say, targeted public investments, they have not led to convergence towards general UK-level economic performance. Given the tough economic and fiscal choice it implies, the balance-of-payments deficit also represents a challenge – and potential roadblock – for those advocating for Welsh independence.

The article proceeds as follows. Section 2 sets out the current constitutional debate in Wales, discussing devolution's ever-changing nature and rising tensions in recent years. Section 3 outlines Wales' current fiscal position as part of the UK, while section 4 places the fiscal deficit in wider and historical context. Section 5 assesses the possibility of addressing the fiscal deficit and Wales' economic underperformance as part of the UK, before analysing some fiscal implications of Welsh independence. Section 6 concludes.

## **2. Current constitutional debates in Wales**

Welsh devolution first came with a peculiar structure: the National Assembly had broad responsibilities for major public services, but limited capacity and shallow powers. It was, in effect, a large-scale local authority: a 'Body Corporate' taking collective decisions, not a legislature holding a distinct government to account. Though it allocated significant public resources, the Assembly could only make secondary rules. Its powers were limited to 'conferred' policy fields, whereas Scotland's Parliament could pass primary legislation in any field not explicitly retained exclusively to Westminster.

Every governing system has limited 'bandwidth' – concentrating on one policy area has opportunity costs for a government's effectiveness in others. Advocates of the status quo often argue that 'now' is not the time to ask constitutional questions, other pressing policy concerns should take priority. Arguments of this kind made from outside Wales generally fail to grasp that the country has seen constant constitutional reform throughout the post-1998 period. Four major Westminster constitutional statutes in less than 25 years (two Government of Wales Acts (GOWAs) (1998, 2006), two Wales Acts (2014, 2017)) plus a 2015 draft Wales Bill, paused in early 2016 illustrate the permanent flux of basic governing arrangements. Welsh devolution has transformed to a full reserved powers parliamentary model: the National Assembly has become the Welsh Parliament, generally known as the Senedd. Its primary laws receive Royal Assent. Though debates around justice policy and the question of legal jurisdiction continued, from 1998–2017 the path of constitutional reform was clearly and consistently towards wider and deeper devolution.

The direction of change partly reflected the ambitions of people committed to expanding and deepening the powers of Welsh political institutions. Mostly, however, it resulted from the frustrations of trying to make Wales' new system work. Reform typically followed sustained reflection and structured expert generated proposals from Wales,

generally resisted initially from London but later partly and grudgingly conceded. A second referendum, held in 2011 on an abstruse question about legislative powers, endorsed a deepening of devolution, albeit on a low 35% turnout: around two-thirds of participants voted for the change. The GOWA 2006 legislative system was a masterpiece of convolution and complexity – inventing ‘Fields’ and ‘Matters’, ‘Legislative Competence Orders’ (LCOs) and ‘Assembly Measures’ that are now happily forgotten. That this system was ever introduced illustrates the generally piecemeal and *ad hoc* approach of Westminster and Whitehall to constitutional reform. Her Majesty’s Government shows a striking inability to, and lack of interest in, thinking systematically about territorial governance.

EU membership was written through the statutory framework for devolution created at the turn of the century. It ensured that the devolved authorities acted in line with EU rules. EU membership also served another function. Devolution was designed to fit policies to the circumstances of each devolved nation or jurisdiction, necessarily creating potential for democratically-endorsed policy difference and divergence. Wholly untrammelled divergence could cause obvious problems for anyone concerned to sustain the UK territorial state. EU membership provided rules and institutions designed to ensure that Europe’s internal market could function, while allowing scope for democratic authorities of – and within – member states to pursue their own legitimate policy objectives. In effect EU membership provided ‘scaffold’ (Wincott 2018) that helped to hold the UK together, while also supporting devolved authorities as they built new policy and institutional structures. For example, it allowed Scottish and non-UK EU students to have tuition-free University education in Scotland while other UK students were charged fees: something it is hard to imagine a UK-only framework allowing. The EU was, in effect, both external and internal to UK territorial politics.

Immediately after the 2016 Brexit referendum political leaders in all three devolved contexts accepted the result, while arguing the UK should maintain the closest possible relationship with the EU (Wincott et al. 2021). Under Theresa May, the UK government’s rapidly set ‘red lines’ contributed to a politics of polarisation. Pursuing Brexit, May’s government stumbled into deep questions about devolution. If the situation of Northern Ireland became particularly tricky, the general territorial politics of Brexit proved to be ‘a bewildering mix of ignorance, apparent disdain, confrontation, cooperation and collaboration’ (Wincott 2018). May’s premiership foundered on her attempt to conjure a

compromise for Northern Ireland within her ‘precious union’, inheriting on the wind of the ever-harder Brexit the Prime Minister herself had helped to conjure .

After replacing May, Johnson pushed Brexit politics in an even harder direction. His administration generated an abrasive territorial politics of UK government recentralisation, sometimes known as ‘muscular’ unionism. Personally, Johnson pursued a robustly disputatious approach to Welsh politics, illustrated by his proposals for an M4 relief road around the Brynglas Tunnels near Newport. He has repeatedly criticised the Welsh Government’s decision not to build the road and suggested the UK government might do so itself (Wincott 2020).

The abrasive approach symbolised by the M4 bypass also underpins the Johnson administration’s new post-Brexit foundations for the UK – including the UK Internal Market Act (UKIM 2020) and various new centrally-controlled expenditure streams. The UK government unilaterally ended consultation on UKIM with Welsh officials about a month before publishing the July 2020 Internal Market White Paper. UKIM was enacted in late 2020 despite the Senedd having refused consent. Somewhat oddly, UKIM borrowed the EU’s internal market language of mutual recognition and non-discrimination, while claiming the UK’s version pre-dated the EU’s internal market by several centuries. More importantly, UKIM’s variants of mutual recognition and non-discrimination offer less scope for devolved policy difference than the EU versions. UKIM and a variety of new funding streams reveal a new appetite for UK government to act on its own account in policy domains previously regarded as devolved. ‘Muscular unionism’ was a new effort by the UK centre to broadcast its presence in devolved locations and intervene without restriction in a wide range of fields (Wincott et al. forthcoming).

By contrast, the Welsh Labour Government’s ‘progressive’ unionism treats the UK as a site for risk-pooling and a voluntary union. This vision requires a fundamental recasting of the UK’s constitutional framework – perhaps including a formal limitation, or ending – of Westminster’s parliamentary sovereignty. The Welsh Government created a constitutional commission in autumn 2021, co-chaired by Professor Laura McAllister and Rowan Williams, to consider possibilities ranging from the incremental to a basic change to Wales’ place within the UK and full Welsh independence.

Historically Wales has lacked a strong, popular independence movement. It has not had a politically credible threat of exit from the UK, and therefore, arguably, has been

easier for London to ignore. Without having approached majority support, since the mid-2010s there has been a marked growth in backing for independence within Wales (Griffiths 2021). Recent opinion polling indicates that between a quarter and one third of respondents who express a view would vote Yes in a Welsh independence referendum, up from typically below a fifth of respondents in polling before 2018 (Institute for Government 2021). Beyond Plaid Cymru, an increasingly significant element among Welsh Labour voters now seems minded to back independence; the non-party ‘Yes Cymru’ movement has also been a significant face at times (Wincott 2021).

UK (or Anglo-British) and Welsh politics seem to be moving in mutually inconsistent directions. The UK government is asserting its sovereign prerogatives increasingly forcefully in devolved places and spaces, while the Welsh government offers a quite different prospectus for constitutional change. Alongside mutual hostility between the UK government and the European Union, deep challenges in Northern Ireland and difficult relations between Boris Johnson and Nicola Sturgeon, the scene is also set, it seems, for a long period of abrasive stalemate between London and Cardiff.

Constitutional debate should be considered alongside Wales’ current fiscal reality and status as a relatively poor part of the UK. Welsh Labour’s argument for the UK focuses increasingly on the UK tax and benefit system’s “great insurance policy” (Bailey 2021) and the potential fiscal costs of independence, rather than unconditional, identity-based Unionism. However, Welsh Government demands for further and more entrenched devolution may be easier to ignore if no fiscally (and politically) credible threat of secession exists. Meanwhile, proponents of independence stress the UK’s highly uneven economic development – which underlies Wales’ fiscal position – should prompt fundamental change in fiscal and economic relations between Wales and the rest of the UK (rUK) (Independence Commission 2020). The following sections analyse Wales’ fiscal position, its causes, and some wider implications for Wales’ constitutional future.

### **3. Fiscal reality – Wales’ current fiscal position**

Wales’ current fiscal framework contains a high degree of vertical fiscal imbalance. Devolved and local governments are responsible for over half of all public expenditure, but less than a fifth of revenues raised in Wales (Ifan et al. 2019). The Welsh Government’s main spending responsibilities include health and social care, education, housing, and



economic development, plus funding local government services in these areas. The UK government is primarily responsible for social security and some justice system functions in Wales, alongside centralised spending such as defence and public sector debt interest payments.

The Welsh Government budget is mainly funded by a UK Government block grant. The block grant calculation does not reflect the relative need for public spending in Wales; instead being based on the previous year's funding, with an incremental change linked to a population share of UK Government changes of spending for England on services devolved to Wales. The relative levels of spending per person in Wales compared to rUK are largely an accident of history (Poole et al. 2016b). Since 2018–19, calculations of changes to the Welsh block grant have included an uplift of 105% (termed a 'Needs-Based Factor'). This needs-based element only applies to the incremental change not the overall size of the block grant, so relative funding levels remain detached from any 'relative need' assessment.

Recent reforms to devolve some taxes have aimed to empower the Welsh Government and increase its financial (Commission on Devolution in Wales 2012). They include full devolution of Non-Domestic (Business Rates) in 2015–16, Stamp Duty Land Tax, Landfill Tax, and partial devolution of income tax. At the moment of tax devolution, there was essentially full equalisation of Wales' lower tax revenues per person. Subsequent relative performance of the Welsh tax base and devolved tax policy will impact on the budget. Despite these changes, UK government fiscal policy remains an overwhelmingly important determinant of the size of the Welsh budget. Total public spending in Wales (devolved and reserved) will remain largely detached from the revenues raised in Wales, still generally collected and pooled at the UK level.

Its fiscal deficit (sometimes known as the 'fiscal gap') is a stark representation of Wales' current fiscal position – particularly in the context of constitutional debates. Since the devolved governments must set a balanced current budget, the fiscal balance of Wales is the combined product of the central government's fiscal position, inter-governmental transfers, and the distributive effects of the tax-and-benefit system. More formally, the notional fiscal balances of the UK's countries and regions reflect the difference between

total managed public sector expenditure in them (including an allocated share of ‘non-geographic’ UK government spending) and their total attributed public sector revenues.<sup>1</sup>

The fiscal balances presented in **Figure 3.1** are underpinned by Office for National Statistics’ (ONS) *Country and Regional Public Sector Finances* (CRPSF) datasets and used to compile *Government Expenditure and Revenue Wales* (GERW) reports.<sup>2</sup> In 2019–20 (for which most recent outturn data is available), Wales’ notional fiscal deficit was £14.4 billion (or 18.4% of its estimated GDP). Expressed per capita (£4,560), this deficit is surpassed only by Northern Ireland (estimated £5,428), both considerably larger than the UK average (£863). Subsequently, large government spending increases, and reduced tax revenues and economic output triggered by the pandemic and its associated policy response, have transformed public finances across the UK. Assuming a proportional hit to revenues and expenditure across the UK, Wales’ notional fiscal deficit could climb to 37.1% of estimated GDP in 2020–21. However, the Chancellor’s commitment to balance the UK government’s current budget by 2024–25 is likely to curtail the size of the deficit in future years.

**Figure 3.1: Notional fiscal balances of the UK nations, 2019–20**

	UK	England	Northern Ireland	Scotland	Wales
<b>Current budget balance (2019-20)</b>					
£ million	-14,521	20,983	-11,166	-10,833	-13,506
% of estimated GDP	-0.7%	1.1%	-23.6%	-6.7%	-17.9%
Per capita (£ per head)	-217	372	-5,895	-1,983	-4,278
<b>Net fiscal balance (2019-20)</b>					
£ million	-57,678	-17,685	-10,301	-15,298	-14,396
% of estimated GDP	-2.7%	-1.0%	-21.7%	-9.4%	-19.0%
Per capita (£ per head)	-863	-314	-5,438	-2,800	-4,560

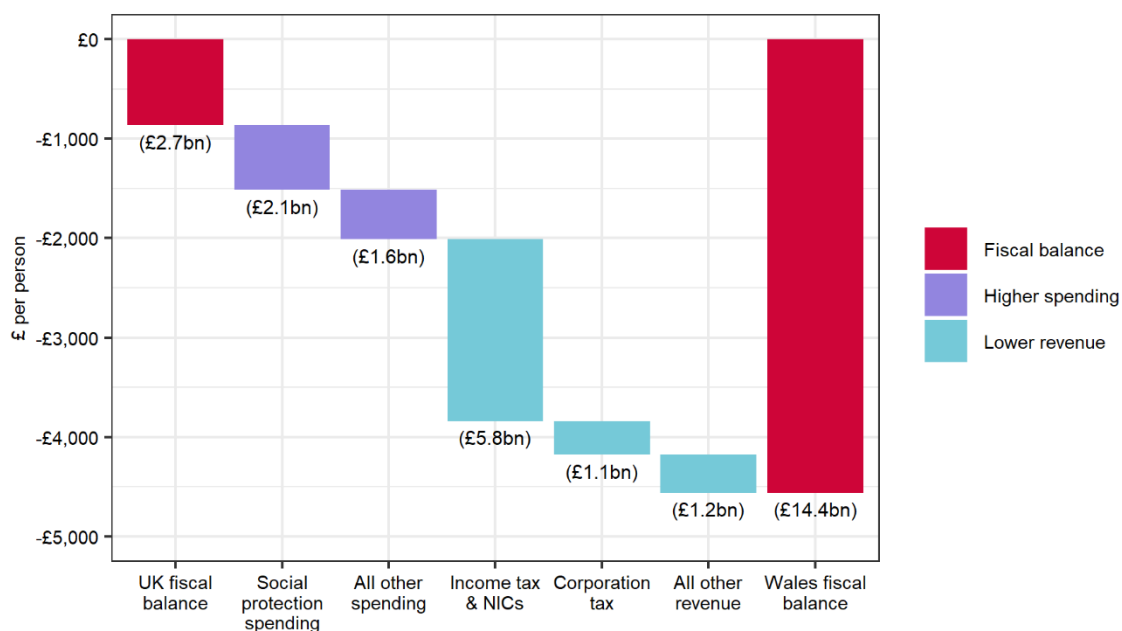
Source: ONS (2021) *Country and Regional Public Sector Finances*, Regional gross domestic product, Mid-year population estimates; ONS (2019) 2018-based principal population projections; and authors’ calculations. Fiscal balances are inclusive of North Sea oil and gas revenue, allocated by geography.

<sup>1</sup> There are no formally agreed set of accounting concepts for the formulation of sub-national accounts. The approach taken in this paper follows that employed by the Office for National Statistics when producing their *Country and Regional Public Sector Finances* datasets. Further discussion of the principles underpinning the geographic allocation of spending and revenues – and the limitations of this approach – can be found in Ifan, Siôn and Poole (2019).

<sup>2</sup> *Government Expenditure and Revenue Wales* (GERW) refers to a series of reports analysing Wales’ public sector spending, revenues, and the nation’s overall fiscal balance (Poole, Ifan, and Jones 2016; Ifan, Siôn, and Poole 2019). Where possible, GERW aims to replicate the analysis and methods used when compiling *Government Expenditure and Revenue Scotland* (GERS) – which is an annual publication by the Scottish Government designated as a National Statistics product by the UK Statistics Authority.

The existence of large fiscal deficits (and surpluses) at a sub-state level are not unusual internationally. Buchanan (1950) describes them as a logical consequence in unitary states which exhibit regional disparities in income and wealth; if policies are applied uniformly across the state’s territory, the tax burden will not fall evenly across geographies. In these instances, intra-regional transfers tend to take place implicitly through the tax-and-benefit system, since revenues exceed public expenditure in richer regions and expenditure exceeding revenues in poorer ones. By contrast, in states characterised by a high degree of vertical decentralisation, intergovernmental transfers are often necessary to fund the programme expenditure of sub-state and local governments, especially where tax collection remains highly centralised. If sub-state governments are expected to provide roughly equivalent public services when levying the same rates of tax, intergovernmental transfers often include, or are accompanied by, a horizontal equalization element to enhance the fiscal capacity of sub-state governments with weaker tax bases and higher spending needs (Boadway 2007). These fiscal arrangements also give rise to sub-state deficits in regions where government spending exceeds revenue-raising capacity.

**Figure 3.2: Disaggregating Wales’ fiscal balance compared to the UK average**



Source: ONS (2021) Country and Regional Public Sector Finances, Mid-year population estimates; ONS (2019) 2018-based principal population projections; and authors’ calculations.

**Figure 3.2** compares the composition of Wales' fiscal deficit to the UK per person average. Lower revenues account for approximately two-thirds of the difference in the overall notional deficit. If Welsh income tax and national insurance revenues matched the UK per person average, total revenues would be £5.8 billion higher. Where the fiscal imbalance is explained by higher spending in Wales, it is mainly attributable to the larger population share qualifying for social protection schemes – state benefit payments that tend to have uniform pan-UK eligibility criteria. Despite devolved and local government accounting for a majority of public sector expenditure in Wales, most inter-regional fiscal transfers occur implicitly through the tax-and-benefit system.

In contrast to Wales, Scotland's fiscal deficit is the result of significantly higher public spending, with tax contributions broadly on a par with the UK average. Meanwhile, Northern Ireland's larger relative fiscal deficit per person reflects both substantially higher public spending and similarly low revenues per person. Six regions of England also recorded fiscal deficits in 2019-20. All these English regions have higher per person revenues than Wales; none has as large a fiscal deficit on a per person basis. Only in three regions of the UK did public sector revenues exceed total spending in 2019-20. London alone consistently records a fiscal surplus. The relative fiscal positions of the countries and regions of the UK therefore reflect internationally high levels of regional inequality (see, for example, Carrascal-Incera et al. 2020) as well as differing public spending arrangements in the devolved countries.

#### **4. Wales' fiscal deficit in a wider and historical context**

In this section, first, we provide a brief account of Wales' economic legacy, before analysing over-time changes in the scale of fiscal transfers. Lastly, we analyse how the Welsh fiscal deficit relates to other financial flows to and from the Welsh economy and relative levels of incomes in Wales.

##### ***4.1. The economic legacy***

Its economic history helps explain the long-term underperformance of the Welsh economy and its current fiscal position. Initial overdependence on primary economic sectors and subsequent missing out on economic diversification during the second industrial revolution

have had long-standing economic effects, with the occupational and industrial structure of Wales lagging behind rUK (Gooberman 2017).

During the latter nineteenth century and early twentieth century, Wales saw significant economic development and population growth. Estimated economic output per head in Wales in 1891 was only slightly below the average across Britain (Crafts 2005; Geary and Stark 2016). However, as part of the so-called 'industrial periphery' – as opposed to the UK's manufacturing heartland and core regions – the Welsh economy retained a reliance on primary sectors (Martin 1988). In 1851, over half of the population was working in Agriculture and Mining and Quarrying; by 1911, these two groups still accounted for nearly half (44 per cent) of a much larger workforce (Williams 1985). Manufacturing and services were a much smaller share of the Welsh economy, while services and income from overseas investments made a large and growing contribution to Britain's balance of payments (Scott 2007). In his famous analysis of Wales' place in the Atlantic economy, Thomas (1962) notes the dominance of coal exports, resulting in patterns of migration and capital formation in Wales diverging significantly from the rUK, fluctuating with the wider export sector of the UK. Williams (1995) points to similarities between the Welsh economy of the period and currently under-developed countries, namely: a reliance on primary sectors; a lower rate of urbanisation; a lack of a manufacturing base; and low levels of mechanisation.

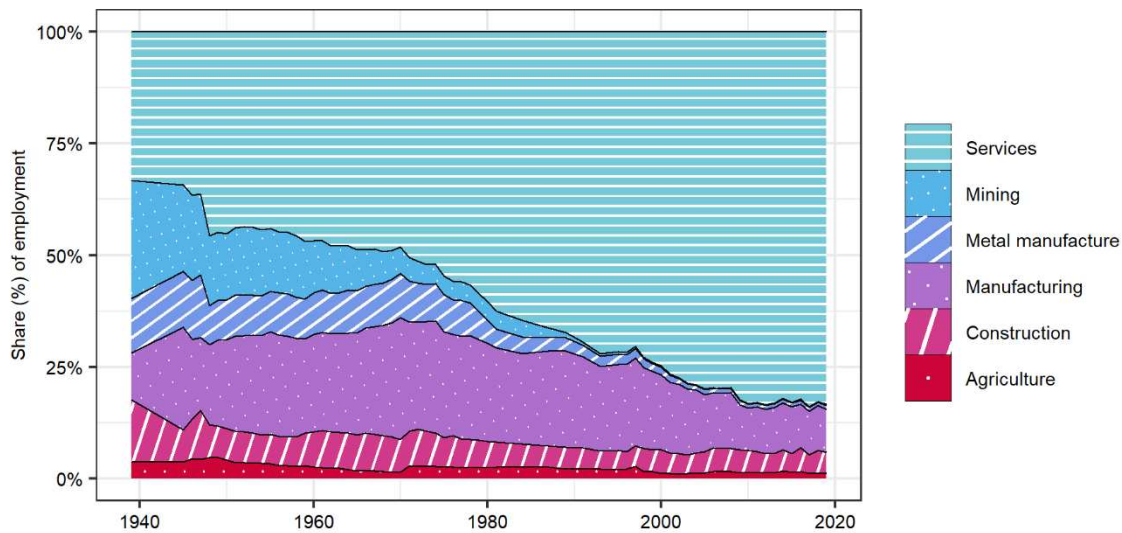
The Welsh economy was thus highly imbalanced and concentrated – two-thirds of the male workforce were in occupations reliant on natural resources and two-thirds of the population lived in just two southern counties. These factors were fully exposed during the inter-war period. Wales' coal workforce halved between 1920 and 1936, while unemployment increased to 17% in 1925 and peaked at 37% in 1932 – well over double the rate for the whole UK. UK Government economic policy arguably worsened Wales' position – for example, restoring the gold standard in 1925 effectively imposed a 10 per cent surcharge exported coal prices (Lovering 1983). Prioritising the interests of finance over industry was a dominant feature of contemporaneous Welsh nationalist writing (Davies 1958). The initiation of regional policy was very limited in scale and largely seen as ineffective (Gooberman 2017). The small size of the UK state meant that fiscal transfers to Wales were limited. A form of regional stabilisation was brought about by flows of labour – between 1921 and 1939, net-migration resulted in 450,000 fewer people in Wales (Thomas 1962). Emigration had a long-term effect on the Welsh population, which took half a

century to recover its 1925 peak, while the male workforce remained a fifth lower in 2001 compared to 1921.

The immediate post-war economy provides a sharp contrast to the interwar period, with a massive reduction in unemployment and huge growth in the female workforce. The UK Government pursued an active and significant regional policy, subsidising industries and compelling them to locate in Wales (Gooberman 2017). The Welsh economy diversified (Thomas 1962) and grew faster than the UK average throughout the 1950s (Nevin 1957). For the first time, manufacturing became a key part of the Welsh economy, and pay in large factories was above the UK average (Gooberman and Curtis 2020). Arguably, however, a new dependency on external investment and regional support emerged.

In 1973, only one in ten large manufacturing sites in Wales were Welsh-owned; 70% of manufacturing employment was in “branch” plants more vulnerable to closure (Tomkins and Lovering 1973). Mass unemployment returned in the late 1970s: between 1978 and 1984, nearly 100,000 manufacturing jobs were lost in Wales. The huge structural shift in Welsh employment from this period is shown in **Figure 4.1**: coal mining was disappearing while steel and other manufacturing industries shrank. From the 1980s, central government’s regional policy ‘virtually ceased to exist’, being replaced by a more invisible role of the state, with large-scale fiscal transfers from rUK (Gooberman 2017). The Welsh economy lacked an internal, self-sufficient base sufficient to withstand the removal of regional support (George and Mainwaring 1988). Relative Welsh economic decline in this period happened as UK interregional inequality increased markedly. By international standard it became very high (Carrascal-Incera et al. 2020).

**Figure 4.1: Employment by sector in Wales, 1939 to 2019**



Source: ONS (2021) NOMIS; Williams (1985); authors' calculations

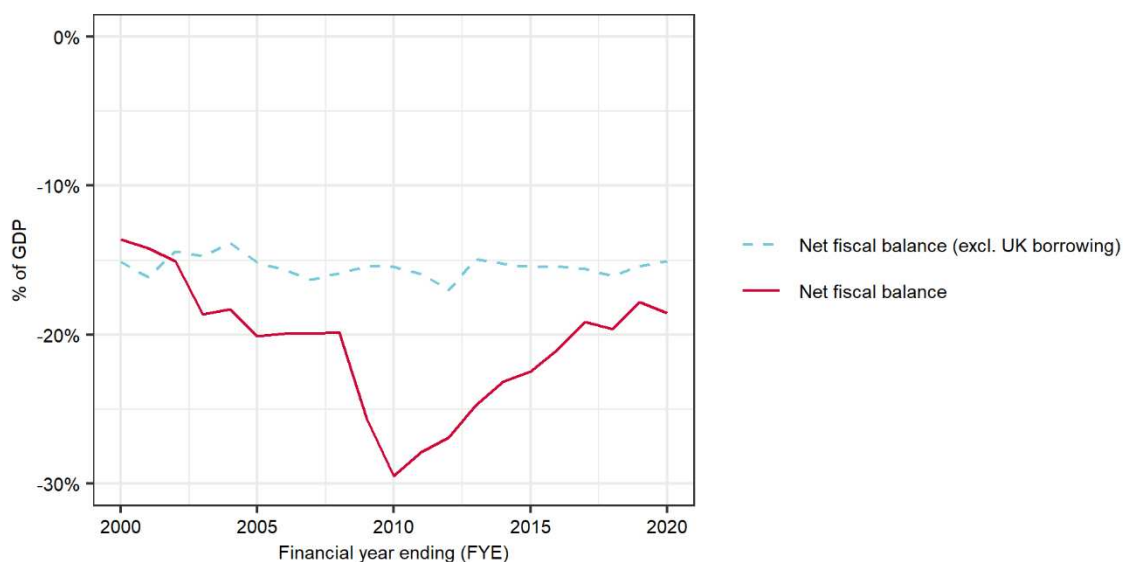
#### ***4.2. Fiscal transfers over time***

As the British state's role in influencing the UK-wide territorial pattern of production diminished, the generation of a net inflow of income has been a major consequence for Wales, separating its experience from that of underdeveloped countries (Cooke 1982; Lovering 1983). Moore and Rhodes (1975) described a 'disguised Central Government subsidy for an indefinite balance of payment deficit', which has detached the territorial patterns of consumption and production (Lovering 1983). Brown (1977) usefully analysed the stabilising and equalising role of fiscal transfers across a state. Given a decline in effective demand for exports, regions cannot erect trade barriers, manipulate exchange rates, or reduce the bank rate of interest – making fiscal transfers a 'compensation for impotence' (Mackay 2001).

A long-standing feature of the Welsh economy, the magnitude and nature of these public (and private) financial flows have varied over time. Nevin (1957) produced the first estimates of public and private flows to and from the Welsh economy, suggesting that total public and private consumption plus capita investment exceeded wealth produced in Wales by an average of £41 million annually between 1948 and 1956. This 'net import', or balance-of-payment deficit, was financed by external private capital finance for Wales' capital-intensive industries not fiscal transfers from UK taxpayers (Nevin 1966). The revenue account of the central government and National Insurance Funds in Wales from 1948–1956

– total central government revenue raised compared to central government current expenditure – showed a surplus of around 1% of GDP on average (Nevin 1957).

**Figure 4.2: Estimated public sector net fiscal balance for Wales, 1999–00 to 2019–20 (as % of GDP)**



Source: ONS (2021) Country and Regional Public Sector Finances, Regional gross domestic product, Mid-year population estimates; ONS (2019) 2018-based principal population projections; and authors' calculations. Fiscal balances are inclusive of North Sea oil and gas revenue, allocated by geography.

Later estimates generally found Wales' balance of payment and fiscal deficits growing over subsequent decades. Brown (1977) estimated Wales' public finance inflow in 1964 amounted to 7.8% of GDP, sustaining an estimated balance of payments deficit of 12.1% of GDP. This pattern was typical of relatively poor regions across Europe. Lovering (1981) estimated the net Welsh trade deficit averaged 11.8% of GDP from 1966 to 1972 – now primarily financed through fiscal transfers not private capital (Lovering 1983). Short (1984) estimated a net flow of government transfers to Wales averaging £719.1 million a year between 1974–75 and 1977–78, roughly 13% of GDP. On a per-person basis this deficit was smaller than Scotland and Northern Ireland, being broadly comparable to North and South-West England.

The Office for National Statistics has produced net fiscal balance estimates for UK countries and regions since 1999–00; for Wales expenditure exceeded revenues raised by £5.2 billion in 1999–00. This net fiscal deficit peaked at 29.5% of GDP in 2009–10, before falling to 18.6% of GDP by 2019–20. Accounting for a population share of UK public sector borrowing, the implied fiscal transfer has remained steady as a share of the economy over the past two decades, hovering at around 15% of GDP over twenty years (see **Figure 4.2**).



### ***4.3. Other financial flows into and out of the Welsh economy***

Fiscal transfers are closely related to other financial flows to and from the Welsh economy. A fuller, integrated set of national accounts – such as those published in the ONS’ ‘Pink Book’ for the whole UK – would include these other financial flows: they are as important to debate about the Welsh economy and its future.

Cuthbert’s (2010) simple model of the Scottish economy can be applied to Wales, capturing public and private financial flows into and out of its economy. Here the fiscal transfer is equivalent to the difference in the value of what Wales exports compared to what it imports, plus a financial outflow of private finance from the Welsh economy (fuller discussion in Ifan et al. 2020). Unfortunately, there is little data available on these private sector flows (Crawley et al. 2018).

Comparing income from the Welsh economy with expenditure by the Welsh economy is one way of approximating its balance of trade with the rest of the world. We allocate components of UK GDP expenditure to Wales by making various assumptions using available data. These estimates (**Figure 4.3**) suggest that consumption by households and government, and investment in Wales, amounted to approximately £92.3 billion in 2019 while Welsh GDP was around £78.9 billion. The estimates suggest Wales’ imports exceeded exports by some £13.3 billion in 2019, or around 17% of GDP. In 2019, the ONS produced estimates of Wales’ balance of international trade, which suggested international exports exceeded international imports by around £2.4 billion, which implies an even larger rUK trade deficit.

**Figure 4.3: Estimated net exports for Wales**

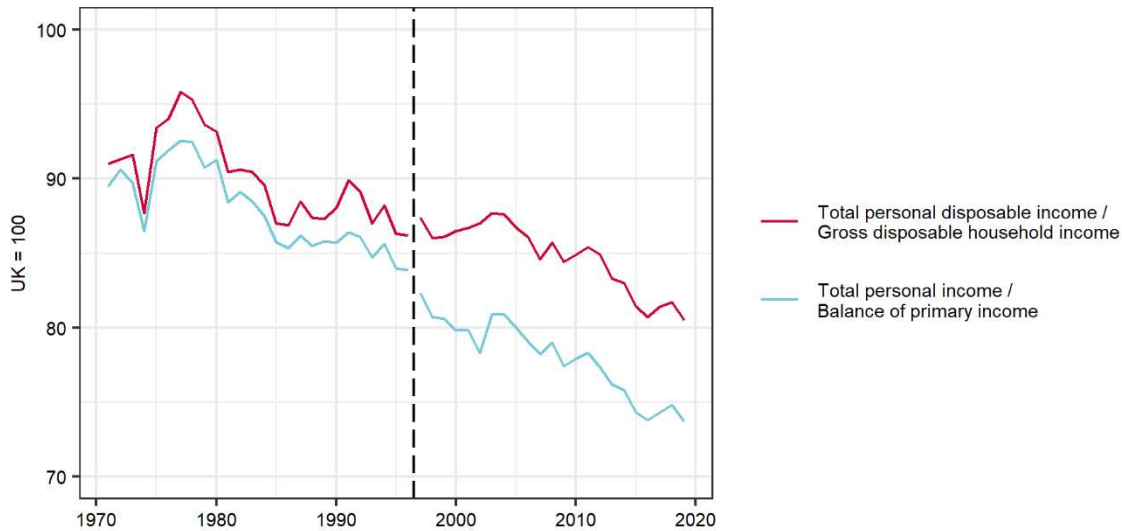
Components of expenditure GDP		Wales	UK	Wales as share of UK
<b>Gross Domestic Product (2019)</b>	<b>Y</b>	<b>78,949</b>	<b>2,255,283</b>	<b>3.5%</b>
Final consumption expenditure	C	58,140	1,499,077	4.0%
of which:				
Households		55,962	1,394,457	4.0%
Non-profit institutions		2,178	54,620	4.0%
General Government	G	21,148	424,006	5.0%
Gross capital formation	I	13,006	399,609	3.3%
<b>Total consumption and investment</b>	<b>C + G + I</b>	<b>92,294</b>		
<b>Total net exports (residual)</b>	<b>(X - M)</b>	<b>-13,344</b>		
of which:				
Net exports (rest of the world)		2,425		
Net exports (rest of the UK)		-15,769		

Source: ONS (2021) Regional gross domestic product: all ITL regions; ONS (2021) Quarterly National Accounts, Q3 (Jul to Sep) 2021; ONS (2020) Regional household final consumption expenditure, NUTS1 countries and regions; ONS (2021) Regional gross fixed capital formation, ITL1 and ITL2, 2000 to 2019; ONS (2021) Country and Regional Public Sector Finances; ONS (2021) International trade in UK nations, regions and cities: 2019; and authors' calculations.

These estimates offer only a rough approximation, but do indicate that Wales' trade deficit with the rest of the world (including rUK) is similar in magnitude to its fiscal deficit. The two are related, in some sense as 'two sides of the same coin' (ap Gwilym and Price 2012): the larger Wales' current account deficit, the more central government funding is necessary for the private consumption of imported goods and services.

Implicit fiscal transfers through the UK tax-benefit system also impact on relative income levels in Wales compared to the UK average. Primary incomes per person in Wales – income from employment, profits, and property – is around 74% of the UK average. After direct taxes and transfers, disposable income per person rises to around 81% of the UK level. There has been a significant, long-standing downward trend in relative primary income levels since the 1970s (**Figure 4.4**). UK-wide taxes and benefits have cushioned this fall somewhat; even so, relative disposable income levels have also declined significantly.

**Figure 4.4: Relative levels of disposable household incomes in Wales, 1971 to 2019 (UK=100)**



Source: ONS (2019 and previous) Personal disposable income (1971 to 1996), gross disposable household income (1997 onwards); and authors' calculations

## 5. Wales' fiscal prospects

What does Wales' fiscal deficit imply for its position as part of the United Kingdom?

Lacklustre economic performance and low income levels, leading to large, persistent fiscal deficits, is sub-optimal both for Wales and the UK. First, we explore how Wales' fiscal deficit could close while remaining part of the UK. Secondly, we explore its implications for the Welsh independence debate and what its current fiscal position suggests about the choices an independent Wales could face.

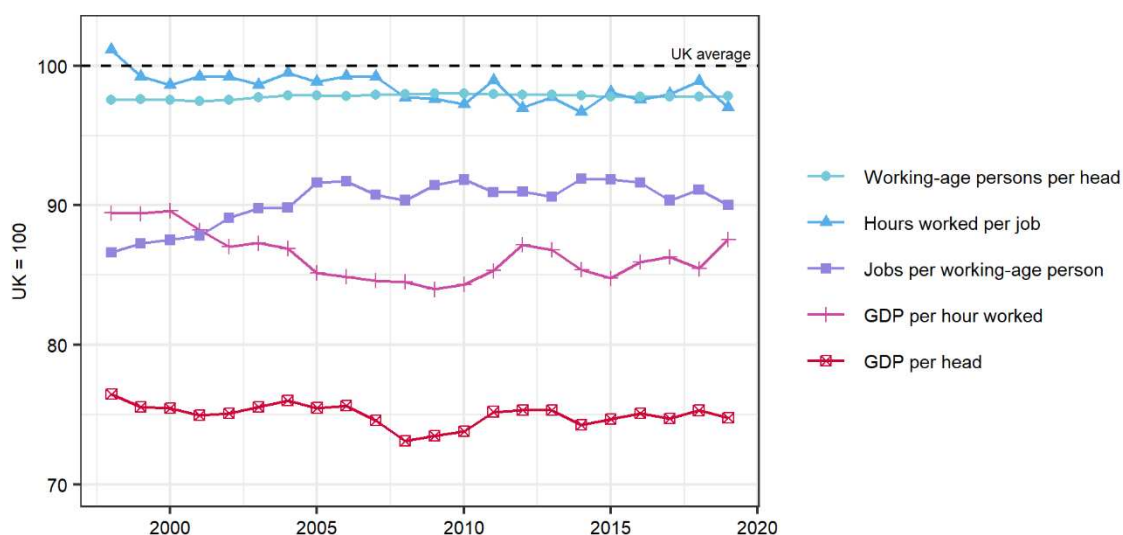
### 5.1. 'Closing the gap' as part of the United Kingdom

Closing the fiscal gap will depend on relative trends in total revenues and spending for Wales. The fiscal deficit results primarily from Wales' lower primary income levels and consequent smaller tax revenues. Ifan et al. (2020) model the effects of GDP per person in Wales increasing to 80% of the UK average by 2029–30, with revenues growing in line with economic growth and higher income levels leading to a slight fall in relative levels of social security spending in Wales. In this illustrative scenario, they find the net fiscal deficit would fall to 9.4% of GDP in 2029–30.

Such 'catch up' economic growth would mark a substantial departure from recent trends. Official data for economic output per head is available from 1966. Welsh output per

head fluctuated between 80% and 85% of the UK average from the 1960s to the early 1990s (Gooberman 2017). The years before devolution in 1999 saw a drop to around 75% (partly due to methodological and definitional differences in the estimates (Holtham 2019)). Early post-devolution economic development plans included the ambitious goal of raising GDP per head in Wales to 90% of the UK average by 2010 (Gooberman 2017), a target subsequently dropped because such a movement would require an economic ‘miracle’ (Institute of Welsh Affairs 2015). Relative levels of GDP per person have stayed broadly stable during the period of devolution, falling to 73% of the UK average in 2008 before recovering to 75% for much of the subsequent decade.

**Figure 5.1: The gap in GDP per person between Wales and UK by source, 1998 to 2019**



Source: ONS (2021) Regional labour productivity, including industry by region, UK: 2019; ONS (2021) Regional gross domestic product: all ITL regions; and authors’ calculations.

**Figure 5.1** breaks down the proximate sources of the GDP per person gap. Relative GDP per person depends on relative trends in the share of the working-age population, the share in employment, hours worked by those in employment, and productivity (measured by GDP per hour worked). The stability of the gap in GDP per person between Wales and the UK masks some important trends – jobs per working-age person grew faster in Wales than the UK during the first decade of devolution, when growing employment in the public sector offset continued falls in manufacturing. However, the improvement in employment levels was offset by falling relative levels of productivity (output per hour worked) and a slight fall in hours worked per job. Reaching 80% of UK GDP per person would require a 7%

increase in GDP per hour worked (reaching 91% of the UK average), a 7% increase in hours worked per person (to reach 94% of the UK average), or a combination of both.

Given the persistence of the gap in GDP per person between Wales and rUK, the likelihood of significant 'catch up' growth over the coming decade can be questioned. Full analysis of the interventions required to improve Wales' relative economic position is beyond our scope here (see Institute for Welsh Affairs (2015)), although it would seem likely to require radical changes to the UK economy and governance. Price (2018) argues that policies should focus on improving levels of education and skills and on increasing "effective economic mass" by enhancing transport and communication links. This approach would require a fundamental shift in historic public spending patterns, requiring significant spending changes from both devolved and UK governments and alteration of devolved competences. Although overall public spending in Wales is higher than the UK average, spending levels have been lower in key areas. Expenditure on Welsh schools and higher education institutions trails the UK average (Sibieta 2019), though education spending is strongly associated with regional success (Holtham and Huggins 2017). Capital spending on transport per person in Wales is around 75% of the UK average, with levels particularly low in the reserved (UK government) area of rail infrastructure enhancements (Welsh Government 2020). Government-led research and development spending per person is also significantly lower in Wales (Welsh Government 2021b).

Some of these historic spending patterns are the result of devolved government choices. Welsh Government spending choices suggest education has not been a priority since devolution. Welsh policymakers have been relatively cautious in leveraging private sector funding for infrastructure (Holtham 2019). These patterns also reflect historic and contemporary UK government spending choices and current constitutional arrangements. In some areas further devolution could lead to higher investment spending (e.g. rail infrastructure devolution – see Ifan et al. (2021)). The Welsh Government's capital borrowing powers could be enhanced (given currently low annual limits of £150 million). Though unlikely to prove economically transformative given the UK government's insistence that tax devolution in one area should not harm or draw investment away from other regions, further tax devolution might enhance the Welsh Government's economic development capacity.<sup>3</sup> Given the current UK government's constitutional positioning

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<sup>3</sup> See for example, the UK government response to the possibility of devolving Air Passenger Duty to Wales.

significant further devolution appears unlikely – most economic levers seem set to remain with the UK government.

The 2019 Conservative manifesto pledged to “level up” the UK. The Levelling Up White Paper published in February 2022 acknowledged the UK’s high geographical inequality and set medium-term missions, including closing the gap in pay, employment, and productivity between top and bottom performing areas. Achieving these missions would improve Wales’ relative economic and fiscal position. Specific commitments to Wales currently include replacing previous EU funding levels in cash terms by 2024–25. Wales received by far the largest EU structural fund support of all UK regions (on a per person basis) and fulfilling this commitment would entail Wales receiving almost a quarter of the planned UK-wide Shared Prosperity Fund. However, even EU allocated funding levels amounted to only approximately 0.6% of Welsh GDP, well below the levels provided at the height of UK regional policy (Gooberman 2017). Other new UK government funding streams, including the Levelling Up Fund, are unlikely to provide transformative levels of additional resource. The tight fiscal context set by the current Chancellor, alongside the promised future focus on tax cuts rather than additional spending, suggests additional investment to achieve the levelling up missions may fall short, especially in comparison to the example set by Germany following reunification (Enezel 2021). For Wales, there is added uncertainty as to how UK government-controlled funds will relate to Welsh Government economic development policies, raising concerns around governance, coordination, and duplication of funding streams.

Large-scale fiscal transfers reflect the Welsh economy’s performance as part of the UK. Since ending this dependence requires radical change, substantial fiscal transfers which enable levels of consumption in Wales higher than current production, will continue for the foreseeable future. Given Wales’ specific demographic challenges (see Ifan, Siôn, and Poole 2020), transfers focus on current funding challenges for public services. The East German experience since reunification shows transfers can trigger economic convergence (FitzGerald and Morgenroth 2019) – without radical change UK fiscal transfers to Wales are unlikely to do so.

## ***5.2. ‘Closing the gap’ as an independent country***

An independent Welsh state would have additional policy levers that could help close the ‘fiscal gap’, but without rUK transfers, this endeavour would be considerably more pressing. Independent Wales’ inherited fiscal position would differ from that outlined in the *Government Expenditure and Revenue Wales (GERW)* reports, due to day-one policy positions, and the terms of any rUK-Wales separation treaty. For instance, the division of UK assets and liabilities is often cited as one of the biggest unknowns with potential to impact an independent Scotland’s initial fiscal position (Dalzell 2016; Roy and Spowage 2021). What factors might affect the size of an independent Wales’ inherited deficit, and the prospect of ‘closing the gap’?

£34.5 billion of the designated £45.4 billion government expenditure for Wales in 2019–20 is classed as ‘identifiable spending’ – identified as benefitting a particular country or English region. Unless current policies change, government spending at the onset of independence is likely to be broadly similar. The treatment of pension liabilities might be the largest source of uncertainty. State pension spending is by far the UK Government’s single largest spending item in Wales – amounting to £5.1 billion in 2019–20 (or 6.8% of Welsh GDP). Since the UK state pension is a ‘mainly flat-rate, largely non-contributory’ scheme, state pension payments feature as current expenditure in the UK’s *Whole of Government Accounts*; future obligations are not listed as a balance sheet liability (Bozio et al. 2010).<sup>4</sup> Retired individuals’ pensions are, in effect, mostly funded by those currently in work, not past tax contributions. Independence is likely to end Welsh taxpayer payments to HM Treasury and the UK Government’s responsibility for the state pension in Wales. A different arrangement might apply to public sector pension schemes, whose members accrue their pension entitlements over their period of employment. Were an independent Welsh state to take on these liabilities, it might also claim a proportional share of any scheme’s assets.

The remainder of government expenditure apportioned to Wales consists of £4.8 billion of non-identifiable spending – a population share of spending deemed to be incurred on behalf of the UK as a whole rather than a specific geographic region (e.g. defence spending and interest payments on the national debt); a £1.2 billion share of government spending outside the UK; and a £5.0 billion accounting adjustment (largely offset by balancing items on the revenue side). Reconciling these figures with the post-

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<sup>4</sup> The *Whole of Government Accounts* are consolidated financial statements covering the entire public sector, published annually by the UK government.

independence fiscal position is tricky. For instance, sustaining its apportioned per capita level of UK spending would see an independent Welsh state allocating 2.6% of Welsh GDP on defence, considerably higher than NATO's 2.0% target – an implausible prospect. Similarly, Wales' 2019–20 non-identifiable spending includes a population share (£2.7 billion) of the UK's national debt interest payments. Yet, there is no guarantee that this method would be used when apportioning UK liabilities (and assets) should Wales become independent.

The UK government has repeatedly asserted it would retain sole responsibility for UK-issued debt stock should Scotland leave the UK.<sup>5</sup> In a similar situation, Wales could opt to pay its share of UK debt in full on becoming independent (issuing its own government bonds) or agree to repay interest and principal as it falls due. Each option needs an agreed method to apportion Wales' share of historic UK debt. Summarising the views of legal analysts, Rowlands (1997) sees no obvious consensus on the legal basis for apportioning public debt on secession. Historical examples show debt allocated by population, relative GDP, revenue contribution, and successor states being freed from all debt liabilities by all-party mutual agreement (de Aghion and Williamson 1993).<sup>6</sup> Assuming that an independent Wales would honour the cost of servicing an equitable share of UK debt, the apportionment method would likely be keenly negotiated: unlike Scotland, Wales' share of UK GDP is considerably lower than its population share. A population share (4.7%) of the UK's general government gross debt of £1,821 billion in 2018–19 would give Wales a debt burden equivalent 113% of its GDP; a GDP share (3.5%) results in a considerably reduced debt burden at 84% of GDP. The actual outcome would depend on relative bargaining positions, reflecting the penalty costs for both parties.

Even on the most charitable assumptions, an independent Wales inherited fiscal position looks unsustainable. Short-term, the deficit could be funded by borrowing, but debt would accumulate rapidly. From day one an independent Wales would need to make significant tax and spending policy changes. Ifan et al. (2020) modelled the possible impact of fiscal consolidation on public sector net debt acquired post-independence. They use a pre-Covid projection of the fiscal deficit in 2022–23 and apply the same assumptions made

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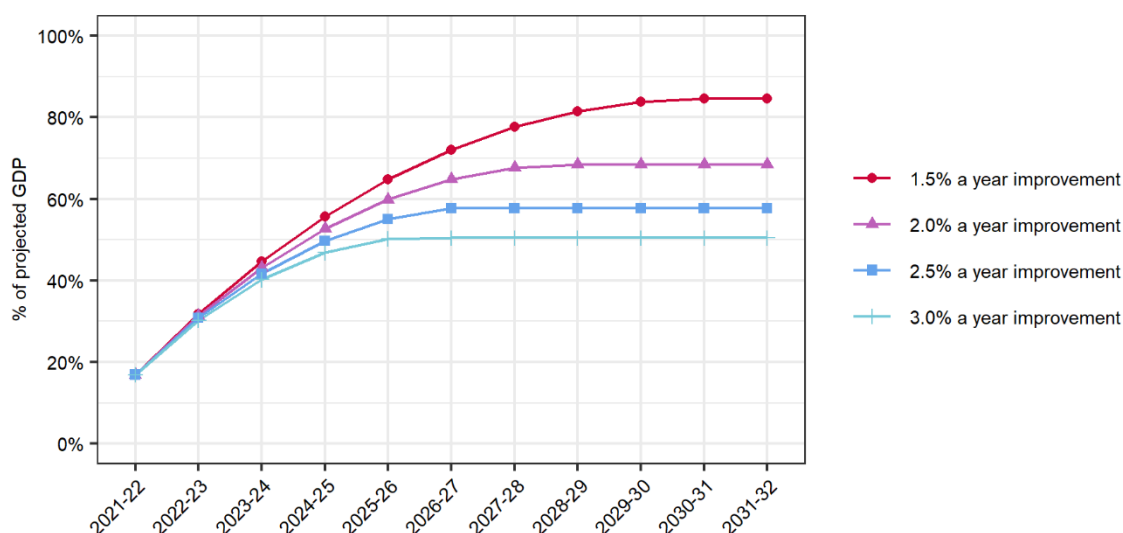
<sup>5</sup>[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/270643/uk\\_debt\\_and\\_the\\_Scotland\\_independence\\_referendum.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/270643/uk_debt_and_the_Scotland_independence_referendum.pdf) See HM Treasury (2014).

<sup>6</sup> The zero-option was agreed among the successor states of the USSR. However, the Ukraine instead opted to inherit a share of former USSR debt as a way of asserting the country's sovereignty (Rowlands 1997).



by the Scottish Sustainable Growth Commission (2018) on debt costs and other spending. If Wales became independent in 2022–23, a 1.5% improvement in the structural balance – a widely used benchmark for fiscal consolidation – implies that *new* public sector debt would peak at 73% of GDP in 2030–31 (Figure 5.2).<sup>7</sup>

**Figure 5.2: Illustrative path of total new public sector debt under different fiscal consolidation paths**



Source: Ifan, Siôn, and Poole (2020).

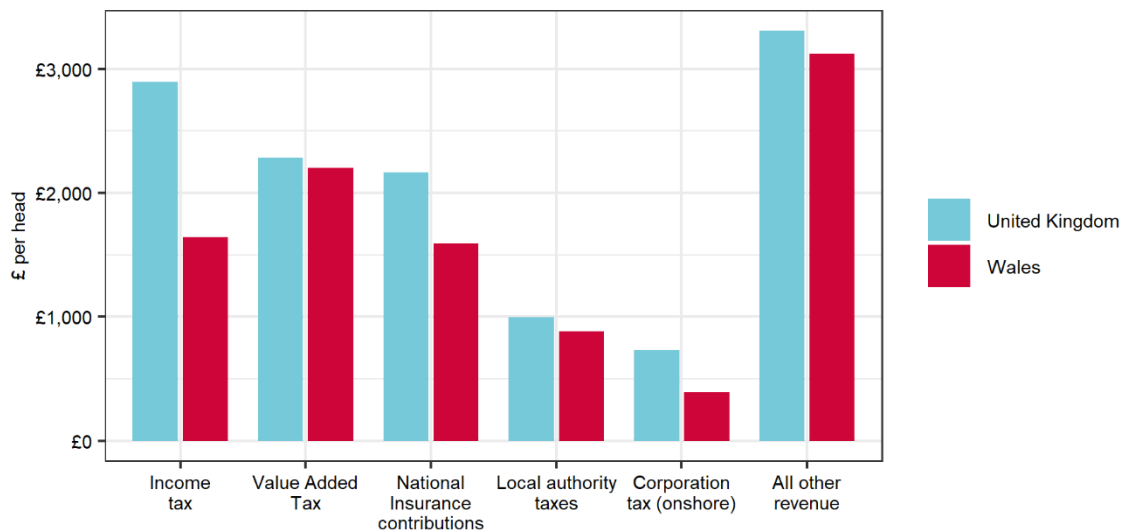
Particularly during recessions, fiscal consolidation can amplify negative economic effects (Eyraus and Weber 2013). They can, Cugnasca and Rother (2015) note, be somewhat mitigated in economies with highly liberalised trade, if negative effects on aggregate demand are diluted through the trade channel. This might apply in Wales, since imports and exports are likely to be high when expressed as a proportion of its GDP. The composition of fiscal consolidation also matters; cuts to government consumption and investment are generally associated with larger multipliers than tax increases and transfer reductions (Gechert and Will 2012). Fortuitously, independent Wales’ optimal tax design might yield more revenue than present arrangements. A breakdown of tax revenue sources per head in 2019–20 shows Wales is unique among G7 and EU-15 countries as well as the UK in having Value Added Tax (VAT) – a tax on the consumption of goods and services – as its largest source of tax revenue (Figure 5.3).<sup>8</sup> On independence, Wales could choose a tax

<sup>7</sup> ‘New public sector debt’ is exclusive of any inherited UK debt, although population share servicing costs for UK debt are included in the initial fiscal balance calculation.

<sup>8</sup> Conte et. al (2019) explore how European countries with large tax takes relative to the UK generally have higher income tax rates and larger social security contributions.

system more suited to its narrow and more positively skewed income distribution (relative to the UK average), though any tax policy could be constrained by cross-border and capital mobility post-independence.

**Figure 5.3: Public sector revenues by source, 2019–20 (£ per head)**



Source: ONS (2021) Country and Regional Public Sector Finances, Mid-year population estimates; ONS (2019) 2018-based principal population projections.

Fiscal policy should be considered alongside post-independence currency arrangements; Wales' options are likely to echo those widely discussed for Scotland prior to, and in the aftermath of its 2014 independence referendum (Armstrong and Ebell 2014; Dalzell 2018). An independent Wales would need to balance minimising trade barriers and cross-border exchange costs against the increased autonomy and associated benefits of control over exchange rates and adjustment mechanisms. Wales' initial substantial level of indebtedness suggests that flexibility over monetary and exchange rate policy afforded by a new currency might prove useful. But regardless of whether the transition to a more sustainable fiscal position is achieved exclusively through fiscal policy, or using a combination of fiscal, monetary and exchange rate levers, Wales' large balance of payment deficit would need to be addressed. Doing so would likely require a reduction in imports and consumption of goods and services.

Independent fiscal sustainability will also hinge on Wales' the long-run economic performance. Isolating the effects of state separation from the political and historical context of independence presents obvious challenges. Even when the break-up is peaceful,

secession can depress a newly independent country's economic output: crucially these effects can endure. Despite a relatively peaceful breakup, trade-link disruption following the Soviet Union's dissolution meant that the fall in output experienced were as large as those for former Yugoslavia (Suesse 2017). A large panel study of countries between 1940 and 2016 found that a decade on, secession lowered newly independent states' GDP by 24% relative to countries which most closely resembled their prior economic circumstances – though democratization and adoption of more liberal trade regimes mitigated this impact (Reynaerts and Vanschoonbeek 2021). Post-independent trade and border arrangements could prove a large determinant of the future economic prospects for an independent Wales.

## 6. Conclusion

After political devolution in 1999, *ad-hoc*, piecemeal and almost-constant reforms have consistently deepened and widened Welsh devolution. Recently this reform trajectory has been supplanted by an abrasive stalemate between radically different constitutional visions: the current UK Government's 'muscular unionism' has re-centralising tendencies; its Welsh counterpart's 'progressive unionism' depicts the UK as a voluntary union that requires a fundamental constitutional renewal. The establishment of the Independent Commission on the Constitutional Future of Wales, alongside a growing (though still-minority) support for Welsh independence, illustrate an increasing questioning of and tensions around Wales' place in the UK.

Wales' constitutional debate requires a stronger foundation in political economy, including an unblinking assessment of its fiscal and economic reality. Estimates consistently find that Wales has a large and persistent fiscal deficit, funded by transfers from rUK. The causes and consequences of this fiscal position shed light on Wales' potential constitutional future. Its fiscal deficits mainly reflect long-term economic decline and Wales' position as a poorer area of the UK. Over the past four decades, invisible and automatic fiscal transfers through the UK's tax-benefit system have largely replaced UK Government attempts to alleviate economic disparities through active economic and regional policies.

Fiscal reality leaves Wales in an unenviable position: relative economic fortunes are unlikely to be reversed with current economic, fiscal, and constitutional arrangements.

Large rUK fiscal transfers are set to continue, boosting relative disposable incomes and consumption in Wales. However, these fiscal transfers do little or nothing to turn around the fiscal position or relative performance of the Welsh economy. By removing these fiscal transfers, independence also poses economic difficulties for Wales. It would, we argue, entail challenging fiscal and economic policy choices to address Wales' balance of payments deficit. Sub-state nations with credible secession threats sometimes enjoy stronger fiscal support (Claeys and Martire 2015); ironically, the potential roadblock Wales' fiscal position presents to independence may further weaken the prospect of public investment support from the UK Government.

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