Y Pwyllgor Cyllid | Finance Committee
FIN(5)-22-17 P6

2025

Gwasanaethau Cyhoeddus Cymru
Wales Public Services

Welsh Government Budgetary Trade-offs: Looking Forward to 2021-22

September 2017

Prifysgol Caerdydd
Cardiff University

Canolfan Llywodraethiant Cymru
Wales Governance Centre

Wales Public Services 2025

Wales Public Services 2025 is hosted by Cardiff Business School and is a unique partnership between Cardiff University and five national bodies in Wales: the Welsh Local Government Association, SOLACE Wales, the Welsh NHS Confederation, the Wales Council for Voluntary Action and Community Housing Cymru. Its goal is to provide fiscal, economic and policy analysis on public services in Wales which is authoritative and independent.

The Wales Governance Centre

The Wales Governance Centre is a research centre that forms part of Cardiff University's School of Law and Politics undertaking innovative research into all aspects of the law, politics, government and political economy of Wales, as well the wider UK and European contexts of territorial governance. A key objective of the Centre is to facilitate and encourage informed public debate of key developments in Welsh governance not only through its research, but also through events and postgraduate teaching.

Author Details

DR DARIA LUCHINSKAYA

Research Associate, Wales Public Services 2025 and Research Fellow at the Institute for Employment Research, University of Warwick

JOSEPH OGLE

Research Assistant, Wales Public Services 2025

MICHAEL TRICKEY

Programme Director, Wales Public Services 2025

ED GARETH POOLE

Lecturer in Politics and International Relations, Wales Governance Centre at Cardiff University

GUTO IFAN

Research Assistant, Wales Governance Centre at Cardiff University

The authors would like to thank colleagues in the Institute for Fiscal Studies, the Welsh Local Government Association, the Welsh Government and others who have assisted us. Any errors or omissions are the responsibility of the authors.

For further information please contact:

Michael Trickey

WPS2025@cardiff.ac.uk

Wales Public Services 2025

Tel: 029 2087 0913

Contents

Executive Summary

2018 is a watershed year for devolution in Wales. From this year forward, each annual budget will now incorporate decisions on Welsh taxes, borrowing for capital expenditure, and any use of a new facility called the Welsh Reserve. In addition, recent developments at the UK level – the Autumn Statement 2016, the Spring Budget 2017 and the General Election – each have an impact at the Welsh level through the UK's block grant to Wales.

This report sets out the key changes to the UK fiscal context and to Welsh devolution over the past year, and using this as a basis, runs through a number of public spending scenarios. It demonstrates that current UK spending plans could result in a further and potentially damaging period of cuts in unprotected services. With new devolved tax powers expected to have only a limited impact on total spending by 2021-22, decisions about the future balance between protected and unprotected services are likely to become increasingly stark and may prompt questions about the affordability of the current range of services.

The economic and fiscal context

- After seven years of fiscal consolidation, the incumbent Chancellor relaxed his target for achieving a balanced budget to the mid-2020s, providing the Treasury some flexibility which we account for in this report.
- Although spending plans in the March 2017 UK Budget provided for a modest cash increase, expenditure per person on public services is still forecast to fall by 4.8 per cent in real terms over the period between 2017-18 and 2021-22.[1]
- Despite Wales' new tax powers, UK Government spending decisions will continue to be the dominant influence on the overall level of devolved spending. The degree of uncertainty at the time of publication mean that we cannot include a Brexit settlement in our modelling.

Welsh Taxes and the Fiscal Framework

- The new Land Transaction Tax and Landfill Disposals Tax come into effect from 2018 and the Welsh Rate of Income Tax (WRIT) from 2019. These three devolved taxes, together with business rates but excluding council tax, comprise around £3.3bn of revenue, approximately 24 per cent of the Welsh Government's resource budget.
- After deductions from the Block Grant to take account of devolved taxes, tax devolution is likely to have only a limited impact on overall spending over the next four years.
- Current Welsh Government policy is that the current income tax rates for Wales will not be increased for the duration of the current Assembly. Even if this were not the case, varying WRIT rates by 1p would only generate a 1.5% increase or decrease in the 2019-20 overall Welsh resource budget under our baseline scenario (assuming no behavioural response).
- The new Needs Based Factor in the Barnett Formula provides more funding for the Welsh Block Grant for any increase in spending in England than was previously the case, but the scope of this advantage will be very modest unless there is a marked increase in UK public spending.

1 Office of Budget Responsibility, Economic and Fiscal Outlook (2017a).

The impact of austerity on the Welsh Budget so far

- The Welsh Government budget for day-to-day spending on public services (resource spending, RDEL) decreased by 11.5 per cent in real terms between 2009-10 and 2017-18.[2] The Welsh Government's budget for investment, or capital spending (CDEL) is 32.4 per cent lower in real terms in 2017-18 than it was in 2009-10.
- The Welsh Government responded to cuts by, broadly, 'protecting' funds for schools, social services (by way of local government) and, after October 2013, spending on the NHS. These protected service areas consequently now account for a larger proportion of the total budget. The core NHS revenue budget increased from 39 per cent of the Welsh Government RDEL budget in 2009-10 to 48 per cent in 2017-18.
- Cuts to councils' spending have been smaller than in England. On the basis of the most recent available outturn figures, Welsh Government funding for local government day-to-day spending (excluding business rates and housing benefit) fell by 14 per cent in real terms between 2009-10 and 2015-16 (£655 million). This was partly offset by a 17 per cent increase (£207 million) in collected council tax revenues (excluding Council Tax Reduction Scheme). Average Band D council tax rates rose by 11.6 per cent from 2009-10 to 2015-16.
- Net local authority current total spending on schools decreased by 4 per cent, while spending on social services increased marginally by 0.6 per cent over the same period.
- There was an overall 23 per cent cut in current spending on all other, 'non-protected', local authority services.

Scenarios for the Welsh Budget envelope 2018-19 to 2021-22

Given the uncertainties of medium-term fiscal policy, this report sets out three main resource budget scenarios (R1, R2 and R3) for UK public spending from 2018-19 to 2021-22 and their implications for the total 'envelope' of devolved spending in Wales. The scenarios all assume a continued UK Government commitment to protecting central budgets for the NHS, schools, defence and international development.

- A baseline 'austerity' scenario (R1) follows plans announced in the March 2017 budget to 2019-20, allocates a Wales share of the Treasury's planned £3.5bn efficiency savings, and assumes UK departmental spending allocations are uprated for inflation in 2020-21 and 2021-22.
- An 'easing of austerity' scenario (R2) follows R1, but cancels the planned £3.5bn efficiency savings, and builds in 2017 Conservative manifesto spending pledges.
- Lastly, a 'benchmark' scenario (R3) protects the 2017-18 allocations in real terms in following years.

All three scenarios would result in continued real terms reductions in the Welsh block for resource expenditure (as shown in Table E1).

Table E1: Three scenarios for the Welsh block grant for resource expenditure (excluding depreciation) 2017-18 to 2021-22 (£ millions)

Scenario	2017-18	2018-19	2019-20	2020-21	2021-22	% change 2017-18 to 2021-22
R1	13,400	13,196	12,998	13,001	12,998	**-3.0%**
R2	13,400	13,246	13,182	13,261	13,334	**-0.5%**
R3	13,400	13,332	13,287	13,291	13,288	**-0.8%**

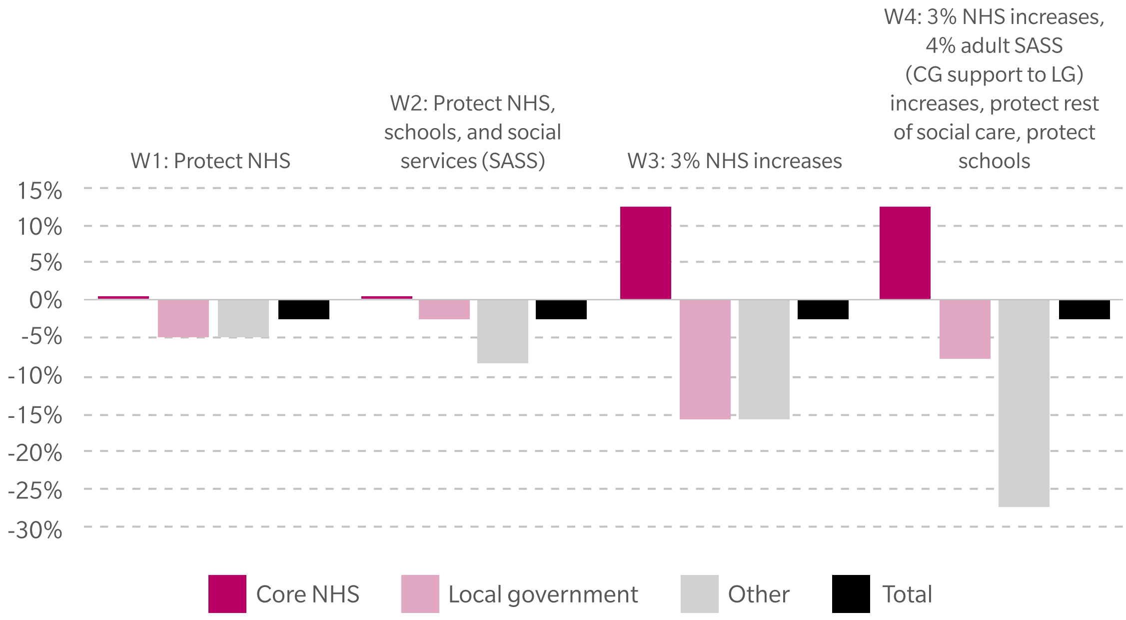
2 Figures adjusted for the devolution of business rates in April 2015 and council tax benefit in April 2013..

Scenario R1, which is based on current UK plans, would result in a further 3% cut in the Welsh block grant. Cuts in scenarios R2 and R3 would be much smaller, at just 0.5 per cent for R2, resulting in an extra £300 million for the Welsh Government in 2021-22 than would be the case in scenario R1.[3] But in all three scenarios, the block grant in 2021-22 would still lower be than in 2017-18.

Future choices and Welsh budget trade-offs

The Welsh Government is likely to face significant challenges in its funding of public services over the next four years as pressures continue to grow. For each of the three scenarios for the Welsh resource budget above (R1-R3), we consider four scenarios for Welsh Government decisions (W1-W4) on allocating these resources in the next four years. Each scenario considers a various basket of different protections for the NHS, social services and schools and how these affect 'unprotected' services and are summarised in figure E1:

Figure E1: Cuts to Welsh Government spending by service area (2017-18 to 2021-22) in the baseline scenario R1, by Welsh Government spending scenario



Any increases in spending for protected areas would result in future cuts for unprotected services. In the scenario with the most protections, W4 – which increases adult social services to match the Health Foundation's (2016) estimates of increasing cost and demand pressures and protects the rest of social services and schools in real terms – cuts to unprotected services rise to 27 per cent (Figure E1). Reductions at that level could have profound implications for the sustainability of some unprotected services.

If protected budgets are maintained in real terms rather than increased (as in scenarios W1 and W2), the impact on unprotected services is more limited. But in these circumstances, NHS and social care budgets would not be keeping pace with cost and demand pressures.

Local government budgetary trade-offs to 2021-22

Assuming the baseline resource budget scenario, modelled changes in total local government revenues between 2017-18 and 2021-22 range from -0.6 per cent to -10.4 per cent, depending on changes in Welsh Government support. At the local level, we consider the following three social services spending scenarios:

S1: Councils do not protect any area of spending from cuts, nor privilege any in the event of a budget increase.

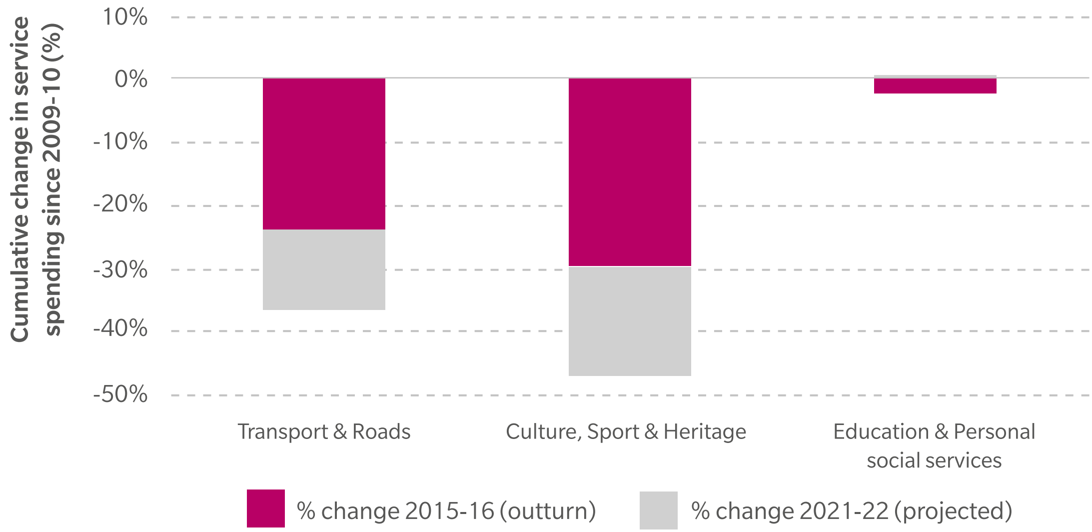
3 To build a full picture of the overall Welsh resource budget, we assume that the Welsh Government RDEL changes at the same rate as the Welsh block grant and then add in business rate revenues.

S2: As S1, with councils protecting spending on education in real terms at its 2017-18 level.

S3: As S1, with councils protecting spending on education and social care in real terms at its 2017-18 level.

If councils continue to protect education and personal social services in real terms (S3), there will be further cuts unprotected services on top of the cuts so far. Figure E2 illustrates the impact on specific budgets.

Figure E2: Cuts to local government services under scenario S3, 2009-10 to 2021-22



Conclusion

Looking forward to 2021-22 and beyond, the pressures on public services of an ageing population will intensify. Although health and social care are at the heart of these pressures, other services such as housing, transport, leisure and culture have a key role in an ageing society and are important to the seven Future Generations outcomes. Many of these unprotected services have already seen significant cuts in local spending.

Given the current fiscal trajectory, it is hard to see how Wales can square the circle of reducing funds and growing demand as it goes into the 2020s. Without increases in the overall envelope for the Welsh Budget, and with efficiencies on their own unlikely to be sufficient to bridge the funding gap, difficult decisions about what services are affordable are likely to come increasingly to the fore.

The new tax powers and flexibilities set out in the Fiscal Framework will strengthen the budget possibilities available to the Welsh Government but the fiscal policy of the UK Government will continue to be the biggest determinant by far of Welsh Government total spending.

The issues raised here reflect long term structural challenges. A relaxation in UK Government fiscal policy would make a difference, but the long-term growth in demand and cost pressures will require a long term response.

1. Introduction

This report, by the Wales Public Services 2025 Programme based at Cardiff Business School has been produced in partnership with Cardiff University's Wales Governance Centre (WGC). It looks at the choices and options for the Welsh Budget over the remainder of the term of the Fifth Assembly (to 2021-22) based on a number of scenarios. It follows a study commissioned by Wales Public Services 2025 from the Institute for Fiscal Studies (IFS), published in September 2016 which looked at the challenges for the Welsh Budget over the period 2015-16 to 2019-20 in the light of current fiscal policy and austerity (Phillips and Simpson, 2016). We gratefully acknowledge the continued advice and encouragement of the IFS in building on this work and their generosity in allowing us to draw on their modelling.

There have been significant changes since the IFS study. At the UK level, the Autumn Statement 2016 and the Spring Budget 2017 set out the fiscal policies of a new Chancellor. The 2017 General Election has transformed the political environment, including a minority government dependent on a 2-year £1 billion confidence and supply agreement with the Democratic Unionist Party. And the task of negotiating a Brexit settlement with the European Union and within the UK looks increasingly formidable.

But autumn 2017 will also mark the start of a new era for fiscal policy in Wales. The forthcoming Welsh Budget and its successors will for the first time encompass new powers on devolved taxes (including the potential for new made-in-Wales taxes). The first new taxes come into effect in April 2018 and the partial devolution of income tax expected to follow in April 2019.

Alongside, a new Fiscal Framework agreement (December 2016) between the UK and Welsh Governments will come into effect, changing the way in which the UK's block grant to Wales is calculated and introducing new flexibilities for the Welsh Budget over borrowing for capital and the creation of the Welsh Reserve. This report draws on, but does not duplicate, a recent analysis by the WGC and IFS on the fiscal framework (see Poole et al., 2017).

These new powers will expand the existing scope for decisions on tax and public spending in Wales, widen the range of choices about financing devolved public services and open up a discussion about strengthening the future tax base.

They represent a major step in the devolution journey although their impact is likely to take time to build. For the period of this study at least, the fiscal and economic policy of the UK Government will remain a dominant factor in determining the money available for devolved services in Wales.

Section Two of the report discusses the wider UK fiscal and economic environment and also considers the potential budgetary impact of the latest stage in devolved public finances ushered in by the new Fiscal Framework and the Welsh Rate of Income Tax. Section Three then looks at the impact of austerity on public spending, both at the Welsh Government and local government level, since 2009-10.

Section Four projects the overall envelope for the Welsh Government budget up to 2021-22 by exploring three scenarios for the Welsh block grant from the UK Government, taking account of the new Fiscal Framework as well as Wales' new and existing tax powers. The Section then sets out a range of options for the Welsh Government's expenditure on public services over the next four years and the choices and trade-offs it faces.

Finally, Section Five considers the implications of the preceding scenarios on Welsh local government finances and budgetary pressures, as well as the implications for certain service areas resulting from specific trade-offs at the local government level. The report concludes by summarising the main policy implications arising from the scenarios.

2. The Welsh economic and fiscal context – what has changed?

Since September 2016 a number of fiscal events have occurred. The Autumn Statement (November 2016) and the Spring Budget (March 2017) have set out the UK Government's position on funding public services, which have had moderate implications for Wales through the Barnett formula. Moreover, the UK underwent a General Election in May 2017, and the Conservative manifesto (May 2017) set out a number of policy directions at the UK level that are likely to have implications at the Welsh level as well. In this Section, we look at the main fiscal changes that have taken place since September 2016 and their implications for Wales. We also consider the impact to the overall spending envelope available to the Welsh Government, in particular the implications for the Welsh Budget of the newly devolved taxes and the change to the Barnett Formula arising from the new Fiscal Framework Agreement between the Welsh and UK Governments.

Tax devolution and the new Fiscal Framework will both give the Welsh Government significant new flexibilities and tools while also making progress towards 'Fairer funding'. But they are unlikely to have more than a limited impact on the overall size of the Welsh Budget in the next four years. UK-level policy decisions that affect the size of the block grant through Barnett 'consequentials' still possess the dominant role.

2.1 The UK fiscal and economic context

Despite the devolution of selected taxes to Wales (discussed in Section 2.2), UK Government fiscal strategy will continue to be the dominant influence on the overall level of Welsh Government spending.

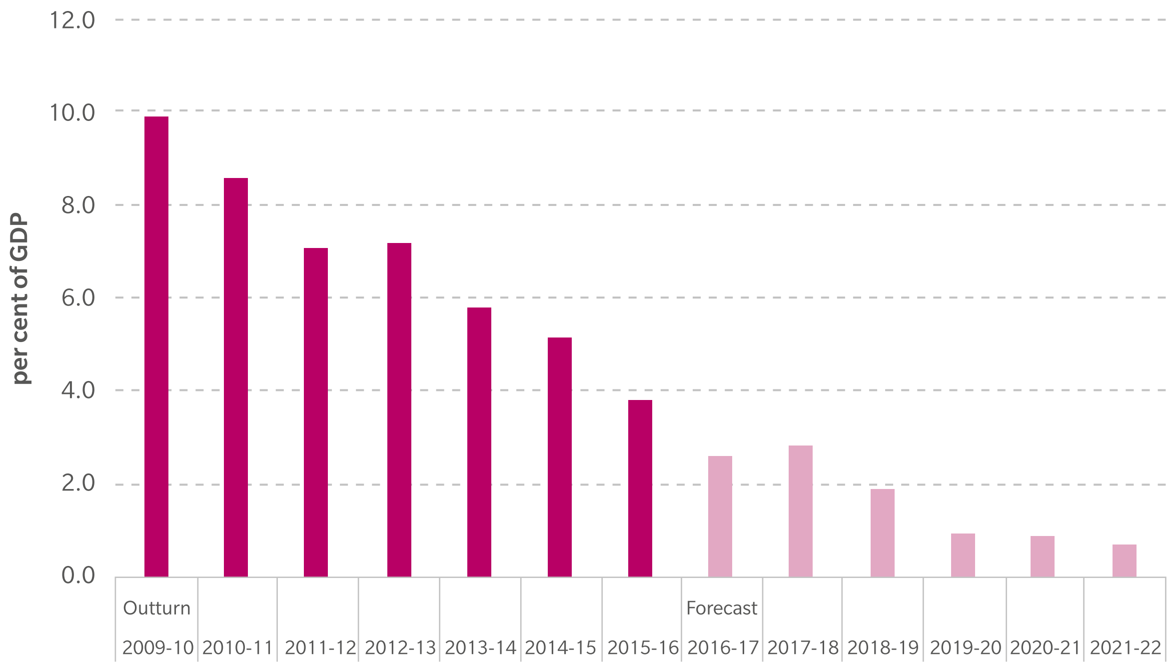
Welsh budget planning is taking place against a background of uncertainty over the direction of UK fiscal and economic policy including, but not limited to, Brexit. The Chancellor's forthcoming autumn fiscal event should provide greater clarity.

The analysis below builds on recent reports by the Office for Budget Responsibility (OBR) and IFS, including OBR forecasts as appropriate.

2.1.1 March 2017 Budget plans

The UK Government has further to go in achieving its objective of bringing its finances into balance. The original target date of 2015 has been put back several times, partly due to the sluggish performance of the UK economy. The OBR forecasts that on current plans the UK Government will still be borrowing £16.8 billion a year in 2021-22 in cash terms (£15.7bn in 2017-18 prices), or 0.7 per cent of GDP (OBR, 2017a).

Figure 2.1: UK budget deficit (public sector net borrowing) as a percentage of GDP



Source: OBR Economic and Fiscal Outlook March 2017, Historical official forecasts, public sector net borrowing as a percentage of GDP.

The current Chancellor, Philip Hammond, relaxed the Government's fiscal rules in his first Autumn Statement (2016). Under the new fiscal mandates, the goal was for the budget to return to surplus within the 'next' parliament. While there was some borrowing to fund capital projects, overall the austerity programme remained firmly in place, and £3.5 billion of 'efficiency savings' remained pencilled in for 2019-20.

Although the March 2017 Budget increased departmental resource spending (day-to-day spending on services), including more money for social care, spending per person is forecast to fall in real terms by 4.8 per cent over the period 2017-18 to 2021-22 on top of reductions implemented since 2010 (OBR, 2017a, pp. 136-7).

On current plans and forecasts, spending on public services in 2019-20 could well fall as a share of national income to its lowest point since 2003-04 (Emmerson, 2017a). This is in a context of weak UK economic performance, including flat productivity and flat real average earnings growth.[4] The UK Government has 'protected' some areas of spending, including health, central spending on schools, international development and defence. But even spending on health, one of the few areas which is increasing in real terms, was not keeping pace with growth in the economy, falling by 0.2 per cent of GDP between 2010-11 and 2015-16.[5]

There has been better news on capital spending which is forecast to rise from £49.8 billion in 2017-18 to £68.7 billion in 2021-22, reflecting the role which the UK Government sees for capital spending in stimulating economic recovery and growth.

4 See, for example, Cribb (2017).

5 See OBR (2017b).

2.1.2 Fiscal strategy following the 2017 General Election

Pending the autumn fiscal event in 2017, options for future fiscal strategy being discussed in the financial press include a continuation of austerity, a softening of austerity and a strategy based on low taxation and low spending.

The Conservative Party's 2017 general manifesto pledged to raise the threshold for the standard and higher rates of income tax by 2020 as part of a wider commitment to tax reduction for families and businesses (Conservative Party, 2017). But the manifesto also committed to a balanced budget by the mid-2020s which the Chancellor has subsequently reiterated, although he has also noted the public's weariness with 'seven years of hard slog'.

Current plans do not set out how the remaining deficit will be erased after 2021-22: forecasts for the economy suggest that a mix of further tax rises and spending cuts might be necessary. But extending the target date to around 2025 gives the UK Government more room for manoeuvre over the medium term.

As outlined in the remainder of this section, the issue will be how the Chancellor treads the delicate path between spending pressures, the commitment to eradicating the deficit and the fragility of public finances, including their sensitivity to inflation and small shifts in economic growth, compounded by the uncertainties associated with Brexit.

2.1.3 Pressures and uncertainties

The largest spending pressures arise from the implications of an ageing population and rising care costs (health care, social care and state pension), detailed in the OBR's 2017 Fiscal Risks Report (2017b).[6] But the funding needs of other services, for example in response to crowding in UK prisons, are also being put forward.

The Conservative manifesto made few spending commitments, the most significant one relevant to devolved services in terms of scale being an increase in English NHS spending "by a minimum of £8 billion in real terms over the next five years", i.e. by 2022-23. How this increase would be phased over the five years was not specified, but this would be equivalent to 1.2 per cent a year more in real terms. The Health Foundation (Watt and Roberts, 2016) and others contrast this increase with the historical average increase of 4 per cent a year and warn of a continuing and significant 'funding gap'. The manifesto also drew attention to a modest commitment on schools funding, which works out as a negligible change in real terms over the next 5 years. We consider the possible implications of these commitments for the Welsh budget in the next section.

Other cost pressures look likely to put public service budgets under strain. The public sector pay freeze followed by the pay cap, under which public sector pay scales can rise on average by 1 per cent each year up to and including 2019-20, has been a crucial element in enabling public services to mitigate the impact of austerity. For example, the OBR identifies the public sector pay cap as a key factor in the real terms growth in NHS spending. As the debate over this summer has demonstrated, the cap on public sector pay is coming under increasing pressure. The IFS has calculated that increasing public sector pay in line with private sector pay would add £9 billion to costs by 2021-22 (Emmerson, 2017b). The current rise in inflation following the depreciation in the pound exchange rate will add to the pressure although this is expected to fall back in the medium term.

6 See for example http://cdn.budgetresponsibility.org.uk/July_2017_Fiscal_risks.pdf

2.1.4 Brexit

The considerable uncertainty about the details of any final Brexit settlement, including the length and nature of any transitional arrangements, and its impact on the UK economy makes it difficult to assess the fiscal implications. The actively contested debate among economists reflects very different analyses, although there is a widely-shared view that the impact on the economy and public finances is more likely to be negative than positive over the short-to-medium term. Even a modest impact on economic growth either way could have significant implications for public spending.

The OBR (2017b) currently assumes that any reduction in expenditure transfers to EU institutions, net of the UK rebate, would be fully recycled into extra domestic spending. It is not possible to assess the impact of any 'divorce bill' although its one-off nature should not pose a big threat to fiscal sustainability.

In 2016-17 the UK's net public sector contribution to the EU (after the £4.8bn rebate from the EU and after £4.1 billion of public sector receipts from the EU) was estimated at £8.1 billion in cash terms, or around 1.0 per cent of the UK's overall spending in that year.[7] Although this may be relatively small in the context of the UK Budget as a whole, what happens to the UK's current contribution to the EU will be highly relevant to the Welsh economy and public spending.

The Welsh Government has identified that in total Wales receives around £680 million in EU funding annually, mostly receipts under the Common Agricultural Policy (CAP) and Structural Funds along with other smaller, albeit economically significant, pots of funding.[8] It argues that the baseline of the Block Grant payment for Wales must be re-adjusted, at the point of exit from the EU, to reflect the loss of funds and taking into account funding which Wales would have otherwise reasonably expected from EU sources.

The Conservatives manifesto committed to using the structural fund money that comes back to the UK to create a United Kingdom Shared Prosperity Fund, specifically designed to reduce inequalities between communities but not necessarily delineated on a territorial basis. What this would mean for Wales is not yet clear and given the other uncertainties, we have not included post-Brexit options in our scenarios.

2.2 Welsh tax devolution and the Welsh Fiscal Framework

While certain local taxation powers, such as council tax, and since 2015-16, business rates (non-domestic rates) are already devolved, tax powers at the national level are only now being devolved to Wales. This has meant that although Wales has been responsible for key spending areas such as health, social services and education, there was no mechanism by which the Welsh Government could be accountable to its taxpayers for overall spending levels. In the next few years, Wales will receive new tax powers: the new Land Transaction Tax and Landfill Disposals Tax to come into effect from 2018-19 and the Welsh Rate of Income Tax from 2019-20 (at the earliest). This means that the devolved Welsh Government taxes are:

- Business rates (non-domestic rates, or NDR),[9] which have been fully devolved since 2015-16, collected by local authorities on behalf of the Welsh Government and distributed back to them through the revenue support grant formulae. The 'multiplier' is set annually by the Welsh Government, typically linked to changes in the RPI. The rateable value of business properties is subject to periodic revaluation, the last (and inevitably controversial) revaluation taking effect in 2017-18.

7 The EU figures are taken from (UK Parliament research briefing Number CBP 7886, see http://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-7886). The overall UK spending, or total managed expenditure, was at £772.8bn in 2016-17 (cash terms).

8 See Welsh Government (2017a) paper, 'Securing Wales' future: Transition from the European Union to a new relationship with Europe.'

9 We will refer to non-domestic rates using both terms in this report, particularly using 'NDR' in charts and tables, to save space.

- Land Transaction Tax (formerly Stamp Duty Land Tax) and Landfill Disposals Tax (formerly Landfill Tax) will be devolved from April 2018.
- The Welsh Rate of Income Tax (WRIT) will take effect from April 2019, enabling the Welsh Government to vary the rate at which tax is paid by Welsh taxpayers on 10 percentage points of each tax band levied on earned income except for savings and dividend income. Current Welsh Government policy is that the current income tax rates for Wales will not be increased for the duration of the current Assembly.

The Aggregates Levy, the devolution of which was a discussion point over the last year, was not devolved in the Wales Act 2017 (unlike the Scotland Act 2016). The Aggregates Levy yields only a modest source of revenue, around £34m in cash terms each year.

Assuming current policy, the Office for Budget Responsibility (OBR) forecasts that revenues from the Welsh Rate of Income Tax and Land Transaction Tax will grow modestly over the forecast period, while in contrast, revenues from the Welsh Landfill Disposals Tax are forecast to decrease due to improvements and efficiencies in recycling and waste management.[10]

Welsh devolved taxes, including business rates, are expected to generate approximately £3.5 billion in annual revenues in 2021-22. While this might look like an increase of £237m for the Welsh Government's budget, it should be remembered that the Welsh block grant will be adjusted to take the devolution of these taxes into account. Overall, because Welsh tax revenues are forecast to grow slightly faster than the block grant adjustment, the Welsh budget would be £14m better off in real terms by 2021-22 than under current arrangements (see Box 2.1).[11]

Table 2.1: Welsh devolved tax forecast summary, 2017-18 to 2021-22, £million, 2017-18 prices

	2017-18	2018-19	2019-20	2020-21	2021-22
Income tax	1,950	1,962	1,991	2,037	2,097
SDLT	243	259	273	296	320
Landfill tax	28	25	22	21	21
NDR	1,059	1,023	1,043	1,061	1,080
Total	3,280	3,269	3,330	3,415	3,517

Source: Income tax, SLDT, Landfill tax: OBR March 2017 Devolved Tax Forecast, Table 1.4, p. 7; NDR: PESA July 2017, except for 2015-16, taken from the Welsh Second Supplementary Budget 2015-16, and for 2020-21 and 2021-22, which is projected forward based on the assumption that NDR revenue will grow at 1.7 per cent in real terms (i.e. to continue to grow at its average growth rate 2016-17 to 2019-20).

In the context of a total Welsh resource budget of over £13 billion, Welsh tax receipts would have to increase significantly to generate a noticeable impact on the total amount available to fund public services. For example, to generate a 1 per cent increase in the overall Welsh resource budget in 2017-18, the devolved portion of income tax revenues would need to increase by 7 per cent: a 0.7 percentage point rate increase for each income tax band assuming no behavioural response. Business rate receipts would need to increase

10 It should be noted that OBR forecasts for the Welsh Land Transaction Tax (stamp duty land tax) revenues are forecast to grow slightly faster than comparable England and Northern Ireland revenues (9% vs. 7% for England and Northern Ireland (E&NI) over 2017-18 to 2021-22). Under the terms of the Welsh Fiscal Framework Agreement, the Block Grant Adjustment (BGA) changes from year to year according to what happens to equivalent UK government revenues in England & Northern Ireland (E&NI). If Welsh tax revenue grows at a differential rate to comparable revenues, this would imply that the BGA would not accurately reflect changes to the Welsh Government budget. For a further discussion of this issue see Poole et al. (2017) and Phillips and Simpson (2016).

11 A further consideration is the new Needs Based Factor (NBF), which will also affect the Welsh budget. Applying the NBF to the published March 2017 budget allocations means that by 2021-22, the Welsh budget would be around £40m higher than would otherwise be the case (see Box 2.1 for more information).

by 14 per cent to achieve the same increase in the resource budget.[12]

The majority of attention will naturally focus on the Welsh rates of income tax. Although changing Welsh rates of income tax bands by 1p leads to an increase or a decrease in the Welsh overall resource budget of about £200 million (assuming no behavioural response), the Welsh Government has committed to maintain the current income tax rate for the duration of the current Assembly term (until May 2021).[13] We do not consider the impact of changing the Welsh Rate of Income Tax here, although we plan to examine the role of the Welsh devolved taxes more fully in a later report.

The new Fiscal Framework, now coming into effect, puts in place ‘fair, sustainable and coherent funding arrangements across all the Welsh Government’s tax and spending responsibilities’.[14] A detailed analysis of the agreement, including its relationship to the Holtham Commission and the pressure for ‘fair funding’, can be found in Poole et al. (2017). The implications for the Welsh block are summarised in the text box below. The changes are not expected to be materially significant up to 2021-22.

The Framework has two ways of affecting the Welsh block though in both cases only in relation to incremental change: the Block Grant Adjustment (BGA) and the Needs Based Factor (NBF).

The BGA is a mechanism for adjusting the Welsh block grant in the light of UK tax decisions, for example compensating if higher income tax thresholds reduced Welsh income tax revenues. These arrangements are not projected to affect the overall Welsh budget or our budget scenarios materially over the period to 2021-22.

As a result of the devolution of taxes to Wales and the shift of population-specific revenue risk to Welsh policymakers, the direction of Welsh Government tax policy and the performance of Welsh tax revenues will become very important to the Welsh Government budget in a way that it has not been before.

The second impact is that additions to the Welsh Block generated through the Barnett Formula following changes in UK spending plans will be increased by the new Needs Based Factor of 1.05 (until such time as Welsh spending per head converges down to the new funding floor, unlikely to occur during the period covered by this study (see Poole et. al, 2017). The impact will be modest as long as UK spending grows slowly.

The Fiscal Framework also establishes the Welsh Reserve, including a transfer into the Reserve arising from the devolution of business rates, and provision for borrowing for capital projects. These will strengthen the Welsh Government’s ability to manage its finances but have not been factored into this analysis.

12 This is calculated as follows. A 1% increase in a value, V, is equivalent to an increase in V by amount x, such that x = 0.01V. If V is £14.41bn, it would need to increase by £0.1441bn to increase by 1%. If 2017-18 NDR revenues were to increase by £0.1441bn this would be a 14.2% increase to initial 2017-18 NDR revenue levels.

13 See Welsh rates of income tax FAQs, p. 4 in Welsh Government (2017a).

14 See Welsh Government (2017b) for the Fiscal Framework Agreement.

Box 2.1: How the Welsh Government's New Fiscal Framework will impact the budget

In December 2016, an agreement between the Welsh and UK governments outlined forthcoming changes to the Welsh Government's fiscal framework. This box explains the major agreed reforms and how they impact the modelling of the Welsh Budget in this report.

From 2018-19, the Stamp Duty Land Tax and the Landfill tax will be replaced by two new devolved taxes in Wales, and from 2019-20 (at the earliest) a £2 billion share of income taxes (a 10p share from each income tax band) will come under Welsh Government control. The two governments agreed on how the Welsh block grant will be adjusted to reflect the devolution of these taxes.

An initial baseline adjustment will be made to the Welsh block grant reflecting the revenues foregone by the UK Government at the point of devolution, ensuring neither government is initially better or worse off. Future changes to this block grant adjustment (BGA) will be determined by changes in equivalent UK government taxes, according to the following calculation (known as the Comparable Model):

Cash change in equivalent UK government tax in England & Northern Ireland	X	Comparability factor	X	Population ratio

The change in the BGA will therefore be a Welsh population share of changes in revenues in the rest of the UK, multiplied by a 'comparability factor', reflecting the Wales' relative tax-capacity.

The linking of the BGA to UK government revenues has some important implications. The effect on the Welsh Government budget will depend on the relative performance of Welsh taxes. If Welsh taxes grow more quickly than elsewhere in the UK, the Welsh budget reaps the rewards, and vice versa. It also insulates the Welsh budget from UK-wide economic risks. For example, Welsh revenues could fall in a recession, but if UK government revenues fall too, then a fall in the BGA would mitigate the effect on the Welsh budget. These arrangements are not projected to materially affect the budget scenarios over coming years (see Appendix). Devolved taxes are forecast to slightly outgrow modelled BGAs, resulting in £14 million more for the Welsh Government over the years 2018-19 to 2021-22.

The second key reform outlined in the agreement is the introduction of a new "Needs-Based Factor" (NBF) in the Barnett formula, from 2018-19 onwards. Increments to the Welsh Government's block grant will now be calculated as a product of the following calculation for every UK Government department:

Cash change in department's DEL	X	Department's comparability factor	X	Welsh to English population ratio	X	*Needs-Based Factor*
		Existing Barnett formula				New element

The NBF will be set at 105% initially, meaning any increase to the block grant will now be 5% higher than was previously the case. This is designed to slow convergence in relative Welsh funding towards the level in England, and below the Holtham Commission's estimate of relative need, as happened during the first decade of devolution. Exactly how much extra funding this reform will have on the Welsh budget over coming years depends on how quickly spending grows in England – the greater the growth in English expenditure, the greater the value of the extra 5% to the Welsh budget.

Due to slow growth in spending by UK departments in England, the NBF will also only have a limited effect on Welsh budgets over the years considered in this report, although the precise number will depend on the revenue scenario selected. Under our baseline revenue scenario R1, the NBF means Welsh 'consequentials' will be £38 million higher in real terms by 2021-22 than would otherwise have been the case.

When relative spending per head converges to 115% of the level in England, the NBF will increase to 115%. However, this is unlikely to happen in the short to medium-term.

3. The impact of austerity so far on Welsh devolved spending

In this section, we consider the historical changes to the Welsh Government's budget since 2009-10, including its budget for resource and capital spending on public services. We also look at the changes to spending on public services at the Welsh Government level, and at the local government level. Readers familiar with the Welsh fiscal context can skip to the next section where we consider future scenarios for the Welsh Government budget.

Through the eight years of austerity so far, the Welsh Government and local government have responded to the squeeze on budgets partly through a series of implicit trade-offs, protecting the NHS, social services and schools and reducing spending in real terms on other 'non-protected' services, in some cases by over 20 per cent.

3.1 Welsh Government income and austerity

Since devolution the Welsh Government has been largely funded through a block grant from the UK Government through the Barnett Formula. Business rates were also devolved to Wales in 2015-16. Reflecting its policy commitment to erase the deficit, the Conservative government set out its plans for funding allocated to Resource and Capital Departmental Expenditure Limits (DELs) to different departments, including the block grants to Wales, Scotland, and Northern Ireland, in the 2015 Spending Review. But since its publication, the March 2016 Budget, Autumn Statement 2016 and March 2017 Budget have each allocated additional spending to different UK departments, resulting in extra funds ('consequentials') to the Welsh block grant via the Barnett formula. The March 2017 UK Budget reflects these allocations.

The Welsh Government's resource budget (RDEL) that provides for day-to-day services fell by 11.5 per cent in real terms between 2009-10 and 2017-18, adjusting for business rates devolution, council tax benefit localisation, and using the Welsh Government's First Supplementary Budget 2017-18. Budgeted capital expenditure (CDEL) was cut significantly in the first phase of austerity but recovered slightly in 2014-15. The capital budget for 2017-18 remains 32.4 per cent lower in real terms than in 2009-10.

Table 3.1: Budgeted Resource and Capital Departmental Expenditure Limits allocated to Welsh Government, £millions

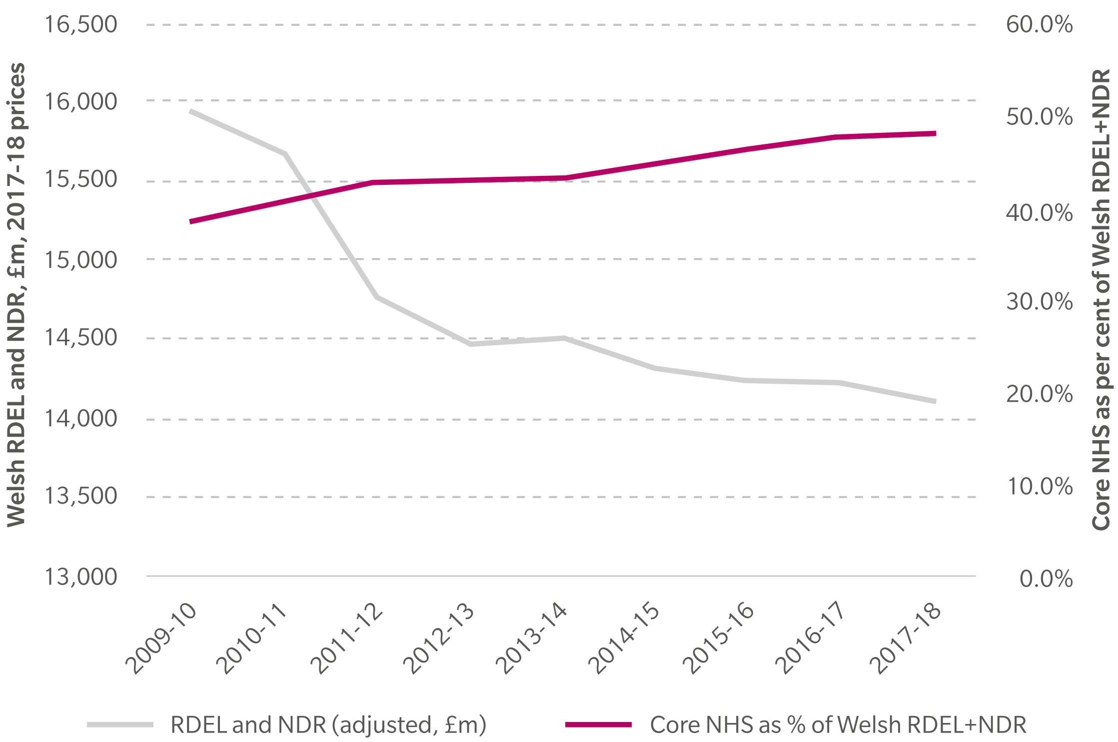
	Resource DEL	Capital DEL
2009-10	15,931	2,204
2010-11	15,660	1,953
2011-12	14,742	1,534
2012-13	14,462	1,413
2013-14	14,482	1,405
2014-15	14,306	1,567
2015-16	14,243	1,603
2016-17	14,224	1,471
2017-18*	14,099	1,489
% change, 2009-10 & 2016-17	**-10.7%**	**-33.2%**
% change, 2009-10 & 2017-18*	**-11.5%**	**-32.4%**

Note: The numbers for RDEL include non-domestic rates from 2015-16, and include the council tax benefit adjustment in 2009-10 to 2012-13.

Source: Welsh Government second supplementary budgets, except for 2017-18 which is taken from the first supplementary budget. It should therefore be noted that first supplementary budgets are often smaller than final allocations because money is held back to be allocated in second supplementary budgets. 2017-18 prices.

The Welsh Government responded to cuts in the Welsh resource block grant by, broadly, 'protecting' funds for schools, social services (by way of local government) and, after October 2013, spending on the NHS. Consequently, these protected service areas now account for a noticeably larger proportion of the total budget. For example, the core NHS budget (sum of total NHS delivery and total Health Central Budgets) accounted for 39 per cent of the Welsh Government RDEL budget in 2009-10 and 48 per cent in 2017-18 (see Figure 3.1).

Figure 3.1: Historic trend in the Welsh Government RDEL and Core NHS as a proportion of the RDEL



Note: The Welsh Government RDEL allocated to MEGs has been adjusted for council tax benefit (added on to pre-reform years 2009-10 to 2012-13) and for non-domestic rates (added on from 2015-16 onwards). Core NHS includes NHS Delivery and Health Central Budgets, except for 2009-10, when Health Central Budget figures are not available. Source: Welsh Government second supplementary budgets, except for 2017-18 which is taken from the first supplementary budget. It should therefore be noted that first supplementary budgets are often smaller than final allocations as money is held back to allocate in second supplementary budgets. 2017-18 prices.

These protections were accompanied by a range of significant cuts to 'non-protected' services, including a 23 per cent cut in funding for local government services outside of social services and education.

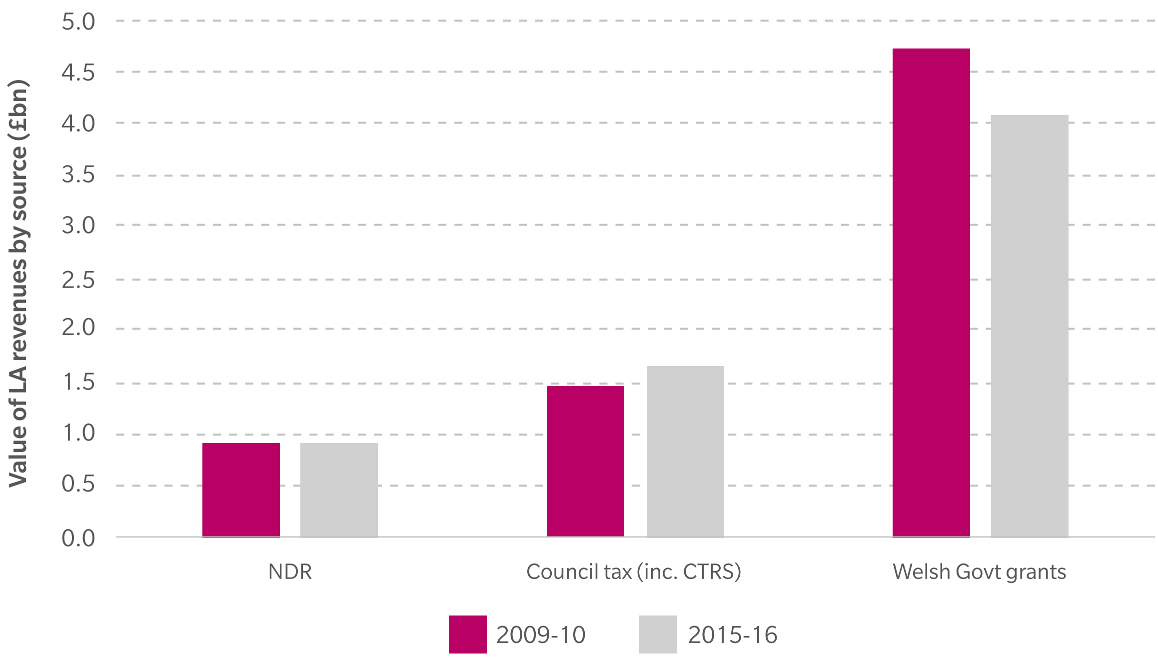
The impact of these reductions has been augmented by a range of cost pressures, including various changes to pensions and other employment costs. An offsetting factor to these pressures has been the public sector pay cap that has been in place since 2010-11. However, the public sector pay cap has been coming under considerable pressure in the UK. In Scotland, the 1% public sector pay cap is being lifted and public sector pay will now be indexed to the cost of living. The IFS has calculated that increasing public sector pay in line with private sector pay would add £9 billion to costs by 2021-22 (Emmerson, 2017b). The Welsh Government has estimated that an additional 1 per cent pay award would cost around £100 million (Davies, 2017).

3.2 Welsh Local Government revenues and spending, 2009-10 to 2015-16

Publicly funded services, otherwise known as net service spending, are financed at the local government level through three main sources of revenue: Welsh Government grants (specific grants earmarked for particular services plus the general Revenue Support Grant - RSG), council tax and business rates.[15] In 2017-18, across the 22 Welsh unitary authorities, 66 per cent of budgeted income came from the formula grant share (business rates plus RSG), 14 per cent from the specific grant share, and 19 per cent from the council tax share.[16]

Figure 3.2 summarises the changes to each of these revenue sources at the all-Wales level over the recent period of austerity (2009-10 to 2015-16). The highest cash change occurred with respect to Welsh Government grants, which declined by 14 per cent (£655m in 2017-18 prices). Put in the context of net service spending, the decline in Welsh Government grants was significantly larger than the total value of spending on older adult social care in Wales according to the latest available revenue outturn data (2015-16).[17] Collected council tax (i.e. excluding council tax benefit, now the Council Tax Reduction Scheme - CTRS) showed a marked increase of 17 per cent (15 per cent including CTRS payments) between 2009-10 and 2015-16, equivalent to £207m (£215m including CTRS payments). Revenues from business rates remained broadly flat over the period, increasing by just 0.9 per cent in real terms.[18] Rises in locally-sourced revenues were therefore not sufficient to fully compensate authorities for reductions in Welsh Government grant support, leaving a net revenue deficit of £432m in 2015-16 relative to 2009-10. In service terms, this is similar to the value of total local authority spending on environmental initiatives and planning, housing (exclusive of housing benefit) and transport services combined in 2015-16.

Figure 3.2: Sources of local government revenues, 2009-10 to 2015-16 (2017-18 prices)



Source: Financing of gross revenue expenditure data (available here: https://statswales.gov.wales/Catalogue/Local-Government/Finance/Revenue/Financing/financingofgrossrevenueexpenditure-by-authority) and in-year council tax collection data (available here: https://statswales.gov.wales/Catalogue/Local-Government/Finance/Council-Tax/Collection/inyearcounciltax-by-billingauthority).

15 Please note that all figures referring to Welsh Government grants exclude, for the purpose of this analysis, revenues accruing to Welsh unitary authorities pertaining to housing benefit which is sent directly to Welsh councils from DWP to match demand.

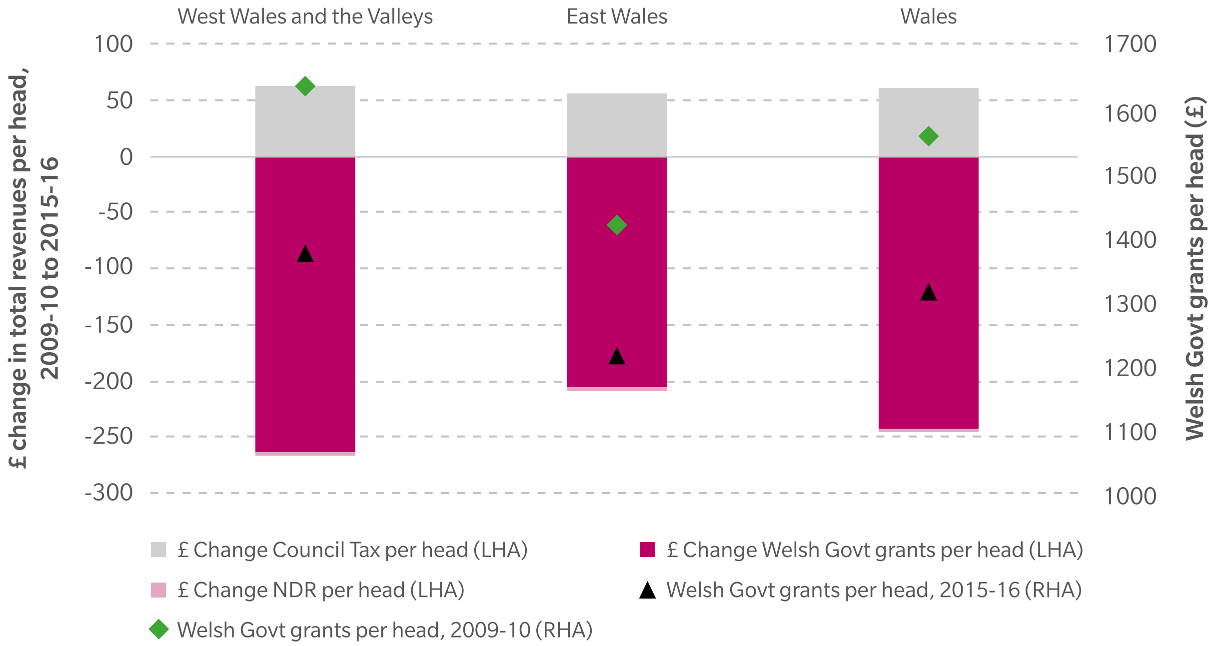
16 Excluding reserve allocations. See financing of gross revenue expenditure data, available here: https://statswales.gov.wales/Catalogue/Local-Government/Finance/Revenue/Financing/financingofgrossrevenueexpenditure-by-sourceoffunding.

17 In 2015-16, the total net service spend among local authorities in Wales on older adult social care services came to £572m (2017-18 prices).

18 In Wales, annual increases in NDR, also known as Business Rates, are set by the Welsh Government with reference to a specific multiplier. Normally the multiplier is set according to the Retail Price Index (RPI), which explains why we see a broadly flat real terms trend over the period 2009-10 to 2015-16. Indeed, the 0.9% rise reported reflects the GDP deflator series used in this text. For more information please refer to the following source: http://gov.wales/topics/localgovernment/finandfunding/businessrates/?lang=en.

Changes to the structure of local government revenues were not uniform across Wales. Figure 3.3 shows the relative contribution of each revenue source to the change in local authority revenues per head for Wales as a whole, as well as for the two Welsh NUTS2 statistical sub-regions (West Wales and the Valleys and East Wales).[19] While the change in NDR has been negligible across Wales, reductions in the level of Welsh Government grant support per head in 2015-16 relative to 2009-10 were greater in West Wales and the Valleys than in East Wales, although revenues in the latter region fell from a lower initial base in 2009-10 as can be seen from Figure 3.3. Indeed, despite some convergence between the regions, grant revenues per head in West Wales and the Valleys remained higher than East Wales in 2015-16.

Figure 3.3: Contribution of revenue sources to the overall change in local government revenues per head, 2009-10 to 2015-16 (2017-18 prices)



Source: Financing of gross revenue expenditure data (available here: https://statswales.gov.wales/Catalogue/Local-Government/Finance/Revenue/Financing/financingofgrossrevenueexpenditure-by-authority) and in-year council tax collection data (available here: https://statswales.gov.wales/Catalogue/Local-Government/Finance/Council-Tax/Collection/inyearcounciltax-by-billingauthority).

In addition to seeing larger declines in Welsh Government grant support per head, West Wales and the Valleys was also the region with the highest per person growth in council tax revenues. Between 2009-10 and 2015-16, total council tax revenues per person grew by 13 per cent compared to 11 per cent in East Wales, although revenues still remained higher in East Wales given its larger number of Band D equivalent dwellings per head of population.[20] In 2009-10, 17.9 per cent of all local authority revenues in West Wales and the Valleys derived from council tax, compared with 23.6 per cent in East Wales. In 2015-16, these shares increased to 22.3 per cent and 27.7 per cent respectively, highlighting the increasing importance of council tax revenues.

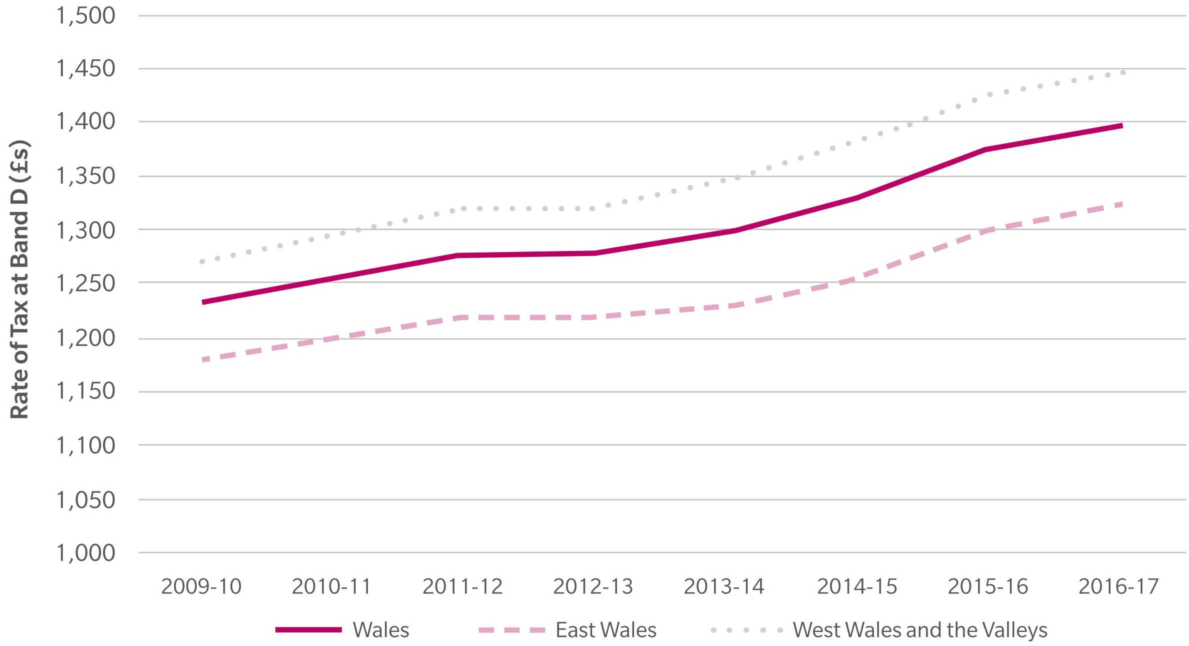
Figure 3.4 shows the trajectory of the average Band D rate in real terms between 2009-10 and 2015-16 for Wales as a whole, as well as for the NUTS2 statistical regions. The rise in council tax reflects a Welsh

19 The Nomenclature of territorial units for statistics (NUTS) is a standard geographical classification that subdivides territories of the European Union (EU) into regions at three different levels (NUTS 1, 2 and 3, respectively, moving from larger to smaller territorial units). At Level 2 (NUTS2), Wales is divided into two groups: West Wales and the Valleys and East Wales. Here we use this division so as to illustrate the types of variation that can be seen across Wales with respect to local authority revenues and spending. Information on the specific local authorities falling within each territory can be found here: https://www.ons.gov.uk/methodology/geography/ukgeographies/eurostat#wales.

20 In 2015-16, council tax equated to £530 per person in West Wales and the Valleys compared to £547 per person in East Wales, a difference which in part reflects the disparity in the size of the council tax base between the two regions. After accounting for council tax discounts and exemptions, in 2015-16 there was one fully taxable Band D equivalent dwelling every 2.7 people in West Wales and the Valleys compared to every 2.4 people in East Wales. Put another way, if West Wales and the Valleys enjoyed the same population adjusted density of Band D equivalent dwelling as East Wales, its tax base would be 12% larger (see data source: https://statswales.gov.wales/Catalogue/Local-Government/Finance/Council-Tax/Dwellings/counciltaxdwellings-byct1rowdescription).

Government policy decision not to institute a freeze (as in Scotland) or limit increases through a tight cap (as in England). Government grants to councils in Wales fell by significantly less than in England, reflecting a different approach to service protection. The average Band D council tax rate rose by 11.6 per cent in real terms across Wales between 2009-10 and 2015-16, albeit with considerable local variation.[21]

Figure 3.4: Council tax Band D, 2009-10 to 2016-17 (2017-18 prices)



Note: Average Band D at the NUTS 2 statistical region level is calculated as a weighted average based on local authority population estimates. Source: Council tax levels by billing authority and band, available at https://statswales.gov.wales/Catalogue/Local-Government/Finance/Council-Tax/Levels/counciltaxlevels-by-billingauthority-band.

Although the Welsh Local Government Revenue Settlement compensates individual local authorities for any relative deficits in their numbers of taxable dwellings, it does so only in relation to the set value of the RSG.[22] As a result, if both low and high tax base authorities wished to return to pre-austerity levels of service spending, the former would need to raise their rates above those of less grant dependent authorities given a comparatively lower return to the same marginal increase in their rates.

Despite political preferences among certain authorities in favour of maintaining lower rates, between 2009-10 and 2015-16 an association emerges showing that, on average, authorities with the lowest tax bases per head of population saw the largest cash increases in their Band D rate.[23] In 2015-16, a strong association is seen between the total value of a council's chosen Band D rate and the size of their tax base; a pattern that may be further extenuated up to 2021-22 and which could raise concerns over equity among council tax payers across Wales.[24]

21 For example, Caerphilly's Band D rate rose by little over 5% between 2009-10 and 2015-16, whereas the Isle of Anglesey chose to raise its Band D rate by 16.8%. Moreover, there appears to be little association between an authorities Band D rate in 2009-10 and the subsequent change in rate (R = 0.09).

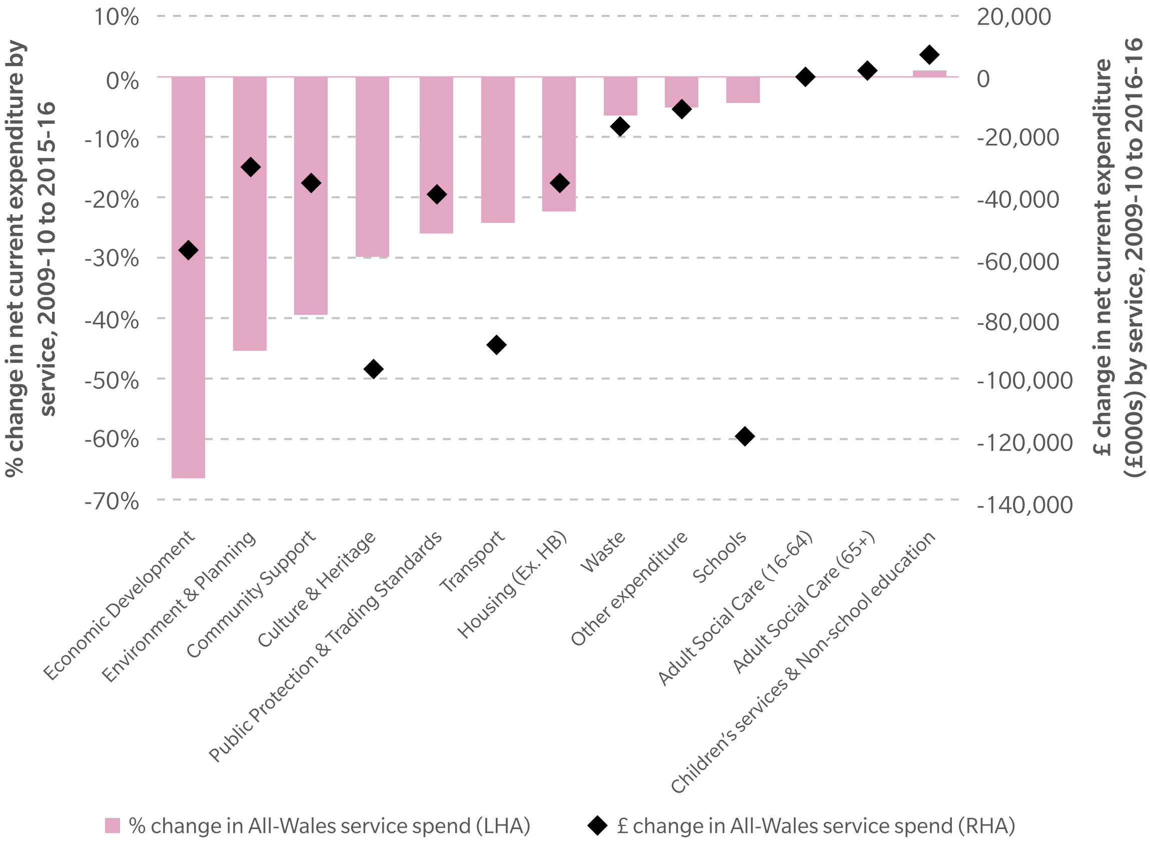
22 This occurs through a distribution mechanism known as Standard Spending Assessments (SSA). SSA funding equals the sum of business rates, council tax and the RSG, and is a fixed total agreed by the Welsh Government. In this framework, council tax represents a notional amount of income based on a standard Band D rate being applied, albeit hypothetically, by all authorities referred to as the Council Tax for Standard Spending (CTSS). This means that as an individual authority's tax base increases relative to others, RSG as a share of its total SSA decreases. In a world where SSA is kept fixed at pre-austerity levels, but RSG falls, either business rates or CTSS must rise in order to enable authorities to spend at their assessed level. In this instance, more grant dependent authorities will be compensated for their lower tax base such that if all authorities wished to spend at the SSA, we would not see any difference in the Band D rate across authorities. However, if SSA fell more or less in line with its RSG component, low tax base authorities wishing to protect pre-austerity levels of service spending would need to raise their rates above those of the less grant dependent authorities given a comparatively lower return to the same marginal increase in rates. From 2009-10 to 2015-16, total SSA for all local authorities declined by 4.3 per cent (£241m).

23 Calculated as the relationship between each local authorities' population per Band D dwelling (a population adjusted measure of council tax base) in 2015-16 and the cash change in their Band D council tax rate, 2009-10 to 2015-16 (R = 0.35). Source: council tax dwellings, by CT1 row description (available at: https://statswales.gov.wales/Catalogue/Local-Government/Finance/Council-Tax/Dwellings/counciltaxdwellings-byct1rowdescription).

24 Calculated as the relationship between each local authorities' population per Band D dwelling (a population adjusted measure of council tax base) in 2015-16 and their Band D council tax rate in 2015-16 (R = 0.62). Source: council tax dwellings, by CT1 row description (available at: https://statswales.gov.wales/Catalogue/Local-Government/Finance/Council-Tax/Dwellings/counciltaxdwellings-byct1rowdescription).

These changes to local government revenues have had a varied impact on subsequent net public service spending across Wales. Figure 3.5 summarises the changes to councils' total net current service expenditure, categorised into specific service areas, over the period 2009-10 to 2015-16 at the all-Wales level. While personal social services and schools remained broadly protected in percentage terms, net spending on the remaining unprotected services declined by 24 per cent, albeit with significant variation across services. For instance, net public spending on economic development activities such as tourism, business support, agriculture and fisheries services declined by 66 per cent collectively.[25]

Figure 3.5: Cuts to net current service spending by service, 2009-10 to 2015-16 (2017-18 prices)



Source: Local government revenue outturn data, available at: https://statswales.gov.wales/Catalogue/Local-Government/Finance/Revenue/Outturn/revenueoutturnexpenditure-by-authority.

Note: Due to prior inconsistencies in the budgetary classification of Flying Start (a high value Welsh Government programme to support families with children aged 0-3 years) across local authorities, it is not possible to produce a consistent series from 2009-10 onwards showing how spending on schools, non-school education and children's social services have changed. For this reason we group children's social services and non-school education together into a single budget category. In light of specific recorded spending movements out of non-school education and into children's social services where Flying Start has now been accorded its own accounting cell reference, we believe this to be a reasonable adjustment. For more information please contact the authors directly.

In total, spending on both protected and unprotected services declined by £514m in real terms from 2009-10 to 2015-16, representing an 8.2 per cent reduction in net spend. Given the disproportionate impact of this total decline in spending on selected services, how projected cuts fall within local government up to 2021-22 and how they compound already diminished service budgets is a topic that we return to in Section 5.

25 Although several local authorities adopted income generation and charging policies in 2015-16 (see source: https://www.wao.gov.uk/system/files/publications/445A2016-Financial-resilience-eng.pdf), only a small amount of the changes described in Figure 3.5 can be reasonably attributed to the mechanistic effect of greater service income reducing authorities' net spending positions while gross expenditure increases. For instance, gross expenditure on economic development activities experienced a similarly large decline of 63 per cent between 2009-10 and 2015-16.

4. Envelope for the Welsh budget

This section considers the overall spending envelope available to the Welsh Government, consisting of the Welsh block grant allocation from the UK Government and the new Welsh taxes. It revisits spending patterns under austerity to date and sets out three revenue scenarios for the next four years. Capital block grant scenarios are also included.

Future UK fiscal strategy is not yet clear, especially given the uncertainties about Brexit, but a radical departure from the goal of a balanced budget seems unlikely. We set the implications for the Welsh block grant scenarios for maintaining the status quo and for a modest easing of austerity.

4.1 Scenarios for the Welsh budget envelope 2018-19 to 2021-22

Given continuing uncertainties about the UK Government's medium-term fiscal strategy and future performance of the economy, this report selects three scenarios for UK fiscal policy and their implications for devolved Welsh spending. We have chosen the assumptions on the basis of their simplicity. As with any economic or fiscal forecast or projection, the projections outlined below are subject to a number of sources of potential error that will generate variations in outturn data.

4.1.1 Resource block grant scenarios

We draw on the plans set out in the March 2017 UK Budget and assume a continued UK commitment to protect central budgets for the NHS, schools, defence and international development. Using the Wales Governance Centre's Welsh tax modelling and applying the NBF to any growth in the Welsh block grant from 2018-19 onwards. The Appendix contains a fuller methodology of modelling the block grant.

The scenarios also make various assumptions about Wales' share of £3.5 billion efficiency savings which the Chancellor included in his Autumn Statement, scheduled to be delivered in 2019-20. Under these plans, £1 billion of the resulting savings are to be reinvested in 'priority' areas, although it is unclear what these are. Some spending areas, such as health and core schools, were exempted from the efficiency savings plans. Because these areas are fully devolved to Wales, protection at the UK level would mitigate the impact of the efficiency savings on the Welsh budget. The forthcoming autumn fiscal event may revisit these efficiency savings plans and could provide more detail about how they might be implemented.

This section investigates the following scenarios:

R1: A baseline 'austerity' scenario for the Welsh block grant based on:

- the plans announced in the March 2017 Budget to 2019-20
- adding in a Wales share of the Treasury's planned £3.5bn efficiency savings[26]
- assuming that the UK departmental spending allocations in 2019-20 will be uprated for inflation in 2020-21 and 2021-22

26 The March 2017 Budget includes a row which says 'Adjustment for planned efficiency savings' in 2019-20, but almost no information is available on how the cuts would be allocated. Details suggest that the NHS, 'core schools', defence, and international aid will be protected. It is also suggested that efficiencies made at the local government be reinvested into social care (mostly a local responsibility). Core schools funding, or the Dedicated Schools Grant, was £40.7bn in 2016-17, approximately 2/3 of the Education Budget (http://www.parliament.uk/briefing-papers/SN06702.pdf). We therefore model efficiency cuts to affect the non-protected third of the Education budget, while core schools are protected in real terms. See: https://www.gov.uk/government/news/efficiency-review-to-drive-productive-public-services

R2: An 'easing of austerity' scenario for resource spending based on R1 and:

- cancelling the requirement for the £3.5 billion efficiency savings
- building the Conservative manifesto spending pledges into the figures[27]

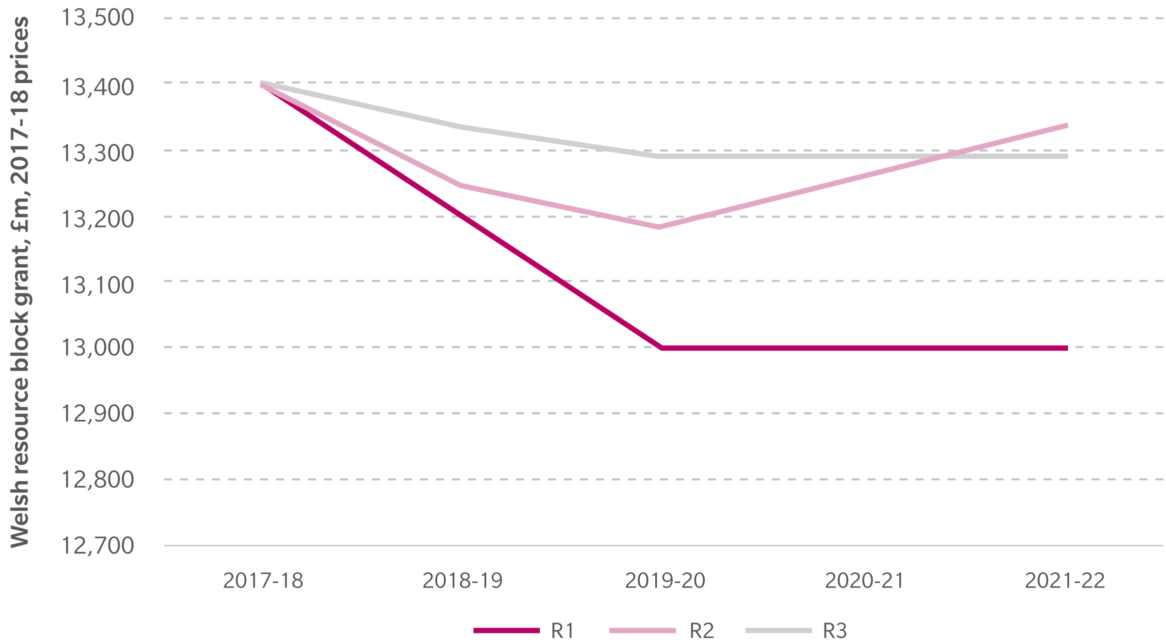
R3: A 'benchmark' scenario which protects the March 2017 Budget allocations through the projection period 2018-19 to 2021-22 by either:

- uprating the March Budget 2017-18 spend from our simulated baseline for inflation (protecting 2017-18 allocations in real terms), or
- using the March Budget 2017 simulated baseline spend for that particular year in cash terms, whichever is higher

All three scenarios would result in continued real terms reductions in the Welsh block for resource expenditure.

The trajectory of the Welsh block grant under the three scenarios R1-R3 (adjusted for the NBF and the BGA) is shown in Figure 4.1. The current (unchanged) policy scenario R1 results in the lowest block grant to Wales. Scenario R2, which cancels the £3.5bn cuts and increases NHS spending results in the middle block grant profile, which dips in 2019-20 but increases thereafter. Scenario R3, which protects UK RDEL allocations in real terms from 2017-18 onwards results in less pronounced changes to the Welsh block grant in 2019-20 compared to R1 and R2. Because allocations are assumed to be kept flat in real terms in 2021-21 and 2021-22 except for scenario R2, which increases funding to the NHS England in real terms, the Welsh block grant under scenario R2 becomes higher than under R3 in 2021-22.

Figure 4.1: Three scenarios for the Welsh block grant for resource expenditure (excluding depreciation) 2017-18 to 2021-22, £million, 2017-18 prices



Source: See Appendix for sources.

27 At the 2017 General Election, the Conservative party pledged to increase NHS spending "by a minimum of £8 billion in real terms over the next five years" (Conservative Party, 2017, p. 66) and second, to "increase the overall schools budget by £4 billion by 2022" (p. 51). No details were given about the profile of this spending, but this report assumes that spending (real terms, in the case of the NHS, and nominal, in the case of schools) will increase linearly from 2018-19 until the additional amount pledged is reached. Since we also do not know how the funding will be allocated between resource and capital budgets in health and education, we assume that both resource and capital will grow proportionately, such that the sum of resource and capital health spending in 2022-23 is £8bn higher in real terms than in 2017-18. We also assume that the increase will occur annually at a rate of 1.3 per cent from 2018-19 onwards. See the Appendix for more detail.

Table 4.1 shows the Welsh block grant under the different scenarios listed above over 2017-18 to 2021-22. For example, in our baseline scenario (R1) the block grant in 2021-22 would be 3 per cent lower in 2021-22 than in 2017-18 in real terms, owing to the efficiency savings enforced on unprotected public services that are due to be implemented in 2019-20. If these efficiency savings are scrapped and the extra allocations to the NHS set out in the Conservative 2017 Manifesto are made (R2), the cuts would be much smaller, at just 0.5 per cent, resulting in an additional £300 million for the Welsh Government compared to scenario R1 in 2021-22.

In turn, if real-terms spending by Whitehall departments is protected from 2017-18 (scenario R3), the Welsh block grant would still fall by 0.8 per cent in real terms. This is because, despite the NBF adjustments going forward from 2018-19, the higher spending per person in Wales relative to England means that the same cash-terms spending per head increase will still be a smaller cash-terms percentage increase, and consequently, a modest real-terms cut.[28]

Table 4.1: Three scenarios for the Welsh block grant for resource expenditure (excluding depreciation) 2017-18 to 2021-22, £millions, 2017-18 prices

Scenario	2017-18	2018-19	2019-20	2020-21	2021-22	% change 2017-18 to 2021-22
R1	13,400	13,196	12,998	13,001	12,998	**-3.0%**
R2	13,400	13,246	13,182	13,261	13,334	**-0.5%**
R3	13,400	13,332	13,287	13,291	13,288	**-0.8%**

Source: See Appendix for sources

Table 4.2 shows the year-on-year change in the Welsh block grant. In the baseline scenario R1, Wales would see a cumulative cut of around £400 million between 2018-19 and 2021-22: cuts of around £200m in both 2018-19 and 2019-20 (or a 1.5% cut year-on-year over those two years). In contrast, in scenario R2, the scale of the cuts is reduced in 2018-19 and 2019-20 (to 1.2% and 0.5% respectively), and there is a slight increase in the block grant of approximately £76 million in both 2020-21 and 2021-22 as a result of the increased allocations to the NHS set out in the Conservative 2017 manifesto. In scenario R3 where 2017-18 allocations are protected, there is a slight cut to the Welsh block grant of about 0.8 per cent between 2018-19 and 2019-20.

Table 4.2: Annual real terms changes to the Welsh block grant for resource expenditure, 2017-18 to 2021-22, £million, 2017-18 prices

Scenario (Change on previous year)	2018-19	2019-20	2020-21	2021-22	Cumulative cut
R1 (£)	-204	-199	3	-3	**-402**
R1 (%)	-1.5%	-1.5%	0.0%	0.0%	**-3.0%**
R2 (£)	-154	-64	79	73	**-66**
R2 (%)	-1.2%	-0.5%	0.6%	0.5%	**-0.5%**
R3 (£)	-68	-45	3	-2	**-112**
R3 (%)	-0.5%	-0.3%	0.0%	0.0%	**-0.8%**

Source: See Appendix for sources.

28 Under current arrangements, the Barnett formula allocates to Wales the same cash–terms increase in spending per head as is assumed to be allocated to England from Whitehall departmental budgets, and this represents a smaller cash–terms percentage change to the block grant than for comparable spending in England because spending per head is higher in Wales. This smaller cash–terms percentage increase translates into a real–terms cut. To see this, consider the following example. Suppose spending per head is £100 in England and £115 in Wales. A £10 per head increase in spending would be a 10% increase in England, but an 8.7% increase in Wales (see Phillips and Simpson (2016). Going forward with the NBF from 2018-19, any positive cash changes will be increased by a factor of 1.05. But even with this boost, the proportionate spending increase will still be lower than in England: the £10.5 NBF-adjusted Welsh cash increase will be a 9.1% increase relative to Wales' £115 spending level.

4.1.2 Capital block grant scenarios

In addition to the resource DEL scenarios outlined above, we also consider two main scenarios for capital DEL based on the March Budget 2017.

- C1: As set out in March Budget 2017, and assuming that capital allocations in 2020-21 will be maintained in real terms in 2021-22.
- C2: As C1, but with 10 per cent of capital spending planned in 2021-22 brought forward to 2019-20 and 2020-21 (spread equally across the two years).

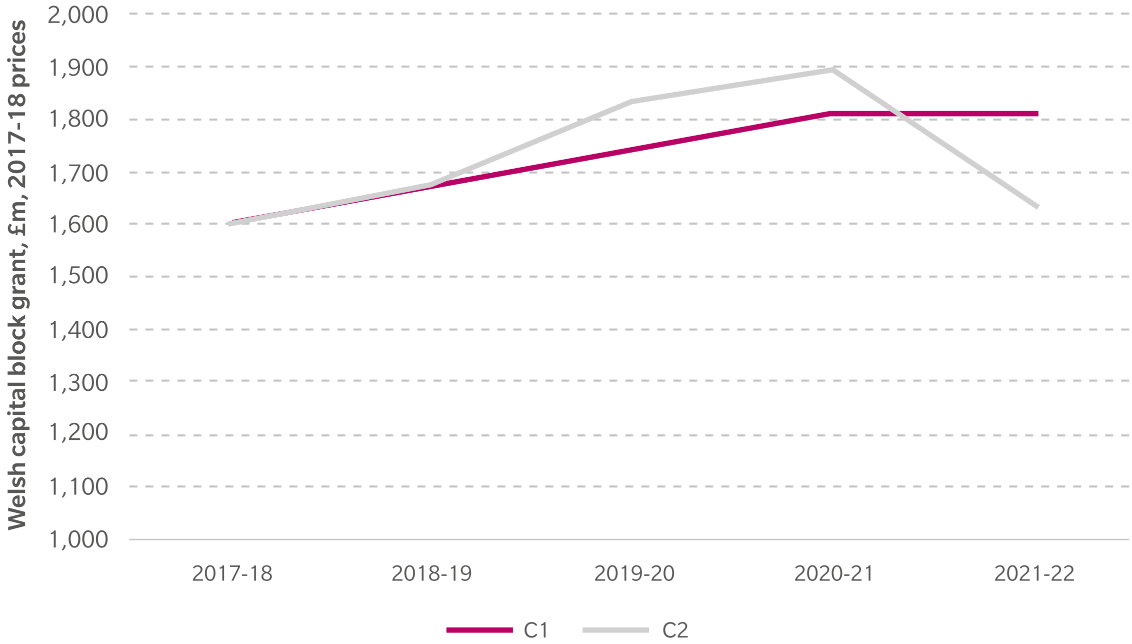
Table 4.3 presents the Welsh capital block grant under each of the above scenarios. In C1, under the March 2017 budget plans, capital is set to increase by 13 per cent over 2017-18 to 2021-22, or by approximately £200 million. If, in contrast, bringing forward some of the extra capital spending to 2017-18 and 2018-19 (scenario C2) would increase the capital block grant in these years at the cost of slightly lower capital spending in 2020-21 and 2021-22. Figure 4.2 shows the profile of the capital block grant under C1 and C2.

Table 4.3: Two scenarios for the Welsh block grant for capital expenditure, 2017-18 to 2021-22, £millions, 2017-18 prices

Scenario	2017-18	2018-19	2019-20	2020-21	2021-22	% change 2017-18 to 2020-21	% change 2017-18 to 2021-22
C1	1,600	1,674	1,743	1,806	1,806	12.9%	12.9%
C2	1,600	1,674	1,832	1,894	1,630	18.4%	1.9%

Source: See Appendix.

Figure 4.2: Welsh block grant for capital expenditure (excluding depreciation), 2017-18 to 2021-22, £ million, 2017-18 prices



Source: See Appendix.

4.2 Choices and trade-offs for the Welsh Budget

As well as devolved spending powers, Wales has some of its own tax-varying powers and will be gaining additional tax-varying powers in the near future. Block grant allocations to the Welsh Government include adjustments for Wales' own sources of revenue, which together form its overall resource budget. The Welsh Government's devolved revenues comprise non-domestic rates ('business rates'), which have been fully devolved since 2015-16; Landfill Tax and Stamp Duty Land Tax, which will be devolved from April 2018; and a 10 pence share of each tax band levied on earned income except from savings and dividends, which will be devolved from April 2019 at the earliest.

We discussed the impacts that the devolved revenues would have on the Welsh Government budget in Section 2.2. This section brings together these sources of devolved revenue and the block grant scenarios, discussed in Section 4.1, and considers the possible trade-offs that the Welsh Government could make in financing public services provision.

Depending on future fiscal strategy, continued trade-offs in Wales over the next four years as a response to growing cost and demand pressures on NHS and care services, linked to an ageing society, could challenge the sustainability of other services as they are currently organised.

4.2.1 Choices and trade-offs 2018-19 to 2021-22

The analysis below looks at future possible choices and trade-offs that could arise going forward on the basis of the three scenarios set out in Section 4.1. We take the 2017-18 First Supplementary Budget as our starting point, and use the block grants and devolved tax revenues discussed in previous sections to inform our modelling for the funding available to the Welsh Government from 2018-19 onwards.[29]

We then consider different spending decisions that the Welsh Government might take, and look at how these affect the resources available to different public services. In setting out these options, we assume that the Welsh Government will continue to want to protect spending on the NHS, schools and social services, particularly adult social care. The Health Foundation has concluded that over the period to 2030-31, NHS funding in Wales will need to increase in real terms annually by 2.9 per cent to meet demand and cost pressures, including the rising prevalence of chronic conditions and advances in medical science and technology (Watt and Roberts, 2016). This assumes at least 1 per cent efficiency savings each year and that the pay cap stays in place until at least 2019-2020. This is close to the long-term funding trend for the NHS across the UK prior to austerity. As indicated earlier, the Health Foundation has warned that the Conservative manifesto spending pledges do not meet the NHS 'funding gap' in England. The organisation also advised that spending on adult social care in Wales will also need to rise by 4 per cent a year in real terms.

Informed by the above research, we investigate the following four scenarios:

- **W1:** Protecting health spending to take account of demand and the core NHS budget by a) ensuring that any funding the that Welsh Government receives from Barnett consequentials as a result of increases in English NHS spending is directed to the Welsh NHS and, b) that the core NHS budget does not fall either in real terms or as a share of the overall Welsh budget. Any overall budget cuts required are shared proportionately across other unprotected service areas.
- **W2:** As W1, plus the protection of social services and schools spending in real terms.

29 We make no assumptions about the use of existing Reserves – for example the Welsh Reserve will include £98.5 million as part of the arrangements for the devolution on business rates – although there is an annual draw-down limit of £125 million. It should also be noted that first supplementary budgets are often smaller than final allocations because money is held back to be allocated in second supplementary budgets. However, we use this budget because it is the latest data available.

W3: Increase NHS spending by 3 per cent per year real terms (as suggested by the Health Foundation to ensure long-term sustainability, but include no other protections.

W4: As W3, plus increasing adult social services spending by 4 per cent in real terms (also recommended by the Health Foundation), and protecting the remaining social services and schools spending in real terms.

Like Phillips and Simpson (2016), we do not suggest that the Welsh Government should necessarily follow any of the above scenarios, which are designed to illustrate how particular choices might cause trade-offs with other policies and spending areas. As well as highlighting the possible trade-offs facing the Welsh Government, our model also illustrates possible trade-offs at local government level, which are discussed in Section 5.

The Welsh Government's priorities may be inferred from its allocations on different public service areas from the overall resource budget (fiscal resource DEL and business rates),[30] shown in Table 4.4. The largest component is the core NHS fiscal resource budget (£6.6bn), which in 2017-18 accounted for 47 per cent of the overall fiscal resource budget.[31] Given that core NHS takes up such a large proportion of the resource budget, continuing to protect the NHS would put more pressure on other unprotected services.

The second largest component, support for local government, forms a further 30 per cent of the overall budget (including Annually Managed Expenditure (AME) support for local government in the form of business rates revenues), of which around two thirds is allocated to schools and social services. These three types of public services are typically 'protected' from cuts – for example, by keeping spend on these services fixed in real terms. Together, core NHS, the social services component of the Health, well-being and sport MEG, and the schools and social services proportion of central government support for local government (including business rates) add up to £9.5 billion or two thirds of the overall Welsh Government fiscal resource budget. This leaves just one third of the budget available for other services such as the economy and infrastructure, environment and rural affairs, and other services.

30 Although business rates have been formally classified as AME since April 2015, in practice, they are spent on resource-type items at the local government level (see also Phillips and Simpson (2016), p.53).

31 Because Table 4.4 excludes non-fiscal resource DEL, these numbers vary slightly from those presented in Figure 3.1, which was based on RDEL MEG allocations including non-fiscal resource DEL.

Table 4.4: Welsh Government Fiscal Resource DEL, 2017-18, £millions

Welsh Government Main Expenditure Group	2017-18	Percentage of Total allocation to Welsh Government
Health, Well-being and Sport	**6,875**	**49%**
Of which: Core NHS[1]	*6,609*	*47%*
Of which: Public Health[2]	*175*	*1%*
Of which: Social services	*90*	*1%*
DEL funding support for local government	3,298	23%
Other local government spend	32	0%
Communities and Children	371	3%
Economy and Infrastructure	626	4%
Education	1,371	10%
Environment and Rural Affairs	269	2%
Central Services and Administration	278	2%
Total Resource DEL allocated to departments	**13,088**	**93%**
AME support for Local Government (NDR)	1,059	7%
Total DEL and NDR allocated to departments	**14,147**	**100%**

Note: The breakdown of the "Health, Wellbeing and Sport" into core NHS, public health and social services assumes that fiscal resource DEL (which excludes depreciation) is allocated across these areas in the same proportion as total resource DEL (which includes depreciation). 1 - Core NHS comprises NHS delivery and Health central cervices; 2 - Public health comprises Total public health and prevention and Total Sports and Physical Activity. Source: Welsh Government First Supplementary Budget 2017-18. Figure adjusted to exclude housing benefit expenditure in council spending.

The Welsh Government's overall fiscal resource budget establishes the limit for how much can be spent on public services provision. Each of the above spending scenarios (W1-W4) illustrate the different choices faced by the Government: protecting or increasing funding for the NHS, or extending protections to other public services. Spending more in one area naturally requires additional cuts to other, unprotected areas. The following figures (Figure 4.3 through to Figure 4.5) identify how each different revenue scenario (R1-R3) changes the balance between the cuts to protected and unprotected services.

As we set out in Section 4.1, in our baseline resource revenue scenario R1, the Welsh block grant is forecast to be cut by 3.0 per cent in real terms between 2017-18 and 2021-22. Over the same period, revenues from non-domestic rates are forecast to increase by 2.0 per cent in real terms.[32] This means that the Welsh Government's overall resource budget (RDEL+NDR) will face real cuts of 2.6 per cent.

Figure 4.3 disaggregates public services spending by core NHS, schools, and social services, and shows the effects of protecting certain service areas on other key services. Starting with baseline scenario R1, protecting the NHS (scenario W1)[33] would mean cuts to central government support to local government of 5.2 per cent. Keeping the NHS protection in place and extending real-terms protections to schools and social services (W2) would mean that cuts to central government support to local government would be lower: 2.8 per cent rather than 5.2 per cent.

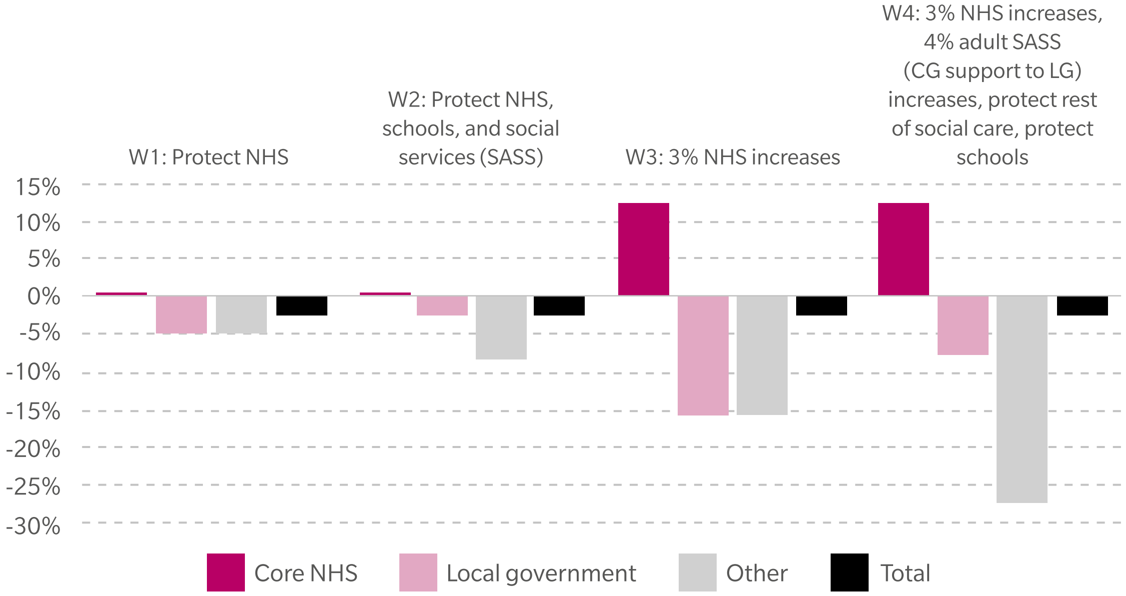
In scenario W3, increasing NHS spending by 3 per cent with no other protections increases the cuts to local government to 15.9 per cent. With the 3 per cent NHS arrangement in place, and increasing Welsh government support to local government for adult social services by providing increases of 4 per cent, plus protecting the rest of social services and schools spending (W4), would result in local government cuts of

32 Assuming that in 2020-21 and 2021-22, business rates continue to grow at their average historic real growth rate between 2016-17 and 2019-20.

33 By matching funding increases in England and ensuring that the core NHS Wales budget does not fall in real terms or as a share of the overall Welsh budget.

7.6 per cent. However, more protections and increases in spending for selected public services compounds pressure on unprotected services such as economic development and regeneration, children's services, and the arts. In the maximum protection scenario R1-W4, unprotected services face average cuts of 27.1 per cent over the forecast period.

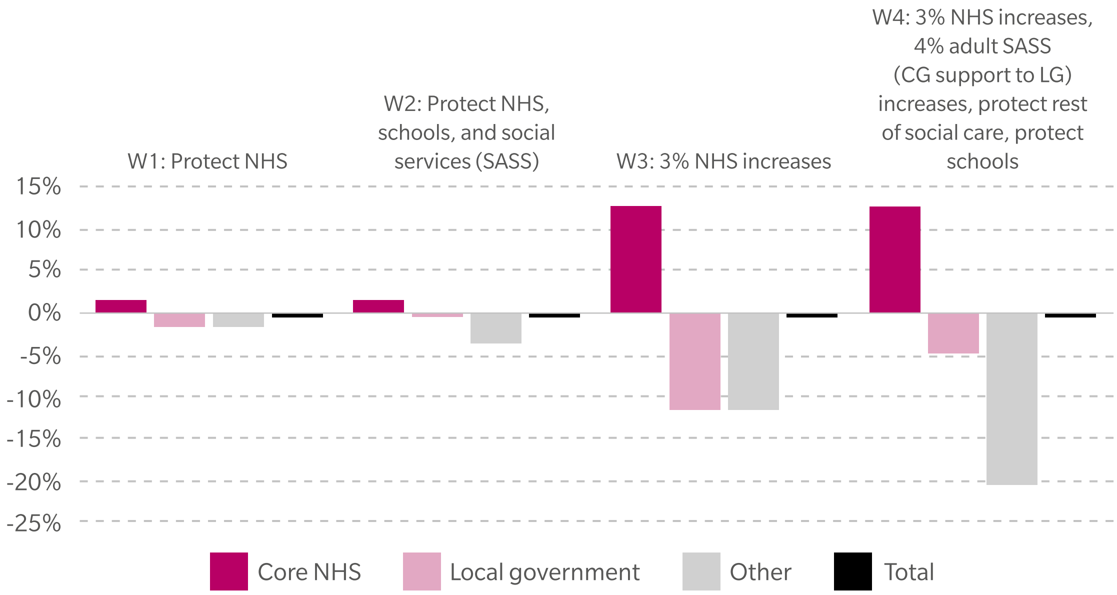
Figure 4.3: Cuts to Welsh Government spending by service area, 2017-18 to 2021-22, in baseline revenue scenario (R1), by Welsh Government spending scenario W1-W4



Source: See Appendix. Authors' calculations.

A similar trade-off pattern holds for revenue scenarios R2 and R3. Both of these scenarios offer higher spending than R1, which decreases the total cut to the Welsh Government resource budget to 0.3 per cent (R2) or 0.5 per cent (R3). The smaller cut to the Welsh Government resource budget in scenarios R2 and R3 compared to R1 also alleviates some of the pressures in the trade-offs between funding protected and unprotected services. For example, in scenario R2, the slightly higher level of the Welsh block grant reduces the extent of cuts to unprotected services to 1.7 per cent and 3.6 per cent in scenarios W1 and W2 respectively, and to 11.6 per cent and 20.7 per cent in scenarios W3 and W4.

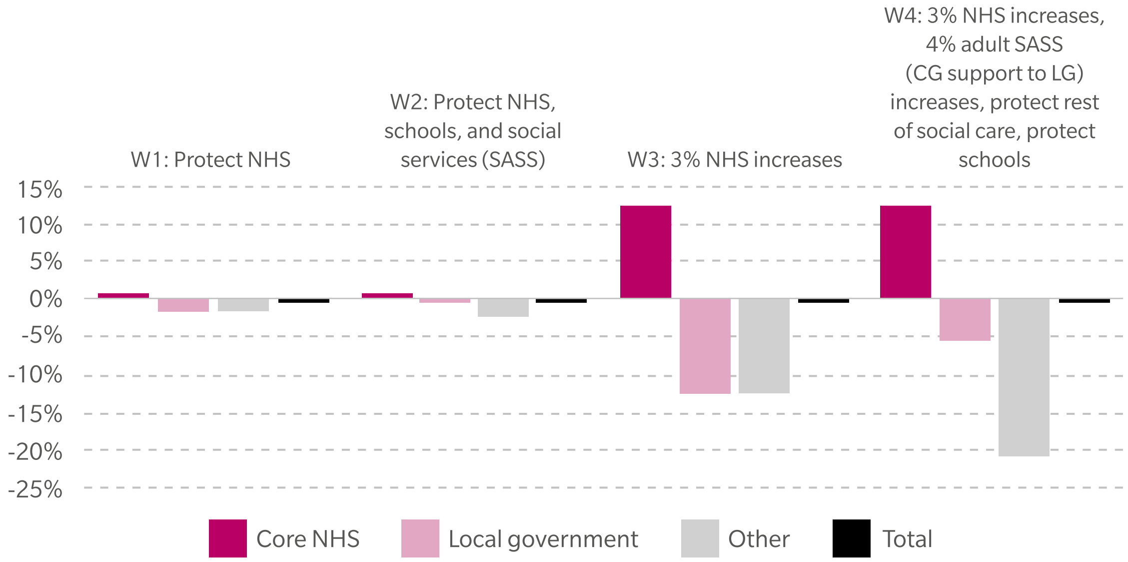
Figure 4.4: Cuts to Welsh Government spending by service area, 2017-18 to 2021-22, in revenue scenario R2, by Welsh Government spending scenario W1-W4



Source: See Appendix. Authors' calculations.

Similarly, in scenario R3 (Figure 4.5), the protection of all public services has a similar effect, compared to the baseline scenario R1. Cuts to unprotected services are similar to those in R2: 1.4 per cent and 2.4 per cent in scenarios W1 and W2, and to 12.2 per cent and 21.2 per cent in scenarios W3 and W4 respectively.

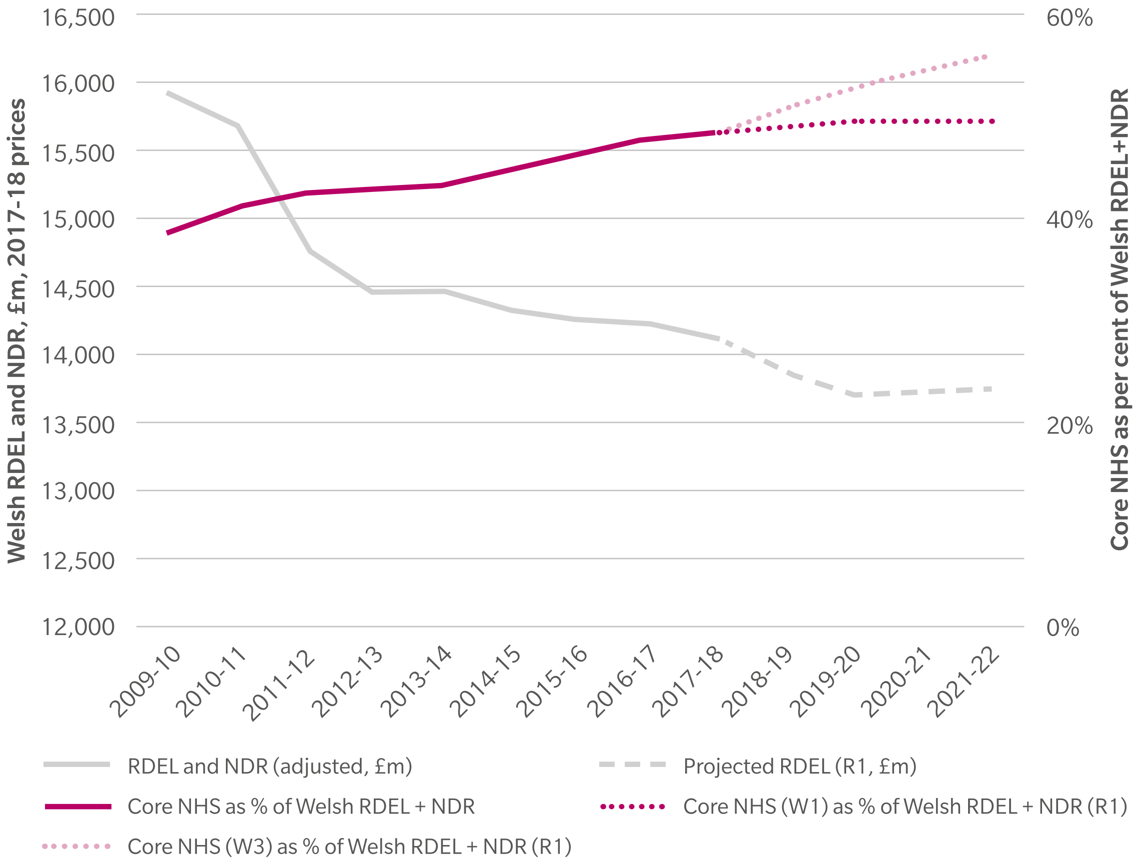
Figure 4.5: Cuts to Welsh Government spending by service area, 2017-18 to 2021-22, in revenue scenario R3, by Welsh Government spending scenario W1-W4



Source: See Appendix. Authors' calculations.

To contextualise what these trade-offs could mean for Welsh public services, we provide the following illustration (Figure 4.6). If we apply the growth rate for the total resource revenue under revenue scenario R1 (the modelled Welsh block grant (NBF and BGA adjusted) and business rates) to the last available figure for the business-rate adjusted RDEL, and apply the core NHS growth rates under scenarios W1-R1 and W3-R1 to the last available core NHS figure and project forwards to 2021-22, we can project what would happen to core NHS as a proportion of the Welsh Government's budget between 2018-19 and 2021-22.

Figure 4.6: Historic and projected Welsh RDEL, £ million, 2017-18 prices, and core NHS as a proportion of the overall resource budget



Source: See Appendix.

Under revenue scenario R1, the overall resource budget falls by 2.6 per cent over 2017-18 to 2021-22. Under Welsh Government core NHS protection scenario W1-R1, core NHS is projected to fall by 5.2 per cent in real terms over the same period. However, because the fall in the RDEL flattens out in 2020-21 and 2021-22 (there is actually a slight real-terms increase driven by the projected increase in business rates), protecting the core NHS in real terms would slightly increase the core NHS share of the Welsh resource budget (from 48.2% to 49.6%) per cent. The core NHS budgeted amount would increase by £18m in real terms).

Under scenario W3-R1, where core NHS is grown by 3 per cent in real terms each year (the Health Foundation sustainable NHS projection), core NHS would rise from 48 per cent of the resource budget in 2017-18 to 56 per cent by 2021-22, or by £853m over the same period.

What about unprotected services at the Welsh Government level? For example, funding to post-16 education has seen considerable cuts over recent years. Colleges receive around two thirds of their income from Welsh Government grants (mostly through the revenue support grant). Between 2011-12 and 2016-17, grant funding fell from £303 million to £281 million, roughly equivalent to a 13% real-terms cut (Welsh Audit Office (WAO), 2017). This cut fell disproportionately on part-time provision since the Welsh Government attempted to protect full-time provision for young people aged 16-19 (see WAO (2017) for more information). If we assume that, overall, the grant to FE colleges would be categorised as 'unprotected', under our scenarios W1-W4 the sector would suffer further cuts between 2017-18 and 2021-22, ranging from 5.2 per cent (W1) to 27.1 per cent (W4). If we assume that the sector grant funding in 2017-18 were the same in real terms as in 2016-17, and apply cuts to 2017-18 going forward to 2021-22, this could mean a real-terms grant funding fall to £266 million by 2021-22 (W1, CAGR of -1.3%) or to £205 million (W4, CAGR of -7.6%).

The above illustrations show that even if the UK government relaxes austerity to an extent, there are still substantial challenges to be met in finding funding to ensure that key Welsh public services keep pace with demand and other pressures. Fundamentally, finding such sums for health and social services would mean very tough choices for other service areas, which could see cuts ranging from 21 to 27 per cent.

5. Scenarios for local government

This section looks at local government income and spending in the light of the scenarios set out in previous parts. Our focus is the twenty-two unitary authorities. The Welsh Government has pursued a distinctive approach to local government finance which has seen smaller cuts in local authority spending compared with England and higher rises in Council Tax. The analysis below reports some of the results from our work which will feed into the IFS UK-wide programme on local government finance. We will be publishing a fuller account of this work later this autumn.

Local government receives its income from three main sources: grants from central government, business rates, and council tax rates. In the context of historic cuts to local government, we focus on our baseline scenario with no income tax changes (R1) to illustrate how the Welsh Government's different spending decisions (W1-W4) affect Welsh Government support for local government. We also consider what implications this might have for different local government funded public services going forward to 2021-22.

5.1 Scenarios for Welsh local government 2018-19 to 2021-22

Although we could run different scenarios for Welsh local governments' budgets by selecting different revenue scenarios and changing Welsh Government's spending allocations, these would all either increase or decrease the support available to local government through the revenue support and specific grants. We focus on our baseline scenario with no income tax changes (R1) to illustrate how the Welsh Government's different spending decisions (W1-W4) affect Welsh Government support for local government. We also make the assumption that local councils do not draw any funds from their reserves in future years to fund their spending. Note that where we protect central government support to local government, we protect the revenue support grant and the redistributed share of business rate revenues only (see Appendix p. 51). This section considers 4 scenarios for Welsh Government support to local government (L1-L4):

- **L1:** Our baseline council revenue scenario, in which the Welsh Government protects core NHS spending (scenario W1),[34] where general and specific grants to councils change at the same rate as other Welsh Government spending, and where council tax revenues increase in line with the OBR's forecast.
- **L2:** As L1, but where the Welsh Government also protects that part of its general funding for councils that relates to councils' education and social services responsibilities (scenario W2).
- **L3:** As L1, but where the Welsh government increases core NHS spending by 3 per cent annually (scenario W3).
- **L4:** As L3, but where the Welsh Government also increases its support to local government adult social services spending by 4 per cent annually, protects that part of its general funding for councils that relates to councils' education responsibilities, and protects the rest of social services (scenario W4).

The following tables (Table 5.1 through to Table 5.4) show what happens to Welsh council revenues under scenarios L1-L4 under resource scenario R1. The extent of the cuts to local government funding depend on the total cut to the Welsh Government overall resource budget and on the protections in place for public services. For example, cuts to unprotected specific grants to local government are highest if the Welsh

34 We assume that Welsh 'core NHS' spending is 'protected' by a) ensuring that any funding the that Welsh Government receives from Barnett consequentials as a result of increases in English NHS spending is directed to the Welsh NHS, and b) ensuring that the core NHS budget does not fall either in real terms or as a share of the overall Welsh budget. This protection results in small real-terms increases in the Welsh 'core NHS' budget. Any overall budget cuts required are shared proportionately across other unprotected service areas.

Government increases funding for health and adult social services and protects the rest of social services and education (L4).

In our local government baseline revenue scenario L1, we assume that the Welsh Government protects core NHS spending but offers no protection to other services, including support to local government (W1). Under these assumptions, specific and revenue support grants (including non-domestic rates) would fall by 5.2 per cent over the period 2017-18 to 2021-22 (Table 5.1). Overall local government revenues would be down by 3.2 per cent, assuming councils only draw on their reserves in 2017-18 and not over the projected period (or 1.7% if reserves are excluded completely).

Table 5.1: Scenario L1, £ million, 2017-18 prices

Welsh council revenues, forecast	2017-18	2018-19	2019-20	2020-21	2021-22	% change
Specific grants	864	837	817	818	819	-5.2%
Appropriations from(+) / to(-) reserves	97	0	0	0	0	NA
Discretionary non-domestic rate relief	-4	-3	-4	-4	-4	2.0%
Central government funding: RSG + NDR	4,114	3,985	3,890	3,896	3,901	-5.2%
Council tax (net of reduction scheme)	1,182	1,221	1,259	1,296	1,334	12.8%
TOTAL	**6,253**	**6,040**	**5,963**	**6,007**	**6,050**	**-3.2%**
Total (excluding reserves)	**6,156**	**6,040**	**5,963**	**6,007**	**6,050**	**-1.7%**

Source: See Appendix.

In contrast, Table 5.2 shows that if the Welsh Government were to partially protect the general funding to local government through the RSG and NDR,[35] overall central funding cuts between 2017-18 and 2021-22 would be smaller than under L1 (2.8%), but the cuts to unprotected specific grants would be larger (8.4%). Overall local government revenues would be cut by less than under L1, (0.6% excluding reserves, or 2.1% including reserves in 2017-18).

Table 5.2: Scenario L2, £ million, 2017-18 prices

Welsh council revenues, forecast	2017-18	2018-19	2019-20	2020-21	2021-22	% change
Specific grants	864	821	789	790	791	-8.4%
Appropriations from(+) / to(-) reserves	97	0	0	0	0	NA
Discretionary non-domestic rate relief	-4	-3	-4	-4	-4	2.0%
Central government funding: RSG + NDR	4,114	4,042	3,989	3,995	4,000	-2.8%
Council tax (net of reduction scheme)	1,182	1,221	1,259	1,296	1,334	12.8%
TOTAL	**6,253**	**6,081**	**6,034**	**6,078**	**6,121**	**-2.1%**
Total (excluding reserves)	**6,156**	**6,081**	**6,034**	**6,078**	**6,121**	**-0.6%**

Source: See Appendix.

The following two local government scenarios L3 and L4 consider what happens to local government revenues if the Welsh Government were to increase core NHS spending to 3 per cent a year in real terms. Under scenario L3 the Welsh Government offers no other protections (W3). Under scenario L4, the Welsh Government additionally considers the impact of increasing adult social service spending by 4 per cent a year in real terms, and protecting the rest of social services and schools spend in real terms (W4).

35 By applying real-terms protections to social services (the proportion of central government support to local government DEL and AME spent on social services, as well as to the social services component of the Health Welfare and Sport MEG) and to schools ((the proportion of central government support to local government DEL and AME spent on schools).

In scenario L3, overall central funding support and specific grants would be both cut by 15.9 per cent between 2017-18 and 2021-22, around three times the amount compared to L1 (Table 5.3). Overall local government revenues would also be cut by substantially more than under L1 over the same period (10.4% excluding reserves, or 11.8% including reserves in 2017-18).

Table 5.3: Scenario L3, £ million, 2017-18 prices

Welsh council revenues, forecast	2017-18	2018-19	2019-20	2020-21	2021-22	% change
Specific grants	864	814	771	749	726	-15.9%
Appropriations from(+) / to(-) reserves	97	0	0	0	0	NA
Discretionary non-domestic rate relief	-4	-3	-4	-4	-4	2.0%
Central government funding: RSG + NDR	4,114	3,877	3,671	3,568	3,458	-15.9%
Council tax (net of reduction scheme)	1,182	1,221	1,259	1,296	1,334	12.8%
TOTAL	**6,253**	**5,909**	**5,697**	**5,609**	**5,514**	**-11.8%**
Total (excluding reserves)	**6,156**	**5,909**	**5,697**	**5,609**	**5,514**	**-10.4%**

Source: See Appendix.

Finally, in our most optimistic scenario for protected public services, L4 (Table 5.4), if the Welsh Government were to increase protections further, cuts to central government funding would be between those in scenarios L1 and L3 (7.6%). However, cuts to unprotected specific grants would be around five times larger than under L1 (27.1%). Overall local government revenues would be cut by less than under L3, but by more than under L1 (6.4% excluding reserves, or 7.9% including reserves in 2017-18).

Table 5.4: Scenario L4, £ million, 2017-18 prices

Welsh council revenues, forecast	2017-18	2018-19	2019-20	2020-21	2021-22	% change
Specific grants	864	779	706	668	629	-27.1%
Appropriations from(+) / to(-) reserves	97	0	0	0	0	NA
Discretionary non-domestic rate relief	-4	-3	-4	-4	-4	2.0%
Central government funding: RSG + NDR	4,114	4,001	3,900	3,854	3,801	-7.6%
Council tax (net of reduction scheme)	1,182	1,221	1,259	1,296	1,334	12.8%
TOTAL	**6,253**	**5,998**	**5,862**	**5,815**	**5,760**	**-7.9%**
Total (excluding reserves)	**6,156**	**5,998**	**5,862**	**5,815**	**5,760**	**-6.4%**

Source: See Appendix.

The tables above show that as the Welsh Government extends protections to selected public services spending, the unprotected part of support to local government is cut by more and more as more protections are added. We emphasise that the above tables take as a starting point UK revenue scenario R1, under which the block grant to Wales bears some of the Barnett consequentials of a £3.5bn cut across unprotected resource spending areas at the UK level in 2019-20. With different assumptions, the corresponding changes to Welsh local government support from the Welsh Government would change accordingly. So far we have also assumed that Welsh council tax revenue would continue to grow at a rate forecast by the OBR. However, local councils have the power to vary council tax. We consider what the implications of raising council tax in Section 5.1.1.

5.1.1 The role of council taxes

Given that the majority of councils' budgets are funded by transfers from the Welsh Government through the local government settlement, councils can use council taxes (and to a lesser extent, fees and charges) to influence a limited part their budgets. We discussed the historic developments regarding council tax in Section 3.2. In our local government scenarios L1-L4, we did not change the growth in council tax revenues. In this section, we model increases in council tax rates by an additional 3.3 percentage points per year above OBR forecasts in 2019-20 to 2021-22.[36]

L1+: As L1 but with council tax increases such that local authorities increase council tax by an extra 3.3 percentage points a year over and above the OBR forecast in 2019-20 to 2021-22, such that by 2021-22 council tax rates are 10 percentage points higher than the OBR March 2017 forecast.

The OBR forecasts that Welsh real council tax revenues will continue to grow at 3.1% a year between 2017-18 and 2021-22 (OBR 2017c). For these forecasts, the OBR assumes that council tax bills will increase by about 4.0 per cent a year from 2017-18 onwards, and that the council tax base (number of residential properties) will grow at 0.8 per cent a year. Overall, Welsh council tax revenues are forecast to increase by 12.8 per cent in real terms between 2017-18 and 2021-22.
If we increase council tax bills by 3.3 per cent a year on top of the 4.0 per cent increase forecast by the OBR over 2019-20 to 2021-22, council tax revenues (net of reduction scheme) would increase by 21.4 per cent under scenario L1+ (Table 5.5) rather than by 12.8 per cent under local government scenarios L1-L4. As a result, while the cuts to general (including non-domestic rates) and specific grants would be the same as under scenario L1 (5.2%), overall cuts to local government revenues would virtually disappear (they would decrease to 1.1 per cent if reserves in 2017-18 are included, if reserves are excluded, however, overall revenues would increase slightly, by 0.4 per cent).

Table 5.5: L1+, £million, 2017-18 prices

Welsh council revenues, forecast	2017-18	2018-19	2019-20	2020-21	2021-22	% change
Specific grants	864	837	817	818	819	-5.2%
Appropriations from(+) / to(-) reserves	97	0	0	0	0	NA
Discretionary non-domestic rate relief	-4	-3	-4	-4	-4	2.0%
Central government funding: RSG + NDR	4,114	3,985	3,890	3,896	3,901	-5.2%
Council tax (net of reduction scheme)	1,182	1,221	1,301	1,383	1,467	24.1%
TOTAL	**6,253**	**6,040**	**6,005**	**6,094**	**6,184**	**-1.1%**
Total (excluding reserves)	**6,156**	**6,040**	**6,005**	**6,094**	**6,184**	**0.4%**

Source: See Appendix.

However, the ability for councils to offset cuts by increasing council tax would vary significantly across Wales, because different Welsh councils depend on council tax as a source of income to different extents. The data show that local authorities that obtain a greater proportion of their income from council tax can offset a larger proportion of cuts to their grants from increasing council tax revenues. Conversely, authorities that rely less on council tax as a source of income relative to other sources, would be able to use the council tax lever to offset cuts to their grants to a lesser extent.

Underpinning these differences, and further constraining the capacity for using council taxes as a policy lever in the face of cuts, is the variation in the council tax rates across local authorities, and variations in the council tax base. Welsh council taxes have already been increasing over time (see Section 3.2 for a discussion), and

36 In Phillips and Simpson (2016), the IFS created a scenario where council taxes collected from taxpayers would rise by an additional 3.3 percentage points per year above OBR forecasts in 2017-18 to 2019-20, such that by 2019-20 they would be 10 p.p. higher than the OBR forecasts. In this report, we use a slightly modified version of this scenario.

further substantial raises may not be feasible. While the evaluation of the fairness of council tax is outside the scope of this report, it is important to highlight these considerations, and to acknowledge that raising council tax without making changes to the council tax system is likely to be a regressive policy move.

The different local government budgets will in turn affect resource allocations on public services run by councils. Council revenues stem from the central government support to local government through grants and redistributed non-domestic rates, as well as from other sources. As councils protect key local public services, such as education and adult social services, there is correspondingly less funding available to other, non-protected local public services, such as libraries, roads and transport, and local environmental services.

5.2 Choices and trade-offs between councils' service areas 2018-19 to 2021-22

In this section, we consider the trade-offs that local authorities could be facing when allocating resources to council-provided public service areas. Under the local government revenue scenarios L1-L4 and L1+ discussed in Section 5.1, councils would face cuts of varying magnitudes. If councils wanted to protect certain areas of spending, this would mean that cuts would have to be made elsewhere.

Councils' main spending areas are education and social services, which constitute more than two thirds of Welsh councils' budgeted revenue expenditure in 2017-18 (see Table 5.6). As we have mentioned earlier, these two service areas tend to be considered political priorities, and, social care especially, face significant cost and demand pressures. While protecting these key services is extremely important in the face of rising pressures, other services – for example, economic development, transport, local environmental services, and culture and heritage services to name a few, have already experienced substantial cuts, as we discussed in Section 3.2. Further cuts, as a result of protecting education and social services could undermine the longer-term sustainability of service provision.

Table 5.6: Welsh councils' budgeted revenue expenditure 2017-18, £million

Area	2017-18 budget	Share of total
Education	2,599	42%
Social Services	1,729	28%
Council fund housing (exc. Housing benefit)	120	2%
Local environmental services	386	6%
Roads and transport	281	4%
Libraries, culture, heritage, sport and recreation	204	3%
Planning, economic and community development	85	1%
Local tax collection	26	0%
Debt financing costs	322	5%
Law, order and protective services	137	2%
Central administration	177	3%
Other revenue expenditure	187	3%
Total revenue expenditure	**6,253**	**100%**

Note: Excluding spending on police and housing benefit. Source: See Appendix.

We consider the following three social services spending scenarios (following Phillips and Simpson, 2016):

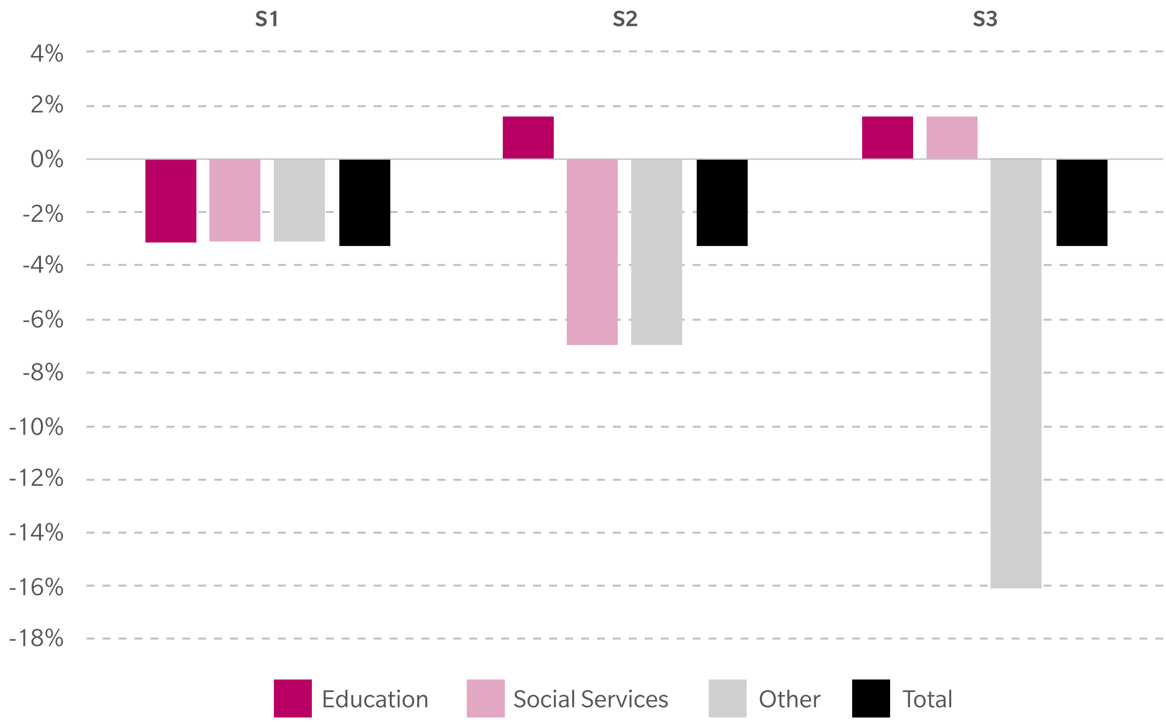
S1: Councils do not protect any area of spending from cuts, nor privilege any in the event of a budget increase. Each council spending area maintains its share of the total based on the 2017-18 budget, increasing or decreasing in subsequent years in line with overall available funding. Debt financing costs are assumed to decrease in line with their average change since 2009 (-1.3% per year in real terms.)

S2: As S1 if the budget is increasing, but if there are cuts then councils protect spending on education in real terms at its 2017-18 level.

S3: As S1 if the budget is increasing, but if there are cuts then councils protect spending on education and social care in real terms at its 2017-18 level. Debt financing costs are also assumed to maintain a constant share of the budget.

Figure 5.1 shows the local government trade-offs under different spending scenarios in our baseline local council revenue scenario L1. The total cuts to local government amount to 3.1 per cent over 2017-18 to 2021-22. If councils do not protect any service area (spending scenario S1), then between 2017-18 to 2021-22 cuts of 3.1 per cent will be distributed equally across all council service areas. If councils were to protect education spending (S2), there would be a small increase in education spending over 2017-18 to 2021-22 (see note to Table 5.7). However, social services and other local council services would face cuts of 6.9 per cent. Under the spending scenario where education and social services are both protected (S3), cuts to other 'unprotected' services increase to 16.2 per cent over the same period. Table 5.7 shows the local government trade-offs under other local government revenue scenarios (L2-L4, and L1+).

Figure 5.1: Cuts to local government spending areas under spending scenarios S1-S3, in baseline council revenue scenario L1, 2017-18 to 2021-22, per cent.



Note: The increase in spending on education under local councils service spending scenario S2 and on education and social care in S3 given local government revenue scenario L1 (also L2) comes from the fact that the local government budget increases slightly in real terms in 2020-21 and 2021-22. See Note to Table 5.7. Source: See Appendix.

Table 5.7: Real-terms cuts to different council spending areas under scenario R1, 2017-18 to 2019-20, per cent

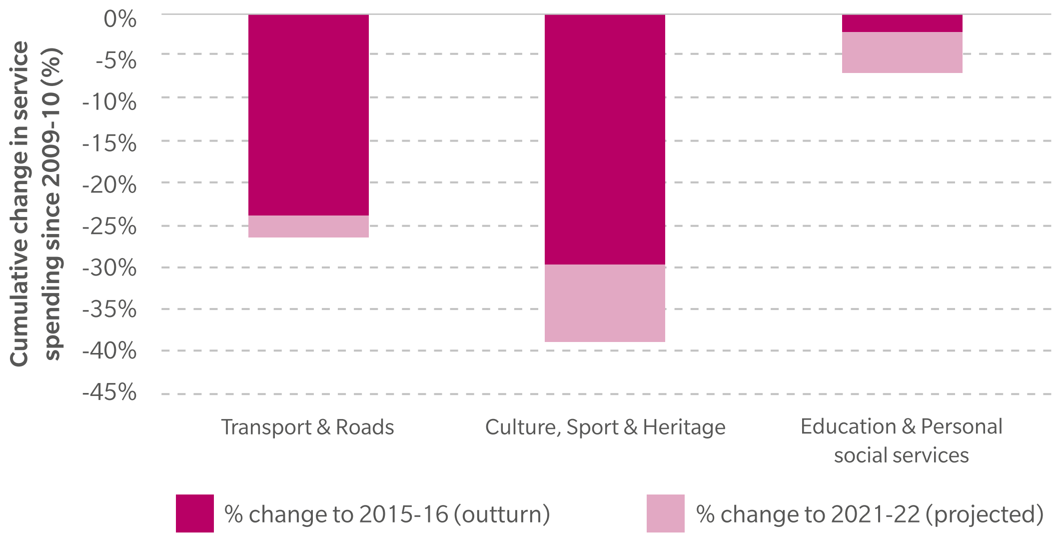
Spend scenario	Spend area	L1	L2	L3	L4	L1+
S1	Education	-3.1%	-2.0%	-12.2%	-8.0%	-0.9%
	Social Services	-3.1%	-2.0%	-12.2%	-8.0%	-0.9%
	Other	-3.1%	-2.0%	-12.2%	-8.0%	-0.9%
	Total	**-3.2%**	**-2.1%**	**-11.8%**	**-7.9%**	**-1.1%**
S2	Education	1.7%	1.7%	0.0%	0.0%	3.3%
	Social Services	-6.9%	-4.8%	-21.7%	-14.3%	-4.2%
	Other	-6.9%	-4.8%	-21.7%	-14.3%	-4.2%
	Total	**-3.2%**	**-2.1%**	**-11.8%**	**-7.9%**	**-1.1%**
S3	Education	1.7%	1.7%	0.0%	0.0%	3.3%
	Social Services	1.7%	1.7%	0.0%	0.0%	3.3%
	Other	-16.2%	-11.7%	-45.1%	-29.7%	-12.2%
	Total	**-3.2%**	**-2.1%**	**-11.8%**	**-7.9%**	**-1.1%**

Note: The increase in spending on education under local councils service spending scenario S2 and on education and social care in S3 given local government revenue scenario L1 (also L2 and L1+) comes from the fact that the local government budget increases slightly in real terms in 2020-21 and 2021-22 in revenue scenario R1. This is because, although NBF-adjusted block grant under R1 stays the same in real terms, implementing the BGA increases the block grant slightly between 2019-20 and 2021-22. This small increase then feeds into the Welsh Government budget, where the increase is made larger because of projected business rates growth. This is reflected in the central government support to local government allocations. Over 2017-18 to 2021-22, in scenarios L1 and L2 the effects of BGA and business rate growth are further increased by the assumptions about council tax revenue growth. As such, the change for education under S2 and education and social care under S3 is 0% over 2017-18 to 2019-20, but 1.7% over 2017-18 to 2021-22. Similar reasoning applies to the higher council tax revenue L1+. In scenarios L3 and L4, the local government budget is falling in real terms in each year, and so the change for education and social care is 0 over 2017-18 to 2021-22. Source: See Appendix.

As can be seen from Table 5.7, depending on the scenario combination, cuts to unprotected ‘Other’ services range from as little as 1 per cent (R1L1+S1) to as much as 45 per cent (R1L3S3). Unprotected service cuts across all five local government revenue scenarios and all three local council spending scenarios average at 13 per cent. Delivering such cuts to services that have already seen substantial cuts would likely represent a significant challenge.

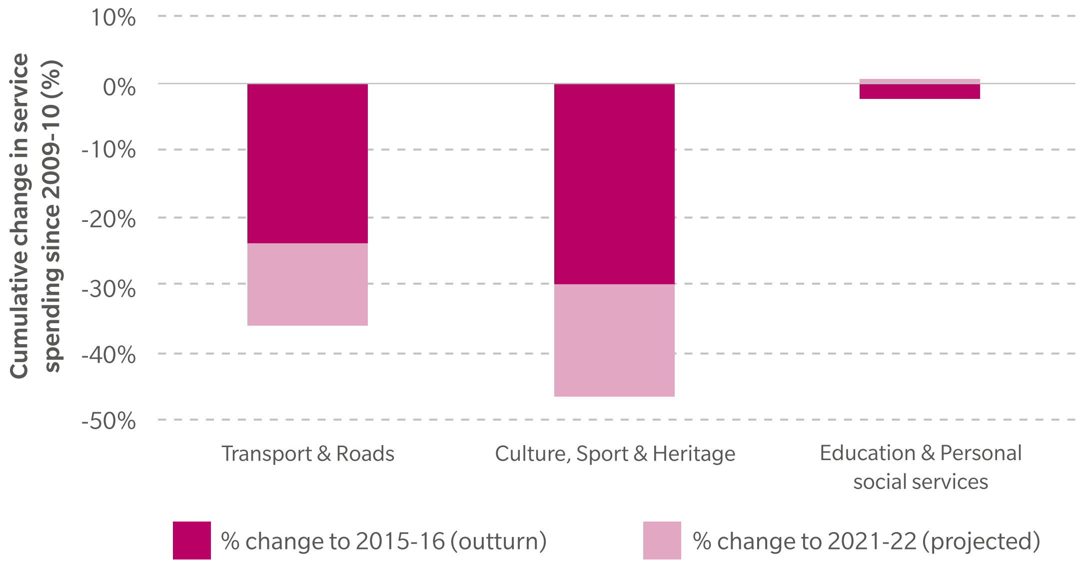
To give an example of some of the potential challenges ahead, Figure 5.2 and Figure 5.3 plot the projected cumulative changes to net spending on education and personal social services (areas that were protected over the recent period of austerity) and the two highest value unprotected services between 2009-10 and 2021-22 with respect to revenue scenario L1 and under service scenarios S1 and S3 respectively. Together these services made up 83 per cent of the total local government service spending in 2009-10. Protecting spending on education and personal social services (scenario S3) sees spending on culture, sport and heritage related services fall by 47 per cent compared to 39 per cent under scenario S1. Similarly, spending on transport and roads is projected to fall by 36 per cent relative to 26 per cent when councils do not protect any area of spending when allocating cuts.

Figure 5.2: Cuts to protected and unprotected local government spending areas in revenue scenario L1 under scenario S1, 2009-10 to 2021-22



Source: See Appendix.

Figure 5.3: Cuts to protected and unprotected local government spending areas in revenue scenario L1 under scenario S3, 2009-10 to 2021-22



Note: Changes up to 2015-16 employ revenue outturn data to calculate changes in net public spending. Projected numbers are calculated using the latest available budgeted revenue expenditure by service data.

Source: Budgeted revenue expenditure by service detail (available here: https://statswales.gov.wales/Catalogue/Local-Government/Finance/Revenue/Budgets/budgetedrevenueexpenditure-by-servicedetail) and local government revenue outturn data (available at: https://statswales.gov.wales/Catalogue/Local-Government/Finance/Revenue/Outturn/revenueoutturnexpenditure-by-authority).

The above analysis and example illustrations show that continuing to protect 'key' public services at the local government level would come at a cost to the other services under our baseline scenario R1. As we have illustrated, service areas such as roads and transport, and culture and heritage services, which have already seen substantial cuts in the past are likely to be cut further to 2021-22. Local-level policy levers such as raising council taxes may have limited room for manoeuvre. The Welsh Government (2016) is seeking systematic and mandatory regional working among local authorities, including with other bodies such as health boards, to deliver more effective and efficient services, as discussed in a recent PPIW report (Johnson and Williams, 2017). We have not looked at shared service arrangements in this report but will be looking at this further in later work.

6. Conclusions

Pending the clarification of the UK Government's fiscal strategy and given the degree of uncertainty about the UK economy and Brexit, Wales could well be facing a further period of squeezed public spending and the need for difficult choices.

Public services in Wales might be said to be just-managing in financial terms, despite significant cuts in some areas. Some are now being delivered in very different ways, often drawing on community-based models.

But resources are being spread thinly and there are some warning signs. The public sector pay cap has been fundamental to the sustainability of services but it is not clear how long that will hold. Meeting the growing demands associated with an ageing society and rising NHS costs will inevitably put an upward pressure on NHS and adult social care budgets. Under our baseline revenue scenario, if the Welsh Government were to grow the NHS in like with the Health Foundation's recommendation of 3 per cent, the NHS budget could be taking over 55 per cent of RDEL by 2021-22.

There is a question about how much further the budgets for unprotected services (such as transport and roads, or culture and heritage) can be cut while still ensuring that they are sustainable. There may not be a single tipping point but continued attrition would call into question whether the full range of services we have now is affordable. The judgement becomes harder because many 'unprotected' services play an important role in enabling 'protected' services to deliver the required outcomes.

As our analysis shows, even a relatively modest relaxation in UK Government fiscal policy would make a difference. And the new tax powers and Fiscal Framework should have an impact over the longer term although the immediate impact will probably be limited.

There will rightly be much attention on how the Welsh Government applies its new tax powers. Welsh Government policy is to leave any increase to the rate of Welsh Income Tax for the next Assembly. But, as we have shown, tax increases would have a limited if important impact on the Welsh Budget, especially if UK policy was focussed on tax reduction. In practice, it could only be part of solution, especially given the current sluggish growth in average earnings.

There will be continued pressure to secure better value from current spending but, on their own, it seems unlikely that efficiencies can fill the funding gap.

The options for managing the pressures on health and social care services will inevitably feature strongly in any future strategy. The OBR (2017d) has explored 'a variety of ways in which Government could deliver the same output for less by lowering costs (not least non-pay costs) and increasing productivity' through service change and integration. Action on both these would seem an essential part of the mix for Wales, the third option, which is to reduce health care provision, seeming highly unlikely. The need to increase productivity in the NHS through service transformation and efficiency is widely recognised and the current Parliamentary Review of Health and Social Care in Wales (Welsh Government, 2017b) is looking hard at these issues. There has been a continuing debate in England about how best to resource service transformation and the role of change funding. The debate is relevant to Wales.

The next four years are likely to be critical to putting the resourcing of public services onto a more sustainable track for the longer-term which can support the community through a period of fundamental economic, demographic and environmental change.

7. References

Cribb, J., Joyce, R., and Norris Keiller, A. (2017). **The UK Labour Market: Where Do We Stand Now?** Institute for Fiscal Studies Briefing Note BN197. Retrieved from: https://www.ifs.org.uk/publications/9170

Cribb, J. (2017). **Earnings and the labour market.**, Institute for Fiscal Studies Presentation, 09 March 2017. Retrieved from: https://www.ifs.org.uk/publications/8971

Davies, C. (2017). Pay cap: **Minister calls for UK cash to fund public sector rises.** BBC News article, 7 July 2017. Retrieved from: http://www.bbc.co.uk/news/uk-wales-politics-40531031

Deaner, B., and Phillips, D. (2013). **Scenarios for the Welsh government budget to 2025-26.** Institute for Fiscal Studies Report No. R83. Retrieved from: https://www.ifs.org.uk/comms/r83.pdf

Emmerson, C. (2017a). **Where next for tax and spend?** Institute for Fiscal Studies Observations, 12 July 2017. Retrieved from: https://www.ifs.org.uk/publications/9363

Emmerson, C. (2017b). **Where next for tax and spend?** Institute for Fiscal Studies Presentation, 12 July 2017. Retrieved from: https://www.ifs.org.uk/uploads/Presentations/WhereNextForTaxAndSpend.pdf

HM Government and Welsh Government. (2017). **The agreement between the Welsh Government and the United Kingdom Government on the Welsh Government's fiscal framework.** Retrieved from: http://gov.wales/funding/fiscal-reform/framework/?lang=en

HM Treasury and The Rt Hon Philip Hammond MP. (2017). **Mansion House 2017: Speech by the Chancellor of the Exchequer.** Retrieved from: https://www.gov.uk/government/speeches/mansion-house-2017-speech-by-the-chancellor-of-the-exchequer

House of Commons Library. (2017a). **School funding England. Current systems and proposals for 'fairer school funding',** Briefing paper 06702. Retrieved from: http://www.parliament.uk/briefing-papers/SN06702.pdf

House of Commons Library. (2017b). **The UK's contribution to the EU Budget.** Briefing paper CBP7886. Retrieved from: http://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-7886#fullreport

Innes, D. and Tetlow, G. (2015). **Central Cuts, Local Decision-Making: Changes in Local Government Spending and Revenues in England, 2009-10 to 2014-15.** Institute for Fiscal Studies Briefing Note BN166. Retrieved from: https://www.ifs.org.uk/publications/7617

Johnson, C. and Williams, E. (2017). **Considerations for Designing and Implementing Effective Shared Services**. Public Policy Institute for Wales. Retrieved from: http://ppiw.org.uk/files/2017/09/PPIW-Report-Shared-services-in-local-government.pdf

Luchinskaya, D., Ogle, J., and Trickey, M. (2017). **A delicate balance? Health & Social Care spending in Wales.** Wales Public Services 2025. Retrieved from: http://www.walespublicservices2025.org.uk/2017/03/08/a-delicate-balance-health-social-care-spending-in-wales/

Office for Budgetary Responsibility. (2017a). **Economic and fiscal outlook.** March 2017. Retrieved from: http://cdn.budgetresponsibility.org.uk/March2017EFO-231.pdf

Office for Budgetary Responsibility. (2017b). **Fiscal risks report.** July 2017. Retrieved from: http://cdn.budgetresponsibility.org.uk/July_2017_Fiscal_risks.pdf

Office for Budgetary Responsibility. (2017c). **Devolved tax forecast.** March 2017. Retrieved from: http://budgetresponsibility.org.uk/download/march-2017-devolved-taxes-forecast/

Office for Budgetary Responsibility. (2017d). **Fiscal sustainability repor**t. January 2017. Retrieved from: http://cdn.budgetresponsibility.org.uk/FSR_Jan17.pdf

Phillips, D. and Simpson, S. (2016). **Welsh budgetary trade-offs to 2019-20.** Institute for Fiscal Studies Report No. R120. Retrieved from: https://www.ifs.org.uk/publications/8470

Poole, E., Ifan, G., and Phillips, D. (2017). **Fair Funding for Taxing Times? Assessing the Fiscal Framework Agreement**. Third Report on the 2016-17 Fiscal Framework Negotiations for Wales. Wales Governance Centre at Cardiff University and Institute for Fiscal Studies. Retrieved from: http://sites.cardiff.ac.uk/wgc/publications/

Poole, E., Ifan, G., and Wyn Jones, R. (2016). **Government expenditure and revenue Wales 2016.** Wales Governance Centre at Cardiff University. Retrieved from: http://sites.cardiff.ac.uk/wgc/files/2016/04/Government-Expenditure-and-Revenue-Wales-2016.pdf

StatsWales. (2016). **Revenue outturn expenditure, by authority.** Retrieved from: https://statswales.gov.wales/Catalogue/Local-Government/Finance/Revenue/Outturn/revenueoutturnexpenditure-by-authority

Tetlow G. (2013). **We shall squeeze... until the pips squeak**. Institute for Fiscal Studies Presentation from the IFS Post-Spending Round Briefing, 27 June 2013. Retrieved from: http://www.ifs.org.uk/budgets/sr2013/gemma_tetlow.pdf

The Conservative and Unionist Party Manifesto 2017 (2017). **Forward together: our plan for a stronger Britain and a prosperous future.** Retrieved from: https://www.conservatives.com/manifesto

Watt, T. and Roberts, A. (October 2016). **The path to sustainability: Funding projections for the NHS in Wales to 2019/20 and 2030/31.** The Health Foundation. Retrieved from: http://www.health.org.uk/publication/path-sustainability

Welsh Audit Office. (2017). **Welsh Government oversight of further-education colleges' finances and delivery.** Auditor General for Wales. Retrieved from: https://www.wao.gov.uk/system/files/publications/FE-finances-eng-2017.pdf

Welsh Government. (2017a). **Welsh rates of income tax FAQs.** Retrieved from: http://gov.wales/funding/fiscal-reform/welsh-taxes/income-tax/?lang=en

Welsh Government. (2017b). **Review of Health and Social Care in Wales - Interim Report.** Retrieved from: https://beta.gov.wales/review-health-and-social-care-wales-interim-report

Welsh Government. (2016). **Local government reform**. Retrieved from: http://gov.wales/topics/localgovernment/local-government-reform/?lang=en

8. Appendix: Modelling the Welsh Government's budget to 2021-22

This report follows the methodology of the earlier Welsh budgetary trade-offs reports closely (Phillips and Simpson, 2016; Deaner and Phillips, 2013). Please see Appendices A and C in Phillips and Simpson (2016) for details. We provide detail about the main assumptions underlying the Welsh block grant, Welsh budget allocations, Welsh local government revenue and local government allocations throughout the report. For convenience, most of the main points are summarised here. In addition, we make several other assumptions in our modelling methodology relating to extending the forecast to 2021-22, and adjusting the Welsh block grant for the new Fiscal Framework Agreement. This Appendix sets out our underlying modelling assumptions.

8.1 Modelling UK-level spending allocations to 2021-22

The most recent spending plans for UK departmental expenditure limits (DELs), including the Welsh block grant, are set out in the UK Spring Budget 2017, from 2016-17 for each year until 2019-20. But these plans are likely to change for several main reasons, and so we model alternative scenarios.

In contrast, Phillips and Simpson (2016) start with the Spending Review 2015, and then add on the March Budget 2016 changes. In this report, we start with the March Budget 2017, and take 2016-17 as our first year. Taking the March Budget 2017 as the starting point resolves some of the comparability issues stemming from the reorganisation of government departments that took place in 2016.[37]

First, the issue of the £3.5 billion of planned but unallocated cuts remains. This formed part of the baseline scenario in the Phillips and Simpson (2016) report, and this update does the same. As of March 2017, these cuts have been factored into the budget tables, but not tied to a particular department. From Government documentation, it seems likely that Health, Core schools, International Development and Defence will be exempt from the cuts.[38] It also looks like £1bn of the cuts would be reinvested into key priority areas (although it is not clear what these areas would be). The Government has suggested that efficiency savings made at local government would be reinvested into social care. Given the limited information available, we allocate the £3.5bn cuts to all departments except Health, Core schools,[39] International Development and Defence, in proportion to the planned resource DELs for those departments in 2019-20. We do not reinvest £1bn into any spending area.

Second, mounting financial pressures, particularly on the public sector pay cap, and NHS and social care funding, coupled with higher than forecast inflation, uncertainty surrounding Brexit, and the delicate political situation following the UK election, mean that the UK government could decide to delay or cancel the cuts planned for the period to 2019-20. We include a resource scenario that cancels the cuts in 2019-20, and

37 Higher and Further education moved out of BIS and into DfE, and Energy merged with the remainder of BIS to form BEIS. Another issue regarding the starting point relates to the classification of R&D expenditure. From March 2016, R&D expenditure shifted from resource to capital DEL in the English departments, but not in the Welsh Government. The 2015 Spending Review was the last source that classified R&D in the same way in England and in Wales. However, the Welsh Government is currently in process of moving to the new accounting standards. For our modelling purposes, the R&D discrepancy is not likely to be of substantial consequence.

38 The March 2017 Budget includes a row which says 'Adjustment for planned efficiency savings' in 2019-20, but almost no information is available on how the cuts would be allocated. Details suggest that the NHS, 'core schools', defence, and international aid will be protected. It is also suggested that efficiencies made at the local government be reinvested into social care (mostly a local responsibility). Core schools funding, or the Dedicated Schools Grant, was £40.7bn in 2016-17, approximately 2/3 of the Education Budget (http://www.parliament.uk/briefing-papers/SN06702.pdf). We therefore model efficiency cuts to affect the non-protected third of the Education budget, while core schools are protected in real terms. See: https://www.gov.uk/government/news/efficiency-review-to-drive-productive-public-services

39 Core schools funding, or the Dedicated Schools Grant, was £40.7bn in 2016-17, approximately 2/3 of the Education Budget (http://www.parliament.uk/briefing-papers/SN06702.pdf). We therefore model efficiency cuts to affect the non-protected third of the Education budget, while core schools are protected in real terms.

allocates extra funding to the NHS, as set out in the Conservative 2017 manifesto. At the 2017 General Election, the Conservative party pledged to increase NHS spending "by a minimum of £8 billion in real terms over the next five years" (Conservative Party, 2017, p. 66) and second, to "increase the overall schools budget by £4 billion by 2022" (p. 51). No details were given about the profile of this spending, but this report assumes that spending (real terms, in the case of the NHS, and nominal, in the case of schools) will increase linearly from 2018-19 until the additional amount pledged is reached.[40] Since we also do not know how the funding will be allocated between resource and capital budgets in health and education, we assume that both resource and capital will grow proportionately, such that the sum of resource and capital health spending in 2022-23 is £8bn higher in real terms than in 2017-18. We also assume that the increase will occur annually at a rate of 1.3 per cent from 2018-19 onwards.[41]

We also use an updated version of the Phillips and Simpson (2016) scenario that holds constant (protects) in real-terms any DEL forecast to fall below its 2017-18 real-terms level on current plans, or alternatively allocates the published March Budget 2017 cash allocations for that year, whichever is higher.

On capital DEL, the Autumn Statement 2016 and the March Budget 2017 resulted in modest capital increases. We include scenarios based on current plans, and ones where capital spending is brought forward, where any changes in given years are spread across DELs in proportion to their contribution to the total capital DEL.

8.2 Modelling the underlying block grants (including the new Needs Based Factor)

The March 2017 Budget sets out the 'rounded' devolved nation DELs (to the nearest £0.1bn), which we take as our starting point. We project the Welsh 'block grant' using our projections for the total UK DEL, our assumptions for how this will be allocated between Whitehall departments, and the Barnett formula, updated for the new Welsh Fiscal Framework. The Barnett formula is applied to spending decisions taken by the UK government regarding different government programmes, and provides additional funding to each of the devolved administrations. The amount of additional funding (Barnett consequentials) depends on whether or not a function is devolved, and the comparable population proportion. From 2018-19, a Needs Based Factor (NBF) of 105 per cent will be introduced into the Welsh Block grant calculations. This means that if the consequentials for Wales are greater than 0 from 2018-19 going forward, the consequential will be multiplied by 1.05 (105%). If the consequential is 0 or less, it will be left as is. The factor will be increased to 115% only at the point at which relative Welsh funding per person converges to below 115% of the level in England (see Poole et al. (2017) for a more detailed discussion).

It should be noted that the 2017 March Budget document does not account for the Welsh and Scottish governments' fiscal frameworks when setting out the block grants, and these will be further adjusted once the fiscal frameworks are applied. This formula is designed so that, in principle, the block grant changes by the same amount per person as the change in 'comparable spending' per person by Whitehall departments in England, where 'comparable spending' is spending in England on functions that are devolved to the Welsh Government.

For the many Whitehall departments which cover both devolved and non-devolved functions, when overall departmental budgets are being set at Spending Reviews, the Barnett formula does not take into account all the change in their budget. Instead, the department is allocated a 'comparability factor' which

40 In other words, NHS real spending allocations will increase linearly until 2022-23, until the point at which the real difference between 2017-18 levels and 2022-23 new levels is £8 billion.

41 The figure of 1.3% is calculated by calculating the compound annual growth rate (CAGR) that an amount of money would have to grow by each year in order to reach a particular value in a set number of years. In this case, the sum of real resource and capital DELs for Health in 2017-18 is £123.7bn. For this value to be £8bn higher in five years' time, i.e. to reach £131.7bn in 2022-23, the initial value would need to grow by 1.3% a year. The CAGR formula is (New Value/Original Value)^(1/No.of years), and in this case, 131.7/123.7)^(1/5)-1 = 1.3%.

reflects the proportion of its overall budget spent on functions for which responsibility is devolved to the Welsh Government. For instance, in the case of the Department for Transport, 80.9 per cent of spending relates to functions devolved to the Welsh Government. To calculate the change in the block grant flowing from the change in this departmental budget, the following calculation is used: the departmental budget change multiplied by 5.69 per cent (Wales' population share) multiplied by 80.9 per cent (the departmental comparability factor), and, from 2018-19, if the resulting consequential is positive, multiplying it by the needs-based factor of 1.05.

Comparability factors are typically updated during a spending review, and no new comparability factors were calculated to reflect the government department reorganisation that took place in 2016. But, in order to model how UK-wide RDEL affects the Welsh block grant, updated comparability factors are useful. We used the Statement of Funding Policy 2015 and moved functions between departments as appropriate to calculate new factors. These are:

Department	Scotland	Wales	Northern Ireland	Compared to population
Business, Innovation and Skills	66.40%	66.3%	66.70%	England
Energy & Climate Change	1.80%	1.80%	15.30%	England
Business, Energy & Industrial Strategy	**26.97%**	**26.82%**	**30.89%**	**England**
Education	100%	100%	100%	England
Education (DfE)	**100%**	**100%**	**100%**	**England**

Note that when the Department for Transport allocates its budget, it may not allocate it in proportion to existing levels of spending by function. In this case the cuts to 'comparable' functions for which responsibility is devolved to the Welsh Government may be more or less than the average departmental cut. Therefore, the use of 'comparability factors' does not necessarily ensure the per-person change in the Welsh block grant equals to per-person change in spending on comparable functions in England. However, at the time of Spending Reviews, the precise allocations to specific functions are generally unknown.
In our scenarios, we have assumed that any changes in departmental spending are treated by the Barnett formula as general changes to budgets, with the updated comparability factors applied. If, however, any changes in departmental spending were allocated to specific functions, the comparability factor that would be used would be either 100% if those functions were devolved or 0% if they were not (this the approach taken when announcements on specific functions are made in annual UK government budgets). In practice, the precise impact of any changes to existing spending plans on the Welsh block grant may differ somewhat from what we model.

8.3 Modelling Welsh tax revenues and block grant adjustments

From 2018-19, Stamp Duty Land Tax (SDLT) and the Landfill tax (LT) will be replaced by new devolved taxes in Wales. We assume a 10p share of each income tax band will also be devolved from 2019-20.

Welsh tax revenue forecasts are taken directly from two sources:

- Income tax, stamp duty land tax, landfill tax and aggregates levy revenues are taken from the OBR's Devolved Taxes Forecast (Office for Budget Responsibility (2017c). These revenues are forecast with the assumption that Welsh Government does not alter tax policy after devolution.
- Non-domestic rates (business rates) revenues are taken from Table 7.1 of HM Treasury's July 2017 PESA (HM Treasury (2017). These are referred to as 'locally financed support in Wales'. However, the

PESA July 2017 release only gives business rates revenue up to 2019-20. To project business rates revenue for 2020-21 and 2021-22, we assume that the revenue will continue to grow at its historic average growth rate 2016-17 to 2019-20, which means that it will grow at 1.7 per cent in real terms in each of 2020-21 and 2021-22.

Block grant adjustments (BGAs) are calculated as set out in the fiscal framework agreement published in December 2016. The baseline BGA for SDLT and LT in 2018-19 is equal to the OBR's forecast of Welsh revenues in 2017-18, and updated according to changes in revenues in the rest of the UK to 2018-19 (via the Comparable Model described in Box 2.1). The baseline BGA for income tax in 2019-20 equals the forecast of devolved Welsh revenues in that year.

Subsequent BGAs are then updated according to the Comparable Model. We use OBR forecasts of SDLT and LT revenues in the rest of the UK (excluding Scotland). As set out in the agreement, separate BGAs will be created for each income tax band. As the required forecasts for these are not yet published, we use HMRC data on tax liabilities in each band for 2017-18, and apply these shares to the OBR forecasts.

8.4 Projecting the Welsh Government's budget's total DEL

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

For example, in our baseline scenario, in 2018-19 the Welsh block grant (adjusted for NBF) is due to fall by 1.5 per cent in real terms relative to the latest available 2017-18 figure. We therefore assume a 1.5 per cent fall in the Welsh Government's total DEL in 2018-19 too.

Although business rates have been formally classed as AME since April 2015, in practice, they are spent on resource-type items at the local government level (see also Phillips and Simpson (2016), p.53). Therefore, we include business rate revenues in the overall Welsh resource budget from 2015-16 onwards.

8.5 Modelling Welsh Government trade-offs

Our scenarios for the allocation of the Welsh Government's DEL and NDR revenues across service areas are essentially arbitrary, but are designed to illustrate the sorts of trade-offs the Welsh Government may face when allocating budgets across service areas. Two features of these scenarios are worth discussing however.

- In our scenarios W1 and W2, Welsh 'core NHS' spending is 'protected' by allocating to it the cash-terms increases in the Welsh block grant that result from increases in NHS spending in England (via application of the Barnett formula). This protection results in small real-terms increases in the Welsh 'core NHS' budget.
- In our scenarios W2 and W4, we protect that part of the funding the Welsh Government provides to councils via the revenue support grant (RSG) and redistributed non-domestic rates (NDR) revenues that relates to councils' responsibilities for education and (adult) social services. We calculate this using the figures set out in the Local Government Financial Settlement which separates out the funding allocations the Welsh government determines for councils into funding allocations for separate service areas (including education and social services).

In scenario W4, when we grow adult social services by 4 per cent in real terms and protect the remaining social services in real terms, what we mean is that we increase the central government support to local government for adult social services, or two thirds of the central government support to local government social service budget, by 4 per cent in real terms. Then we protect the remaining third of the central government support to local government social service budget, and the Health, Welfare and Sport MEG social care component in real terms.

It should be noted that just because the central government spend allocation to particular local government services is protected or increased in our model, it does not mean that the local government will necessarily increase its spend on these services in proportion. This is because central government support to local government is non-hypothecated. Our scenarios for local government look at the impact of local government spending decisions on funding available to local government services.

8.6 Modelling Welsh local government budgets

We discussed the main assumptions underlying the various scenarios for the revenues available to local councils in Wales and the allocation of these funds between now and 2021-22 in Section 5. However, in addition to these assumptions, a number of adjustments have had to be made in order to utilise our projection methodology.

Baseline revenues for local councils

We begin by taking the local government 'budgeted financing of gross revenue expenditure, by source of funding' (from StatsWales) for all Welsh local authority types, in 2017–18 and subtract any revenues accruing to Police authorities.[42] This forms our 2017–18 baseline for the funds available to unitary authorities, fire authorities and national park authorities (together 'local authorities' or 'councils') in Wales, including:

- Revenue Support Grant (RSG)
- Share of redistributed Non-Domestic Rates (NDR) revenues
- Specific grants
- Council tax revenues
- Discretionary NDR reliefs offered to rate payers.

Projecting grants from the Welsh Government

In order to project how central funding for local councils will change over time, we would like to identify these spending items in our projections for the Welsh Government's budget, and simply insert our forecasts for these into our projected revenues for councils. However, the Welsh Government's budget does not individually list all spending items, so cannot be tallied exactly with councils' revenue budgets.

Instead we take baseline figures for RSG, redistributed NDR revenues, and specific grants and grow these in line with those Welsh Government spending items which best approximate the availability of these sources of funding.

For the purpose of analysis, the RSG and share of redistributed NDR revenues are added together and treated as one funding source, the 'formula grant'.[43] Council revenues from this formula grant (NDR and RSG) are then projected forward by applying the same percentage change as in our projections for the sum of the DEL and AME components of the Welsh Government's 'Funding Support for Local Government' (the DEL

42 Available at: https://statswales.gov.wales/Catalogue/Local-Government/Finance/Revenue

43 This is because the division between the two is essentially arbitrary: although non-domestic rates raised in Wales are supposedly hypothecated to local government, the amount raised does not affect the overall amount of funding councils receive, with higher NDR revenues being offset by lower RSG and vice versa.

component is effectively RSG and the AME component is redistributed NDR revenues).
The specific grants received by local councils are not individually listed in the Welsh Government's spending plans, which means we do not directly project what the Welsh Government plans to spend on these items. Instead, we assume that the specific grants received by local councils grow in line with the average percentage change in Welsh Government spending on areas other than 'Funding Support for Local Government' and core NHS spending. This is on the basis that it is from these other spending areas that funding for specific grants will have to come.

Projecting council tax and other revenue sources

Council tax revenues are assumed to grow (from their 2017–18 baseline) in line with the OBR's latest forecast (from the March Economic and Fiscal Outlook.) For example, between 2017–18 and 2018–19 revenues in cash-terms are forecast to increase by 4.9% due to increases in council tax level and the council tax base.

When simulating increases in council tax of a year above forecast, we scale council tax revenues up by 3.3% in 2019-20, 6.7% in 2020-21 and 10% in 2021-22.

For the other smaller revenue lines we make the following assumptions:

- Discretionary non-domestic rate relief are forecast to change at the same percentage rate as business rates revenues.
- We assume that from 2017–18 onwards councils do not draw down any funds from their reserves, and that there are no other adjustments.

Modelling local council budget choices

We begin by taking spending allocation for councils in Wales from the 2016–17 budgeted revenue expenditure. Using this as a baseline, our scenarios for the allocation of local council grant and council tax revenues across service areas are essentially arbitrary, but are designed to reflect the sorts of trade-offs Welsh councils may face when allocating budgets across service areas. In particular, real-terms protection for social services reflects recent experience in Wales (where spending has increased in real terms by 1% since 2009–10). Real-terms protection for education services would contrast with recent (less-than-average) cuts but would accord with recent experience in England.

Calculating cuts in local government spending between 2009-10 and 2015-16

Changes in local government spending by service area are calculated using outturns from 2009-10 and 2015-16.[44] Adjustments were made to the figures for education and social services for the shift of funding for some early years provision (such as Flying Start) from education to social services, and expenditure by national parks was moved to 'other revenue expenditure' in 2016-17 for consistency with 2009-10.

44 Available at: https://statswales.gov.wales/Catalogue/Local-Government/Finance/Revenue.

2025

Gwasanaethau Cyhoeddus Cymru

Wales Public Services

Prifysgol Caerdydd

Cardiff University

Canolfan Llywodraethiant Cymru

Wales Governance Centre