Institute for Fiscal Studies

# Welsh budgetary trade–offs to 2019–20


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E·S·R·C ECONOMIC & SOCIAL RESEARCH COUNCIL

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# Executive Summary

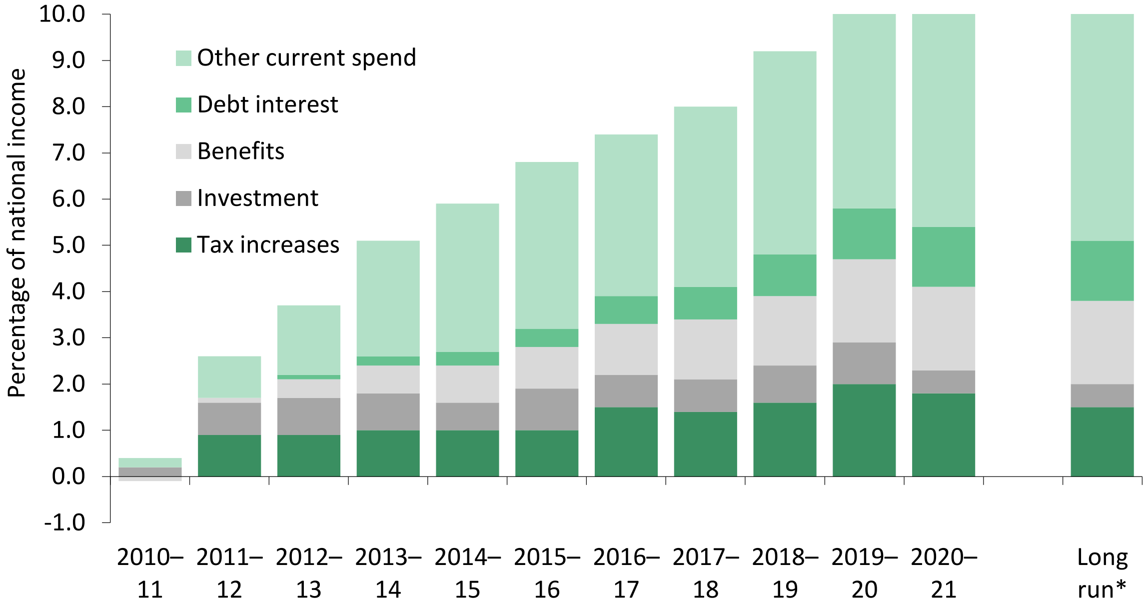
The UK government is part–way through significant cuts in spending on public services as it attempts to deal with the large hole in the UK's public finances. As part of this, grants from the UK Treasury to the Welsh Government have been reduced in real terms each year since 2009–10, and the spending plans set out by the Treasury set out further cuts in each year to 2019–20. While the new Chancellor may slow or even cancel cuts in the short-term as part of a possible 'fiscal stimulus' following the recent referendum on European Union membership, further spending cuts or tax rises in the first years of the next decade would be required if the UK government continued to want to balance its budget. Wales is therefore looking at an extraordinary eleven or more years of retrenchment in public service spending, in stark contrast to the first ten years of devolution, when the Welsh Government enjoyed substantial year–on–year real–terms spending increases.

This report is the first of two, undertaken as part of the independent Wales Public Services 2025 Programme based at Cardiff Business School, looking at the challenges facing Welsh Government and Welsh councils when setting their budgets in the context of continued spending constraint and rising demand. This paper focuses on the medium term outlook to 2019–20, looking at the trade–offs facing the various tiers of government in Wales at they set their tax and spending policies. In doing so it also considers how the evolving economic and fiscal environment might affect the budget available to the Welsh Government. A second study, in 2017, will update this report in the light of the updated economic forecasts and fiscal plans announced in the upcoming Autumn Statement, and will extend it to consider years beyond 2020. The key findings of the analysis in this report are:

## The economic and fiscal situation

- The UK is part–way through what, at the time of the March 2016 Budget, was planned to be an 11 year fiscal consolidation, turning a budget deficit of more than ten percent of national income in 2009–10 into a small budget surplus in 2019–20 and 2020–21. This consolidation consists of tax rises, and cuts to benefits, investment and day–to–day public service spending.
- While the planned net tax rises and cuts to investment spending have already taken place, the planned cuts to benefit spending and day–to–day spending on public services are still far from complete (see Figure 1). For instance, over one–third of the long–run cuts to day–to–day public services spending as a proportion of national income planned were, as of the March 2016 budget, due to take effect between 2017–18 and 2020–21.
- This mix of large cuts for some areas of spending, and more modest cuts or even increases in others all feeds into the Barnett Formula, which determines the bulk of the Welsh Government's budget. On a like–for–like basis, the Welsh Government's DEL fell by 8.2% between 2010–11 and 2015–16. Under current plans it would be 11.6% lower in 2019–20 than in 2010–11. The Welsh Government's capital budget was cut substantially more between 2010–11 and 2015–16, but increases over the next few year years are planned to partially undo these cuts.

Figure 1. The fiscal consolidation over 11 years




Notes: See sources to Figure 2.2., main text.

- New information about the underlying state of the economy and public finances is constantly emerging, and partly as a result of this, policymakers typically adjust their tax and spending plans at least a little on a frequent basis. Following the recent vote to leave the EU, the UK government has confirmed that it is no longer targeting a surplus for 2019–20, although a budget surplus remains as a longer term aim. Doing so would require additional tax rises and spending cuts further down the line. What is not yet clear is whether the delayed surplus target is just a recognition that, if economic forecasts are correct, existing tax and spending plans would no longer deliver such a surplus, or a precursor to changes to those tax and spending plans – perhaps to provide a temporary fiscal stimulus.

- The Chancellor will set out his plans and updated economic forecasts in the Autumn Statement on November 23rd. However, even after this there will still be significant uncertainty about the medium- and longer-term outlook for taxes and spending, not least because our future relationship with the EU will still be unknown. This means the Welsh Government will be making its medium and longer-term financial plans against a fiscal and economic backdrop that is perhaps even more uncertain than usual.

## The Welsh Government's budget and budgetary trade-offs

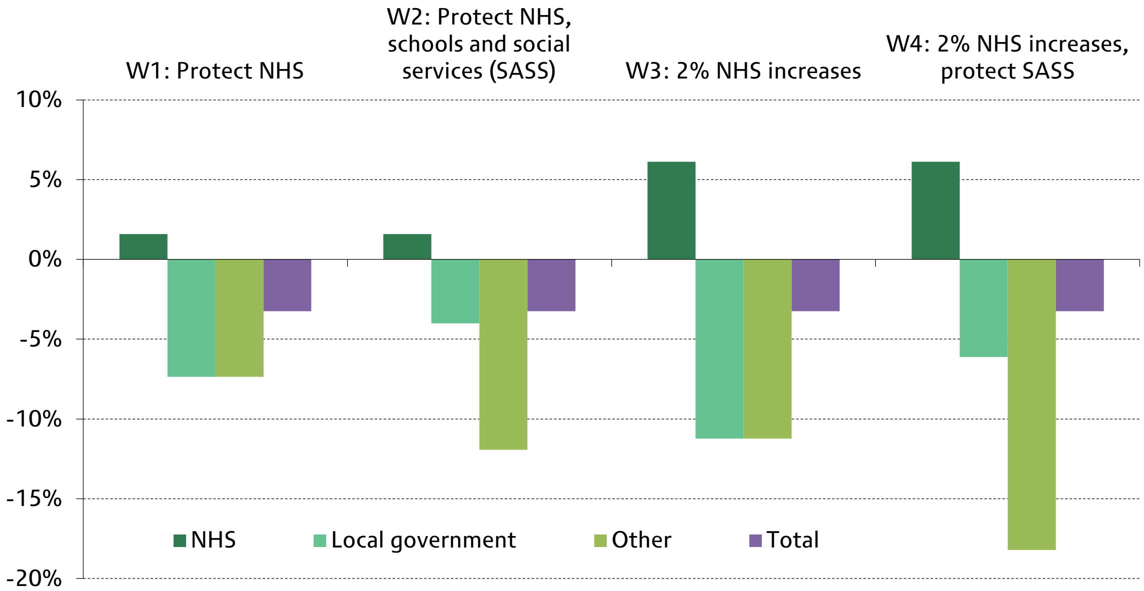
- Plans for UK government public service spending for each year to 2019–20, including the amount of block grant to be provided to the Welsh Government, were set out in the UK government's 2015 Spending Review and updated in the March 2016 Budget. However, the value of the Welsh block grant is likely to differ from the plans set out so far for a number of reasons. These include:
    - The potential allocation of an extra £3.5 billion of spending cuts planned but are yet to be allocated to specific areas (such as the Welsh block grant);

  - Alternatively, the potential for some of the cuts already allocated to be cancelled or delayed, as part of a possible post-EU-vote fiscal stimulus, and;
  - The impact of the higher inflation that may follow that vote, which will reduce the real–terms value of any cash–terms Welsh block grant.

  We therefore analyse a number of scenarios for the Welsh block grant when analysing the trade–offs facing the Welsh Government as it sets its budget.

- We also consider what impact increasing or decreasing all rates of income tax by one percentage point could have on the Welsh Government's budget if income tax were to be partly devolved in 2019–20. Revenues from landfill tax and stamp duty land tax are too small for realistic reforms to these to deliver significant changes in the Welsh Government's spending power (although reforms to these taxes may merit in themselves).
- Together, our scenarios for the block grant and income tax revenues generate our set of scenarios for the Welsh Government's overall budget. Our 'unchanged policy' budget scenario is based on current policy and forecasts. It assumes that any fiscal stimulus leaves allocations for departmental resource spending – including the Welsh block grant – unchanged, and that the UK government implements the remaining £3.5 billion of budget cuts pencilled in for 2019–20. It also assumes the Welsh Government leaves income tax rates unchanged. Under such a scenario, the Welsh Government's resource budget would be 3.2% less in real-terms in 2019–20 than in 2016–17. Cuts would be relatively small in 2017–18 (0.3%) and build up in 2018–19 (1.4%) and 2019–20 (1.6%)
- Figure 2 shows the amount available for the core NHS and local government budgets, and for all other areas of resource spending, under a range of indicative scenarios for how the Welsh Government may allocate its budget (given the baseline 3.2% budget cut).

## Figure 2: Cuts to Welsh Government spending by service area (2016–17 to 2019–20) in 'unchanged policy' revenue scenario, by Welsh Government spending scenario




Source: See sources to Figure 3.2 in main body of text.

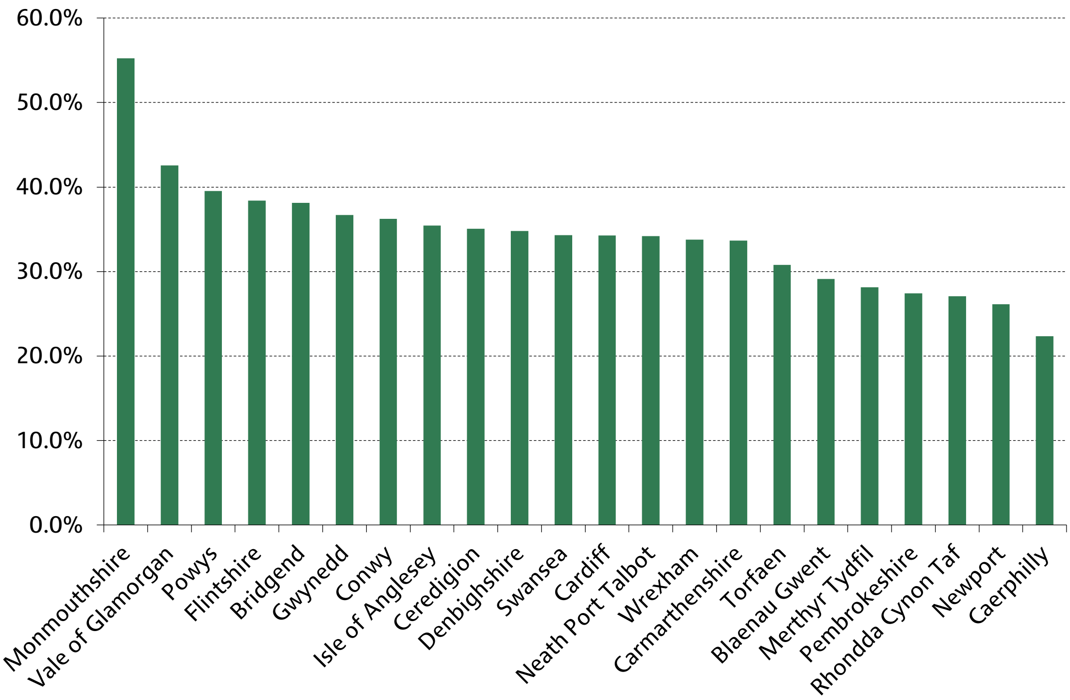
- If the Welsh Government were to protect only the core NHS budget in line with the English NHS budget (W1), other service areas, including local government, would see real-terms cuts averaging 7.4% over the next 3 years. Extending the protection to general grant funding for councils' education and social services responsibilities (W2) would reduce the cuts to Welsh Government's overall settlement funding to councils to 4% but would require average cuts of 11.9% to other service areas (such as higher education, environment and rural affairs, and national housing and transport programmes).
- Allocating 2% real-terms increases to the NHS each year – more than the NHS has received in recent years, but substantially below the increases it saw during the 2000s – could see average cuts to 'unprotected' areas of 18% over the next 3 years, if Welsh Government funding for councils' education and social services is also protected (W4).
- The same sorts of trade-offs will exist but will involve larger or smaller cuts to 'unprotected' spending if the budget of the Welsh Government faces larger or smaller cuts than in our baseline budget scenario (which may happen as a result of UK spending decisions, changes to inflation, or Welsh Government decisions on taxes).
- Even if the UK government were to delay all departmental budget cuts currently planned for the next 3 years, the Welsh Government would still face difficult trade-offs in allocating its budget. For instance, increasing the core NHS budget by 2% in real terms a year, and protecting support to councils for education and social services, would still require cuts of 8.4% to unprotected services.
- If income tax were to be partially devolved, increasing the basic and higher rates by 1p in the pound could offset almost half the overall cuts to the Welsh Government's budget in our baseline scenario, but difficult trade-offs between services would remain. However, in the run up to the 2016 Assembly elections there was more talk of tax cuts than tax rises. The same 1p in the pound cut in income tax rates would increase overall Welsh Government budget cuts to 4.7%, and make trade-offs between services even starker.
- If inflation were to be modestly higher than expected over the next three years such that price levels are 1% higher than currently planned for in 2019–20 then the budget cuts the Welsh Government would face under existing spending plans would increase from 3.2% to 4.1%. If the Welsh Government were to protect only the core NHS budget (W1), other service areas, including local government, would see real-terms cuts averaging 9.0% over the next 3 years (rather than 7.4% given March 2016 inflation forecasts).
- The scenarios therefore show that delivering protection, and particularly spending increases to key services like the NHS, would likely require significant real–terms cuts to other departments, even if the pace of overall budget cuts is eased as part of 'fiscal stimulus measures' or the Welsh Government were to increase tax rates.

## Local government budgetary trade–offs

- The combination of grants, redistributed business rates, their own council tax revenues, and the drawdown of reserves leaves Welsh councils with a total planned revenue budget (excluding housing benefit) of £6.2 billion in 2016–17. Councils have no direct control over the amount they receive in grant funding but they can increase or decrease the rates of council tax they charge.

- In our baseline scenario for council funding, the Welsh Government increases core NHS spending in line with spending on the NHS in England, and allocates cuts equally across the remainder of its budget (W1, above). This would mean a 7.4% cut in general and specific grants to councils by 2019–20. If council tax revenues grew in line with OBR forecasts – which are based on bills going up by 4% a year –, and councils stopped drawing down reserves – a source of funding that is unsustainable in the long term –, the cut to their overall spending power would be 5.9% by 2019–20.
- If the Welsh Government also offered protection for the part of its general grants to councils that relate to funding for education and social services, the reduction in councils overall spending power would be 4.3% over the same time period. However, if the core NHS budget were increased by 2% in real terms a year, even protection for these grants could see councils' spending power cut by 6.6% in real terms by 2019–20.
- If Welsh councils were to increase their council tax rates more quickly, this could offset some of the projected cuts in spending power. For instance, if council tax were increased by a further 3.3 percentage points per year (taking overall increases to more than 7% a year), this would raise around £122 million in 2019–20, enough to offset a third of the cuts in spending power forecast in our baseline funding scenario.
- However, as a result of differences in their council tax bases and rates, the percentage of funding cuts that would be offset by these council tax increases varies from 55% in Monmouthshire to 22% in Caerphilly (with most councils sitting somewhere between 27% and 40%).

Figure 3: Percentage of funding cuts (2016–17 to 2019–20) under baseline council revenue scenario that would be offset by an extra 3.3 percentage point increase in council tax a year (meaning council tax bills rising 7.3% a year in total), by council




Source: See sources to Figure 4.3 in main text.

- As with the Welsh Government, councils face difficult trade-offs when allocating their budgets. For instance, if councils protected their education spending (42% of their budgeted spending in 2016–17) from any real-terms budget cuts, delivering a 5.9% cut in overall spending would require a 11% cut to other services, on average. Extending protection to social services (27% of their budgeted spending in 2016–17) would necessitate cuts to unprotected areas averaging 23%. Such cuts would come on top of the real-terms cuts of between 20% and 50% that areas like housing, culture and leisure, and planning and development, have already faced since 2009–10.
- If cuts to Welsh Government grants are smaller, or Welsh councils put up council tax by more than in our baseline scenario, trade-offs would be less stark, but would still require difficult decisions. For instance, with cuts to councils budgets of 3.9% (which would be the case if councils put up council tax by 7% as opposed to 4% a year), protecting education and social services would require cuts of 15% to other service areas.
- If, on the other hand, grants to councils fall by more, or councils put up council tax by less than the 4% a year forecast by the OBR, then trade-offs may be even more difficult to manage. Indeed, there are scenarios where cuts of up to 35% may be required to some spending areas if education and social services were to be protected.

## EU funding and the Welsh Government budget

The report also considers the costs the Welsh Government may face if the EU funding Wales currently receives is not fully replaced:

- The UK government has stated that funding for payments to farmers will be guaranteed until 2020 but funding for areas like rural development and regional development projects have not been guaranteed except for projects signed off by the time of the upcoming Autumn Statement. Later projects will instead be funded on a case-by-case basis. If only half were funded, rather than having 3.2% less to spend than now, the Welsh Government would have 4.3% less to spend than now, by 2019–20.
- It is even less clear what funding will be available for schemes currently funded by the EU after 2020. If no additional funding was provided, the Welsh Government would have to find over £500 million a year from its existing budget if it wanted to continue to fund these schemes. This could more than double average budget cuts to 6.9% in 2020–21 (assuming the remainder of the Welsh Government's funding was unchanged).

# 1. Introduction

The UK government is part–way through significant cuts in spending on public services as it attempts to deal with a large hole in the UK's public finances. As part of this, grants from the UK Treasury to the Welsh Government have been reduced in real terms each year since 2009–10, and the spending plans set out by the Treasury have confirmed further cuts in each year to 2019–20. Indeed, if, as seems likely, the UK's exit from the European Union (EU) leads to weaker economic growth, further spending cuts or tax rises would be required at some point if the UK government wanted to deliver an overall budget surplus at some point. Wales is therefore looking at an extraordinary ten or more years of retrenchment in public service spending, in stark contrast to the first ten years of devolution, when the Welsh Government enjoyed substantial year–on–year real–terms spending increases.

This report is the first in a series of two reports, undertaken as part of the independent Wales Public Services 2025 Programme based at Cardiff Business School, looking at the challenges facing Welsh Government and Welsh councils when setting their budgets in the context of continued spending constraint and rising demand. This paper focuses on the medium term outlook to 2019–20, looking at the trade–offs facing the various tiers of government in Wales at they set their tax and spending policies. It also précis the UK economic and fiscal situation – information on which is likely to evolve rapidly in the coming months as the fallout from Brexit continues. A second study, in 2017, will update this report in the light of the updated economic forecasts and fiscal plans announced in the upcoming Autumn Statement, and will extend it to consider years beyond 2020.

The rest of this report proceeds as follows. Chapter 2 describes the economic and fiscal context in which the Welsh Government's budget will be set. The most recent official statement of the UK government's fiscal plans – which are the major determinant of the overall size of the Welsh Government's budget – and Office for Budget Responsibility (OBR) forecast for the economy were made at the time of the March 2016 Budget. The fiscal and economic outlook has changed significantly since then, largely as a result of the vote to leave EU. While we await confirmation on how the UK government proposes to adjust tax and spending plans in light of this, and the OBR's view of the economy and underlying fiscal position, we can summarise recent economic data, and the forecasts made by other organisations, such as the Bank of England. We also discuss what can be learned from UK government ministers' informal statements on possible changes to plans for the public finances.

Chapter 3 is the heart of the paper, and examines the trade–offs facing the Welsh Government as it sets its budget. Section 3.1 considers how the decisions the UK government makes may affect the overall size of the Welsh budget. Section 3.2 then examines how Welsh Government decisions on a tax that could soon be partially devolved – income tax – could affect its budget (stamp duty land tax and landfill tax are too small a source of revenue for any realistic changes in policy to have substantial impacts on the overall Welsh Government's budget). Section 3.3 then shows how decisions the Welsh Government takes on major spending areas like health and local government affect the amounts available for other service areas. We consider these trade–offs under a small number of different scenarios for the overall size of the Welsh budget (as set out in Section 3.1 and 3.2).

Section 4 looks in more detail at local government budgets in Wales. In particular we consider how decisions to prioritise particular services – such as schools and social services – may affect the resources available for other service areas for which councils have responsibility. We also consider the extent to which increases in council tax can mitigate cuts in funding from the Welsh Government – and how this varies across Wales.

Section 5 concludes.

The report also includes 3 appendices. Appendix A sets out the methodology we use to model how UK government decisions and Welsh Government decisions on income tax affect the overall size of the Welsh Government budget. It also discusses how we model the trade–offs facing the Welsh Government as it sets its budget. Appendix B briefly examines how the choice by the UK government whether to replace funding Wales currently receives from the EU after Brexit could affect the Welsh Government's budget. Appendix C explains how we model Welsh local government budgets.

# 2. The UK economic and fiscal context

The UK government is currently partway through a planned decade–long fiscal consolidation, composed of tax increases and significant spending cuts, aimed at turning a budget deficit, which at its peak in 2009–10 amounted to of 10.1% of national income, into a surplus by 2019–20. This chapter of the report first describes these plans as of the March 2016 Budget, and in doing so explains why some combination of tax rises and spending cuts has been necessary to return the public finances to a sustainable footing. However, the vote to leave the EU in the recent referendum means that although these plans and forecasts are less than 6 months old, the economic and fiscal outlook is likely to have changed significantly since they were made. The second part of this chapter discusses the potential economic and fiscal implications of Brexit. The third part summarises, arguing that Brexit means there is significant uncertainty about the public finances and hence the Welsh Government's budget in the medium term, let alone the longer–term.

## 2.1 The economic and fiscal outlook as of March 2016

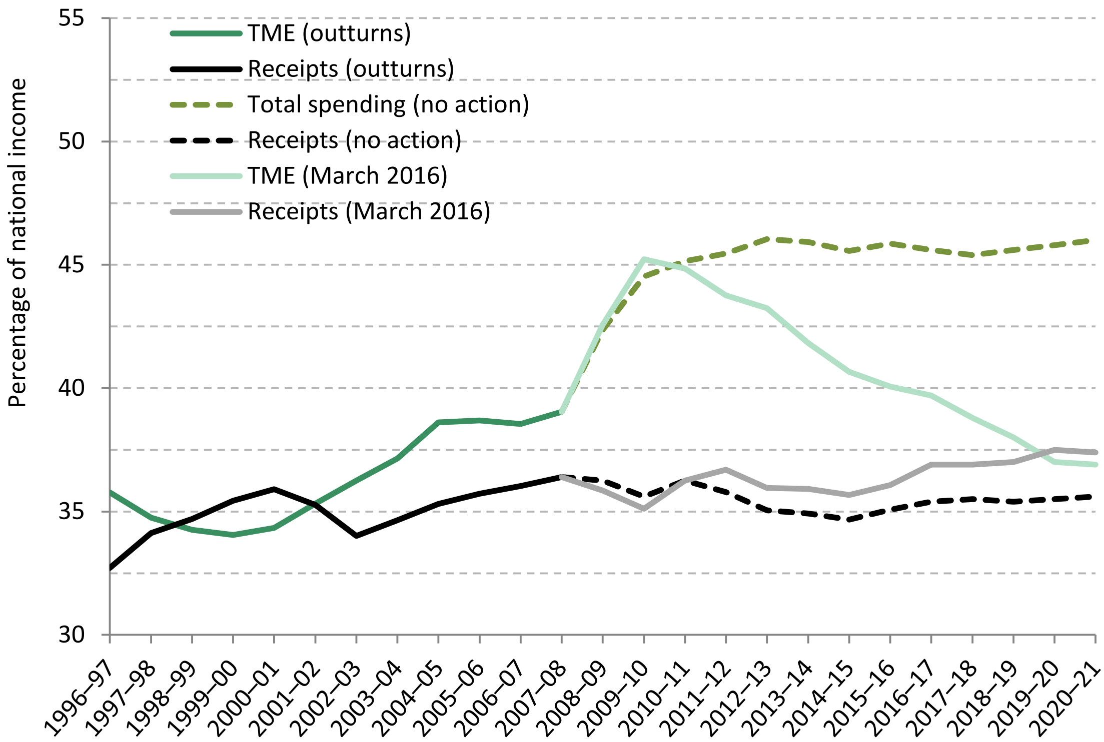
The continuing spending cuts and tax rises we are seeing as part of the UK government's efforts to reduce and then eliminate the budget deficit ultimately arise from a significant reduction in the forecast productive potential of the economy (as well as a particular decline in tax–rich activities such as financial services) following the late 2000s financial crisis and associated 'Great Recession'. With a smaller economy, a given tax system will bring in lower revenues, and therefore the amount of public spending that can be supported will be lower. The fiscal consolidation plan is essentially a ten–year transition period over which time public spending will be reduced and the tax system changed such that sufficient revenues will be brought in to fully finance the amount of public spending being undertaken, given the smaller economy.

The effect of the recession and the downgrade to the productive potential of the economy on the public finances is shown in Figure 2.1, which illustrates what would have happened to tax revenues and public spending as shares of national income in the absence of any new policy action since the March 2008 Budget.

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

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

## Figure 2.1 Forecasts for spending and receipts with and without policy action



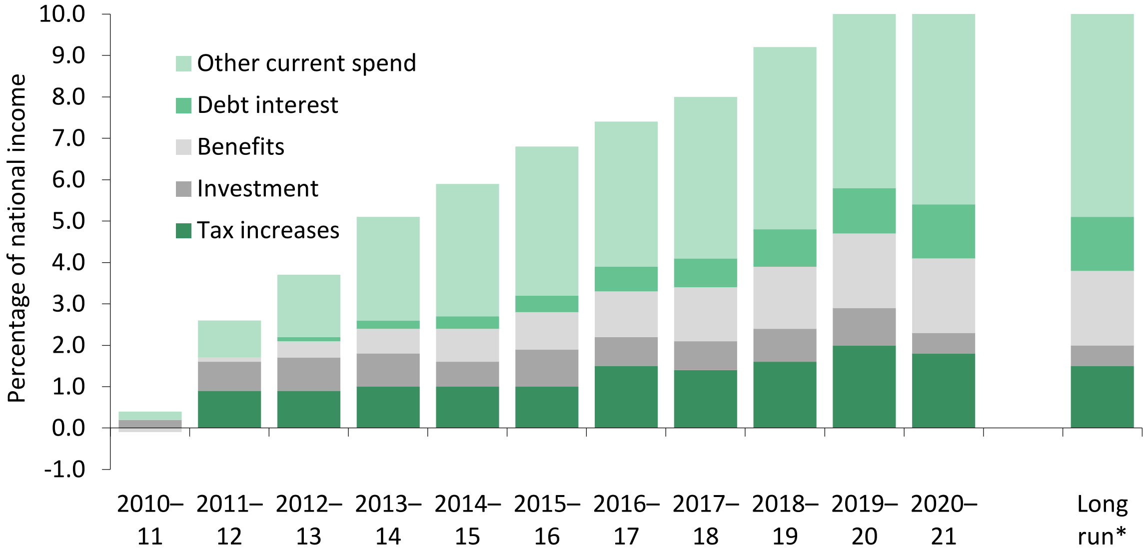

Sources: IFS calculations using all HM Treasury Budget and Pre–Budget Reports between November 2008 and March 2010 (available at http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm–treasury.gov.uk/budget_archive.htm) and all OBR Economic and Fiscal Outlooks between June 2010 and March 2016 (available at: http://budgetresponsibility.org.uk/efo/economic–fiscal–outlook–march–2016/).
Note: 'No action' ignores the direct impact of all fiscal policy measures that have been implemented since Budget 2008. Spending in 2012–13 exclude Royal Mail transfer.

In the absence of any policy action since March 2008 the government would have been borrowing more than 10% of national income (or £190 billion in today's terms) each year by 2012–13, and in each year thereafter. This would not have been sustainable and would have left the UK with an ever increasing national debt.

Since such a fiscal position was clearly unsustainable, the previous Labour government, Coalition government and present Conservative government have all announced a number of tax increases and spending cuts designed to bring borrowing back to sustainable levels. The forecast profiles for tax revenues and spending under current policy are also shown in Figure 2.1. Revenues will increase slightly as a share of national income, but the majority of the consolidation is on the spending side. Some justification for that could be drawn from the fact that most of the 'problem', when looked at as shares of national income, was also on the spending side. Overall, as of March 2016 the plans involved reducing public spending to a slightly smaller share of national income than in the years immediately before the recession, and tax revenues to a slightly higher share of national income. This would deliver a small budget surplus (around 0.5% of national income) by 2019–20 (in contrast, immediately prior to the recession there was a modest budget *deficit* of around 2% of national income a year).

Figure 2.2 shows the composition and timing of the planned fiscal consolidation in more detail. It shows that as of 2016–17, tax rises have increased revenues as a share of national income by 1.5 percentage points, contributing around one-fifth of the overall fiscal consolidation. However, taken together, tax measures planned for future years do not generate net increases in revenue as a proportion of GDP. The contribution of tax increases to fiscal consolidation is therefore set to fall to around one-seventh in the long–run. Cuts to investment spending were also front–loaded (indeed, investment spending is set to increase from today's levels as a proportion of national income in the long–run).

Figure 2.2 The fiscal consolidation over 11 years




Source: IFS calculations using all HM Treasury Budget and Pre–Budget Reports between November 2008 and March 2010 (available at http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm–treasury.gov.uk/budget_archive.htm) and all OBR Economic and Fiscal Outlooks between June 2010 and March 2016 (available at: http://budgetresponsibility.org.uk/efo/economic–fiscal–outlook–march–2016/).
Notes: See http://www.ifs.org.uk/tools_and_resources/fiscal_facts/fiscal–response–crisis for methodological information.

In contrast, cuts to 'other current spend' which includes day-to-day spending on public services such as health and education, and funding for the Welsh Government, have been more back–loaded. Discretionary cuts will have reduced this area of spending by the equivalent of 3.5 percentage points of national income (£68 billion in today's terms) as of 2016–17. This is set to rise to 5.5 percentage points of national income (£107 billion in today's terms) in the long–run. Cuts to benefits and savings in debt interest payments (as a result of the spending cuts and tax rises are also planned to contribute a growing portion of the overall fiscal consolidation over the next few years.

Full spending plans by department have been set out for the years up until 2019–20. Table 2.1 shows the planned real–terms changes to current (or 'resource') and capital Departmental Expenditure Limits (DELs) between 2010–11 and both 2015–16 and 2019–20, both overall and for a number of major Whitehall spending departments based upon the spending outturns for 2010–11 and 2015–16 and budgeted plans for 2019–20.

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

| Department | Total change 2010–11 to 2015–16 | Total change 2010–11 to 2019–20 |
|---|---|---|
| **Resource**[a] | | |
| Wales | –5.8% | –7.6% |
| NHS (Health) | +9.9% | +11.9% |
| Education | –1.7% | –1.0% |
| CLG Local Government (accounting for Business rate retention and localisation of council tax)[b] | –31.3% | –53.3% |
| Defence | –9.0% | –7.9% |
| Transport | –64.8% | –71.1% |
| Home Office | –21.4% | –25.2% |
| *Total (accounting for BRRS)*[c] | –8.2% | –11.6% |
| **Capital** | | |
| Wales | –18.3% | –18.1% |
| NHS (Health) | –15.5% | –0.4% |
| Education | –37.6% | –55.3% |
| Defence | –22.3% | –22.7% |
| Transport | –25.8% | +22.8% |
| Home Office | –55.1% | –57.8% |
| *Total* | –23.3% | –18.6% |

Sources: Calculated from tables in Chapter 1, Departmental Spending, PESA 2015 and 2016 (HM Treasury) available at: https://www.gov.uk/government/collections/public–expenditure–statistical–analyses–pesa.
Notes: [a] Excluding depreciation; [b] For an explanation of the business rate retention scheme (BRRS) and the localisation of council tax benefit and how these have been accounted for, see footnote 2 below; [c] Total change also accounts for the BRRS and localisation of council tax benefit. Figures are real changes as a percentage of the figure for the year 2010–11. Total DELs include items not shown in this table.

DELs set out the amount each department can spend on the parts of their functions subject to multi–year budgeting and account most of departments' spending on public service provision and administration. DELs for current expenditure (excluding depreciation) in 2015–16 were 8.2% below the amount spent in 2010–11 after accounting for inflation, and adjusting for a number of shifts in resources around the budget such as the devolution of business rates to Wales and part–localisation of this tax in England, and the localisation of council tax benefit. DELs for capital expenditure in 2015–16 were 23.3% below the amount spent in 2010–11 after accounting for inflation.

The UK government has not cut all departments equally, however. Indeed, in each Spending Review, small increases in current funding for the NHS have been announced. NHS current spending in 2015–16 was 9.9% higher than in 2010–11, and the most recent plans are for spending to be 11.9% above 2010–11 levels by 2019–20. The cut to the Department for Education's current DEL is also set to be substantially less than the average. This means that other 'unprotected' departments have seen (and are planned to continue seeing) cuts to their DELs that are in some cases substantially larger than the average cut. For instance, the Home Office, which provides most of the funding for the police, is set to see a fall in its current DEL of 25% and its capital DEL of 57% by 2019–10, and the local government element of the Department for Communities and Local Government (CLG) is also set to see a large 53% cut in like–for–like current spending.[2] This, together with the freeze in council tax rates in most areas between 2011–12 and 2015–16, explains the large cuts English local authorities are making and are expected to continue to see.[3] Some departments have also seen big differences in how they have fared on the current and capital sides of the budget: current spending by the Department for Transport is set to be reduced by over 70% between 2010–11 and 2019–20, while initial cuts to its capital budget are planned to turn into a 22% increase by 2019–20.

This mix of large cuts for some areas of spending, and more modest cuts or even increases in others all feeds into the Barnett Formula, which determines the bulk of the Welsh Government's budget. On a like–for–like basis, the Welsh Government's DEL fell by 8.2% between 2010–11 and 2015–16. Under current plans it is set to be 11.6% lower in 2019–20 than in 2010–11. The Welsh Government's capital budget was cut substantially more between 2010–11 and 2015–16, but increases over the next few year years are planned partially to undo these cuts.

## 2.2 Developments since March 2016

New information about the underlying state of the economy and public finances is constantly emerging, and policymakers typically adjust their tax and spending plans at least a little on a frequent basis. The figures set out in the previous sub–section were therefore always likely to change somewhat in the months and years ahead.

However, the vote to leave the EU in the recent referendum means that the underlying position of the economy and public finances over the next few years has likely changed much more substantially than would normally be the case 6 months down the line. In particular, the changed fiscal environment means that the UK government has abandoned its plans for a budget surplus by 2019–20, although it still hopes to achieve a surplus at some point in the future.[4] As discussed below, such a surplus would now be unlikely without significant further

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[2] The CLG: Local Government DEL has been adjusted for two policy changes: the 50% retention of business rates by local authorities as a whole (previously this was retained centrally and distributed as part of the revenue support grants which form part of the CLG: Local Government DEL); and the localisation of support for council tax, funded by an addition to the revenue support grant (previously council tax benefit, part of the Department for Work and Pensions' AME). In particular, we have added forecast retained business rates to post–reform (2013–14 and later) years, and added council tax benefit expenditure to pre–reform years (2012–13 and earlier).

[3] See Innes and Tetlow (2015) and Innes and Phillips (2015).

[4] George Osborne, the former Chancellor of the Exchequer, announced the target was abandoned on July 1st (see for instance: http://www.bbc.co.uk/news/business–36684452). Theresa May, the new Prime Minister, confirmed this in her first Prime Minister's Questions: "We have not abandoned the intention to move to a surplus. What I have said is that we will not target

spending cuts or tax rises being implemented in the current parliament on top of those already planned. It is still an open question whether the abandonment the commitment to deliver a budget surplus in 2019–20 would be accompanied by a more general loosening of the UK government's purse–strings (such as tax cuts or spending increases).

## Estimates and forecasts of the EU vote on the economy and public finances

The overall impact of leaving the EU on the UK's public finances will depend on two distinct components, each of which is uncertain to some degree:

- **The mechanical effect.** Given that the UK is a net contributor the EU's budget, the ending of at least some of the fiscal transfers between the UK and EU (and vice versa) that is likely to accompany exit from the EU would, on its own, strengthen the UK's public finances.
- **The national income effect.** Any effect of leaving the EU on UK national income would affect the public finances. A rise in national income would strengthen the public finances, while a fall would weaken them.

Looking first at the "mechanical effect", the UK's gross contribution to the EU's budget (after accounting for the 'rebate' we receive) stood at £14.4 billion (or 0.8% of national income) in 2014. However, the EU returns a significant fraction of that each year. The amount varies, but on average, the UK's net contribution stands at around £8 billion a year (Browne, Johnson and Phillips (2016)). If, once we leave the EU, we no longer make this net contribution, *and if national income is unaffected*, then we could continue to fund those areas of spending undertaken by the EU in the UK (such as support for agriculture, regional development and research), and use this money to fund other spending, cut taxes, or reduce the deficit (Emmerson, Johnson, Mitchell and Phillips (2016), henceforth Emmerson *et al* (2016)).

However, the public finances are sensitive even to relatively small changes in national income. If, for instance, leaving the EU reduces national income by just 0.6%, that would be enough to outweigh the positive effect on the public finances of freeing up the net £8 billion that we currently contribute to the EU.

Emmerson *et al* (2016) undertook a comprehensive review of estimates of the impact of leaving the EU on the UK's economy. They found that the clear consensus among economists is that the decision to leave the EU will reduce UK national income by more than 0.6% relative to what it would otherwise have been, in both the short– and longer–term, although the precise impact is far from certain.[5] This reflects a number of factors such as increased trade costs between the UK and the rest–of–the–EU, a resulting reduction in foreign investment, potential restrictions on immigration, and in the short–term, at least, uncertainty about what the UK's future relationship with the EU will look like. The impact will depend upon the precise nature of the agreement reached with the EU – such as whether financial services firms retain 'passporting rights' allowing direct provision of services to other EU

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that at the end of this Parliament." (https://hansard.parliament.uk/commons/2016-07-20/debates/16072025000019/Engagements).

[5] Of the 14 short–term quantitative estimates found by Emmerson et al (2016) in their literature review, 12 suggested the effects would be negative, one (broadly) neutral, and one (Economists for Brexit), positive.

member states – and the speed with which an agreement is reached (Emmerson, Johnson and Mitchell (2016)).

Among the reviewed estimates, those by the National Institute of Economic and Social Research (NIESR, Baker et al (2016)), were both based on a particularly comprehensive economic modelling exercise, and close to the middle of the range of estimates. NIESR's most optimistic scenario – one where the UK signed up to the European Economic Area and thereby had close–to–full membership of the European single market but continued to observe free movement rules and contribute to the EU budget – sees national income 2.1% lower than it otherwise would be by 2019. The most pessimistic scenario, which assumed no special free trade deal with the EU, is estimated to reduce national income by 3.5% relative to where it would have otherwise been in 2019.[6] Importantly, this negative impact is not expected to dissipate in subsequent years.[7]

Emmerson et al (2016) estimate that if NIESR is broadly right about the economy, then the budget deficit in 2019–20 will be between about £20 billion and £40 billion higher than it otherwise would be. Under such circumstances, the government would fail to reach a budget surplus in 2019–20 unless it were willing to raise taxes or cut spending by more than it already planned.

HM Treasury (2016b) suggest one way in which additional real-terms cuts could come about was through keeping cash spending plans unchanged in the face of higher inflation. In their modelling a (at that time forecast) fall in the value of the pound would push up inflation meaning that existing plans for departmental budgets, if held fixed in cash-terms, would be relatively less generous in real-terms. These additional real-terms cuts would offset some of the rise in borrowing resulting from the more general economic slowdown predicted by most economic analyses. Even so, HM Treasury (2016b) forecast that without additional cuts to cash–terms spending cuts or tax rises, the budget surplus target would be missed.

This means the government is faced with a choice: double down on spending cuts and tax rises to meet the target of a budget surplus in 2019 –20; or abandon the target. It looks highly likely that it is the latter approach that will be taken. Indeed, on July 1st, the former Chancellor of the Exchequer, George Osborne, announced that the UK government was abandoning its targeted surplus in 2019–20. The new Prime Minister, Theresa May confirmed this in her inaugural Prime Minister's questions.[8] However, while the target is being abandoned, the UK government still aims, eventually, to reach a budget surplus. If this is the case, then a further fiscal tightening of between £20 billion and £40 billion may be required sometime after 2019–20. That is equivalent to an extra year or two of spending cuts or tax rises as a proportion of national income at the pace that has been undertaken since 2010.

[6] HM Treasury (2016b) estimates a more substantial 6% hit to national income over the same time–horizon in its similar 'severe shock' scenario.

[7] Indeed, estimates that try to take into account estimates of the links between trade and productivity of the domestic economy (so called 'dynamic effects') find larger effects on national income in the long than in the short run.

[8] Theresa May in her first Prime Minister's Questions stated in response to a question by Jeremy Corbyn: "We have not abandoned the intention to move to a surplus. What I have said is that we will not target that at the end of this Parliament." (https://hansard.parliament.uk/commons/2016–07–20/debates/16072025000019/Engagements).

If it is clear that the plan for a surplus by 2019–20 is abandoned, it is anything but clear whether this is simply a recognition that existing tax and spending plans are no longer likely to deliver such a surplus, or foreshadows a more active 'fiscal stimulus', in an effort to boost the economy. Such measures could include, on the tax side, a temporary reduction in the main rate of VAT[9] and/or temporary increases in up-front capital allowances for business investment. On the public spending side, options would include cancelling some of the cuts planned to public service or benefit spending, and/or additional investment spending, which may have the added benefit of boosting the supply-side of the economy (although high quality "shovel ready" projects may be difficult to find).

Chancellor Hammond has stated that the Treasury will review the economic data over the coming months and "reset fiscal policy if we deem in necessary".[10] This reflects the fact that even though there is a broad consensus that the economic and fiscal effects of the vote to leave the EU will be negative there are wide margins of error around the central estimates of the impact. By the time of the Autumn Statement – expected sometime between late October and early December –, there will be a little more information about the short–term effects of the vote on economy, which may guide decisions about whether changes to existing tax and spending plans would be appropriate.

## Post–referendum economic forecasts and data

It should be noted that the discussion so far has focused on pre–referendum estimates of leaving the EU, and government statements on fiscal policy that are largely based on such estimates. There is, as yet, little in the way of concrete post–referendum economic data (the first estimates of July–September national income will not be available until late October, for instance). However, there are updated post–referendum forecasts for the economy, and some initial data from specific sectors of the economy, from surveys of businesses, and from the financial markets. In general, while the updated forecasts suggest a continued consensus among economics of a negative impact of Brexit on the UK economy, early economic data paints a more mixed picture.

The average forecast for growth in 2017 by independent forecasters monitored by HM Treasury has been reduced from 2.1% in June to 0.7% in August, for instance.[11] At the same time, borrowing forecasts for 2017–18 have been revised up from £45.5 billion to £63 billion, and CPI inflation in quarter 4 2017 from 1.9% to 2.5%. In its August Inflation Report, the Bank of England (2016) also revised down its forecasts by a similar magnitude: it now expects the economy to be 2.5% smaller in summer 2019 than it thought would be the case in its May report (where the central forecast was based on the UK voting to remain in the EU). CPI inflation has been revised up by 0.4 percentage points in Q3 2017 and 0.3 percentage points in Q3 2018.

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[9] A temporary VAT cut is likely to be more effective in boosting consumer expenditure than a temporary income tax cut of the same size. This is because a household has an incentive to bring their spending forward to take advantage of temporarily low prices. See Crossley, Low and Wakefield (2009).

[10] See, for instance: http://www.bbc.co.uk/news/business–36864099.

[11] See: https://www.gov.uk/government/collections/data–forecasts#2016.

As already mentioned, evidence from real economic data and surveys has been more mixed. The purchasing managers' index surveys – which question companies in the manufacturing, construction on services sector on current business and future business expectation –saw sharp falls in July to levels associated with a 0.4% fall in national income if sustained for one quarter.[12] However, in August they bounced back to levels which, if sustained, would suggest growth of 0.1% during the July-September quarter as a whole.[13] Furthermore, retail spending increased significantly in July (ONS (2016a)), and unemployment benefit claims fell (ONS (2016b)). Perhaps the most striking development is the substantial fall in the value of the pound: from around \$1.50 and €1.30 immediately prior to the referendum (when the consensus was the UK would vote to remain) to just over \$1.33 and €1.18 in mid-September 2016.

It is also important to note that even once some more data become available this Autumn – and the Chancellor announces his immediate fiscal policy responses –, the medium and longer term outlook for the economy public finances will still be unclear. There will still be a lot of uncertainty about the economic and fiscal effects of leaving the EU, not least because we will still not know what our future relationship with the EU will look like. Economic and fiscal forecasts, and the associated tax and spending plans, are likely therefore be subject to major revisions in the next few years.

## 2.3 Summary

The forthcoming Welsh Government Budget takes place in a challenging fiscal and economic environment. It follows 7 years where cuts have been made as part of a large UK–wide fiscal retrenchment, which has been necessitated by an unsustainable budget deficit that would not have closed without such tax rises or spending cuts. Under the most recent plans, set out in the March 2016 Budget, around one-third of the total cuts in day-to-day government spending are still yet to come.

The Budget will also take place a time of considerable economic and fiscal uncertainty – not least because of the recent vote to leave the EU. The consensus is that leaving the EU will reduce the UK's national income, depressing tax revenues and raising certain areas of spending, such as benefit spending. This "national income" effect is expected to outweigh the direct effect of leaving the EU on the UK's fiscal position – the cessation or reduction in net contributions to the EU's budget – leaving the public finances in a weaker state than expected back in March 2016.

The UK government has indicated – perhaps wisely – that it will not double down on the pace of cuts in order to meet the existing commitment for a surplus by 2019–20. However, it has also indicated that it plans eventually to reach a budget surplus, which, if the economic effects of leaving the EU are in line with estimates, would eventually require additional spending cuts or tax rises on top of those already planned of between £20 billion and £40 billion. Delivering these would be akin to extending the current pace of fiscal retrenchment for an additional year or two, which would extend austerity further into the early 2020s. The larger

[12] See: https://www.ft.com/content/0ad2e3a1–8157–34da–b199–818801e52957.

[13] See: https://www.markiteconomics.com/Survey/PressRelease.mvc/3de4f3638ea3472bb7b986ebe0b9931d.

spending cuts or tax rises that would eventually be needed would, of course, likely impact the revenues available to the Welsh Government and/or the net incomes of Welsh households.

It is not clear whether abandoning the budget surplus target for 2019–20 is simply a recognition that existing tax and spending plans will no longer deliver the previously planned surplus, or a foreshadows a change in those tax and spending plans. Note that the higher inflation that the fall in the value of the pound is likely to generate would reduce the real–terms value of the announced cash–terms spending plans. Thus, without any change in cash budgets, real–terms spending cuts would be larger than anticipated when the cash–terms spending plans were set. Will the UK government allow this effect to operate in order to deliver some of the additional spending cuts or tax rises ultimately required? Or will they offset or more–than–offset these inflation–driven cuts by boosting cash–terms budgets, perhaps in an effort to support the economy over the next few years?

Before considering the decisions the Welsh Government makes over its budget, we therefore next consider how changes to UK government spending plans may affect the amount Wales receives through the Barnett formula over the next few years, focusing on scenarios where some or all of the planned cuts to Whitehall spending are cancelled. We also consider how inflation may affect the real–terms value of funding the Welsh Government may have at its disposal.

# 3. Welsh Government budgetary trade–offs: the picture to 2019–20

The Welsh Government, like the devolved governments of Northern Ireland and Scotland, receives the majority of its funding in the form of block grants from the UK Treasury, with some additional revenue provided by devolved taxes. At present the only devolved source of revenue for the Welsh Government is non domestic rates ('business rates'),[14] but landfill tax and stamp duty land tax (SDLT) are scheduled to be devolved in April 2018 and it is proposed for a portion of income tax to be devolved too. The Welsh Government then decides how to allocate its funding to different functions or departments.

In this chapter we first consider (Section 3.1) the potential scale of block grant funding the Welsh Government will receive between now and 2019–20: while plans were set out in the 2015 Spending Review, they have already been amended in the March 2016 Budget, and may be amended again in the light of Brexit. We then consider the Welsh Government's devolved revenue streams (Section 3.2). Finally in Section 3.3 we consider the trade–offs facing the Welsh Government as it sets its budget for different service areas under a number of scenarios for its overall budget (derived from the block grant and devolved revenues).

## 3.1 The Welsh block grant

As discussed in Section 2.1., plans for the various DELs for each year to 2019–20, including the amount of block grant to be provided to the Welsh Government, were set out in the UK government's 2015 Spending Review. In the March 2016 budget, additional funds were allocated to various UK government departments, generating additions to the Welsh block grant via application of the Barnett Formula.[15] The most recently published planned DELs and figures for the Welsh block grant in the *Public Expenditure Statistical Analysis 2016* (PESA 2016) publication (HM Treasury, 2016b) reflect these allocations.

The value of the Welsh block grant in the years ahead is likely to differ somewhat from these published plans, however, for several reasons. First, the March 2016 Budget announced further as yet unallocated cuts to UK government departmental spending of £3.5 billion in 2019–20. If these go ahead, it is likely that there would be at least some further cuts to the Welsh block grant (the precise scale of which would depend just on how the cuts were allocated across UK government departments). More fundamentally, as discussed in the Section 2.2, the decision to leave the EU may lead to changes in the value of the block grant. This could reflect increases in inflation as a result of the weaker pound (so a given cash block grant is worth less in real terms) or changes in cash–terms spending plans. We therefore examine several scenarios for both resource (Table 3.1) and capital (Table 3.2) funding via the block grant.

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[14] Powers over council tax are also devolved to the Welsh Government, but revenues accrue to Welsh local government (see Chapter 4).

[15] The Barnett formula allocates to the Welsh Government a population share of the cash–change in spending by UK Government departments in England for which responsibility is devolved to Wales. See Appendix A for details.

Our baseline scenario (R1) for resource spending is based on the overall plans for DELs announced in the 2015 Spending Review and March 2016 Budget. The Welsh block grant is taken from PESA 2016 and adjusted to account for the allocation of the remaining £3.5 billion of cuts in 2019–10 in proportion to existing DELs (excluding Health and the Department for International Development, which are deemed protected) and the workings of the Barnett formula.[16] We then examine the impact on the real–terms value of the Welsh block grant of the following scenarios:

R1+ As R1 but with inflation 0.5 percentage points higher in both 2017–18 and 2018–19, following the depreciation of the pound.

R2 As R1 but with the cancellation of the yet–to–be allocated cuts in 2019–20.

R2+ As R2 but with inflation 0.5 percentage points higher in both 2017–18 and 2018–19, following the depreciation of the pound.

R3 As R1 but with the cancellation of any planned cuts to any department's budget.

Our decision to model alternative scenarios (R2 and R3) with higher spending than our baseline scenario (R1) reflects recent statements from the UK government that suggest less focus on deficit reduction – and therefore spending cuts –, at least in the short–to–medium term (see Section 2.2). However, as already discussed, most estimates and forecasts suggest a weaker economy as a result of the decision to leave the EU, which would push up the budget deficit even if all planned cuts still went ahead. Thus if the new government wants to eliminate the budget deficit at some point in the future, even larger budget cuts or tax rises than planned now would eventually be needed (in the early 2020s, for instance).[17]

Table 3.1 shows the Welsh block grant for each year between 2016–17 and 2019–20 in these scenarios. In our baseline scenario (R1), the block grant in 2019–20 would be £12.6 billion in real–terms, 3.8% below its level this year (£13.1 billion).

If the planned but as yet unallocated cuts in 2019–20 are scrapped (scenario R2), the cut would be around a fifth smaller than in our baseline scenario at 3.1%, giving the Welsh Government an extra £90 million to spend in that year (£12.7 billion). In our 'optimistic' scenario R3, the Welsh resource block grant falls slightly (0.2%) between 2016–17 and 2019–20 even though spending on Whitehall departments is unchanged or increasing in real–terms. This is because 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.[18] This smaller cash–terms percentage increase translates into a real–terms cut.

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[16] Further explanation of our method of projecting the Welsh block grant and modelling choices over Welsh taxes and budgetary options can be found in Appendix A.

[17] Wales Public Services 2025 will return to this issue in a report in 2017.

[18] 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.

Table 3.1. Welsh block grant for resource expenditure (excluding depreciation), 2016–17 to 2019–20, £billion

| Scenario | 2016–17 | 2017–18 | 2018–19 | 2019–20 | Cumulative cut |
|---|---|---|---|---|---|
| R1 | 13.1 | 13.0 | 12.8 | 12.6 | –3.8% |
| *R1+* | 13.1 | 13.0 | 12.7 | 12.5 | –4.7% |
| R2 | 13.1 | 13.0 | 12.8 | 12.7 | –3.1% |
| *R2+* | 13.1 | 13.0 | 12.7 | 12.6 | –4.0% |
| R3 | 13.1 | 13.2 | 13.1 | 13.1 | –0.2% |

Source: See Appendix A for sources.

Table 3.2 shows that in our baseline scenario (R1), cuts to the block grant accelerate over the next three years: £60 million in 2017–18 (0.4%), around £200 million (1.5%) in 2018–19 and around £240 million (1.9%) in 2019–20. In scenario R2, the only difference is that the cancellation of additional cuts in 2019–20 reduces the scale of cuts that year to around £150 million (1.2%). In scenario R3, where all future UK departmental cuts are cancelled, Wales would see a small increase in its block grant in 2017–18 followed by small cuts in the following two years that just more than offset the initial increases.

Table 3.2. Real terms changes to the Welsh block grant for resource expenditure (excluding depreciation), 2016–17 to 2019–20, £million

| Scenario | 2017–18 | 2018–19 | 2019–20 | Cumulative change |
|---|---|---|---|---|
| R1 | –58 | –197 | –240 | –495 |
| *R1+* | *–122* | *–258* | *–238* | *–618* |
| R2 | –58 | –197 | –151 | –406 |
| *R2+* | *–122* | *–258* | *–149* | *–529* |
| R3 | 94 | –68 | –58 | –32 |

Source: As Table 3.1.

Because the UK government sets DELs in cash terms, an increase in inflation following the UK's vote to leave the EU, would, in the absence of any policy response, reduce the real–terms value of the Welsh block grant (and other departmental budgets). As shown in Table 3.1, an increase in inflation of the magnitude we have assumed in scenarios R1+ and R2+ would leave the Welsh Government facing a little less than 1 percentage points in additional real–terms cuts. Of course the precise scale of additional cuts due to higher inflation depends on just how high inflation rises.

The timing of any squeeze would depend on the time–path of inflation. In scenarios R1+ and R2+ we have assumed the additional inflation takes place equally in 2017–18 and 2018–19. This would increase the pace of cuts expected next year and the year after, meaning cuts to the real-terms value of the block grant would be less back-loaded than otherwise.

We also briefly consider a number of scenarios for capital DEL. As with our scenarios for resource DEL, the variant scenarios involve higher capital spending than our baseline scenario, at least in the short term.

C1 As set out in PESA 2016.

C2 As set out in PESA 2016, but with 10% of capital spending planned in 2019–20 brought forward to 2017–18 and 2018–19 (spread equally across the two years).

C3 As set out in PESA 2016, but capital spending 10% higher in 2017–18 and 2018–19 and 5% higher in 2019–20 than currently planned.

Table 3.3 shows the path of the Welsh capital block grant under these three scenarios. If the latest plans are maintained – as per our baseline scenario, C1 – the block grant for capital spending will decline through to 2018-–19 before increasing in 2019–20 to a little above its 2016-–17 level. In our accelerated capital spending scenario, C2, this pattern would be reversed, with spending rising up to 2018–19 before dropping in 2019–20 to 7% lower than its 2016–17 level (note that cumulative spend is the same as in scenario C1.) C3 puts capital spending at around 5–6% higher than its 2016–17 level in each year through to 2019–20, and cumulative spending over the period 5% higher than in the other two scenarios.

### Table 3.3. Welsh block grant for capital expenditure, 2016–17 to 2019–20 (£billion)

| Scenario | 2016–17 | 2017–18 | 2018–19 | 2019–20 | Cut by 2019–20 | Cumulative spend |
|---|---|---|---|---|---|---|
| C1 | 1.54 | 1.50 | 1.51 | 1.56 | 1.3% | 6.12 |
| C2 | 1.54 | 1.56 | 1.58 | 1.44 | –7.0% | 6.12 |
| C3 | 1.54 | 1.62 | 1.64 | 1.63 | 5.5% | 6.43 |

Source: See Appendix A for sources.

## 3.2 Devolved revenues

In addition to the block grant, the Welsh Government has its own sources of revenue. Presently, these consist of non–domestic rates (business rates) raised in Wales, which have been fully devolved since 2015–16.[19] Table 3.4 shows the March 2016 forecasts for revenues from non–domestic rates and the baseline resource block grant.

Furthermore, as a result of the Wales Act (2014), stamp duty land tax and landfill tax are to be devolved to the Welsh Government in April 2018. The Act also legislates for the possible devolution of 10 percentage points of each income tax band on non-savings non-dividend income to the Welsh Government, who would have the ability to vary each rate independently.[20] There is also agreement in principle for the devolution of the aggregates levy.[21] Forecast revenues for these taxes are also shown in Table 3.4.

[19] Prior to this the Welsh Government had the power to vary rates, but there was revenue pooling with England (so that the Welsh Government budget was not affected by changes in the underlying non–domestic rates tax base).

[20] The Wales Act 2014 requires that a referendum be held and won before devolution of income tax can take place. The Wales Bill 2016 going through the UK parliament will remove that requirement if it is passed.

[21] Devolution of the aggregates levy to Wales and Scotland has been delayed due to the need to obtain state aid approval from the EU. With the recent vote to leave the EU it is possible (although not certain) that such approval may not be necessary once the process of exiting the EU is complete.

The Table shows that revenues from the three largest of these taxes are forecast to be increasing in real–terms over the next few years, with income tax, business rates and SDLT growing at an average of 1.9%, 1.2% and 7.5% and 1.9% a year, in real terms, respectively. In contrast revenues from the landfill tax are forecast to decline, as a result of continuing increases in recycling and improvements in waste management. Revenues from the aggregates levy are expected to be broadly stable.

Table 3.4. Devolved taxes and their contribution to overall revenues in Wales (change in 2016–17 tax revenues to increase RDEL+NDR by 1%), £billion, real–terms

| **Scenario** | **2016–17** | **2017–18** | **2018–19** | **2019–20** | **Increase in revenues required to increase budget by 1%** |
|---|---|---|---|---|---|
| Baseline (R1) RDEL | 13.10 | 13.04 | 12.85 | 12.60 | N/A |
| Non–domestic rates | 0.98 | 0.99 | 1.00 | 1.01 | 13% |
| *Total* | 14.1 | 14.0 | 13.8 | 13.6 | N/A |
| *To be devolved* | | | | | |
| SDLT | 0.20 | 0.22 | 0.24 | 0.25 | 65% |
| Landfill tax | 0.04 | 0.04 | 0.04 | 0.04 | 298% |
| Aggregates Levy | 0.03 | 0.03 | 0.03 | 0.03 | 437% |
| Income tax (partial) | 1.94 | 1.97 | 2.00 | 2.05 | 7% |

Source: As Table 3.4, plus OBR Devolved Tax Forecast and communication with Welsh Government.

When (or in the case of income tax *if*) these taxes are devolved, an adjustment to the block grant will be made, initially equal to the amount of tax revenues being devolved (so that neither the UK government nor Welsh Government suffers financial 'detriment' simply as a result of tax devolution). In subsequent years these initial adjustments would have to be indexed – most likely with reference to the changes in equivalent revenues in England and Northern Ireland.[22] If devolved revenues grow faster or slower than this indexed block grant adjustment (BGA) the Welsh Government would gain or lose revenues. In what follows we assume that given current tax policy revenues grow at the same rate as the BGAs so that devolution on its own does not affect the Welsh Government's budget.[23] However, if the Welsh Government varies tax policy there would be direct effects on its budget.

Table 3.4 also shows that, given current revenue forecasts, revenues from landfill tax would need to rise by 298% to generate a 1% increase in the Welsh Government's overall resource

[22] The initial block grant adjustments (BGAs) made in Scotland to account for tax and welfare devolution are being indexed a method termed the "Indexed per capita" method, whereby the BGA is multiplied each year by a factor (1+X)*(1+Y), where X is the rate of growth of revenues per capita in the rest of the UK, and Y is the rate of growth of the Scottish population.

[23] The OBR's forecasts for devolved income tax revenues assume Welsh revenues will remain a constant percentage of UK revenues between 2016–17 and 2019–20. Stamp duty land tax revenues are forecast to grow by 9% as opposed to 7% for the UK as a whole in 2019–20. If these forecasts are accurate, and the "Indexed per capita" method used in Scotland were adopted, Wales would likely gain a little from tax devolution. In contrast, Poole, Ifan and Wyn Jones (2016) argue that the distribution of income in Wales means that an increase in the income tax personal allowance to £12,500 a year by 2020 (a Conservative party manifesto pledge in the 2015 UK general election) would reduce Welsh tax receipts by more than tax receipts in the rest of the UK, making it more likely that income tax devolution would reduce the Welsh budget.

budget; stamp duty land tax would need to increase by 65% to generate a 1% increase in the overall resource budget, and; Non–domestic rates revenues would need to increase by 13% to generate a 1% increase in the overall resource budget. Revenues from the devolved portion of income tax would need to increase by 7% to generate a 1% increase in the Welsh Government's overall resource budget – equivalent to a 0.7 percentage point increase in each income tax rate, assuming no behavioural response.

Given that very large changes in landfill tax and stamp duty are required to generate even modest changes in the overall Welsh budget, and there are legislative restrictions on increases in non–domestic rates, in the next section we focus on the effect changes in income tax, if it were devolved, could have on the Welsh budget. In particular we model scenarios where all income tax rates are decreased (T2) or increased (T3) by 1 percentage point in 2019–20 (the year after landfill and stamp duty land taxes are planned to be devolved). As shown in Table 3.5, this is equivalent to increasing/decreasing the Welsh budget by around £0.2 billion in 2019–20.

Table 3.5. Welsh resource DEL plus devolved tax revenues under different income tax scenarios, 2016–17 to 2019–20, £billions

| Scenario | 2016–17 | 2017–18 | 2018–19 | 2019–20 | Change from baseline |
|---|---|---|---|---|---|
| Income tax fixed | 14.1 | 14.0 | 13.8 | 13.6 | 0 |
| (T2) 1p tax cut | 14.1 | 14.0 | 13.8 | 13.4 | –0.2 |
| (T3) 1p tax rise | 14.1 | 14.0 | 13.8 | 13.8 | +0.2 |

Source: As Table 3.1.

## 3.3 Trade-offs when allocating the Welsh budget

The Welsh Government faces difficult trade–offs in allocating its budget (made up of the block grant and its tax revenues) to the different service areas it funds. In this section we examine the nature of these trade-offs under a number of different scenarios for the overall Welsh budget based on the analysis of sections 3.1 and 3.2. We do this by looking at the resources available for 'unprotected' services when areas like health and grants to councils to provide education and social services are protected from cuts, or even increased. In particular we consider the following four scenarios for the allocation of the Welsh Government's resource budget:

W1 Protecting the core NHS budget by ensuring it receives any funding the Welsh Government receives via the Barnett formula as a result of increases in English NHS spending and, furthermore, does not fall in real terms or as a share of the overall budget.[24] Any cuts required are shared proportionately across other service areas.

[24] The core NHS budget is defined as the NHS Delivery and Health Central Budgets from the Health, Wellbeing and Sport Main Expenditure Group of the Welsh Government's Budget. This is larger than the "Delivery of Core NHS Services" Budget, which is the main sub-component of the NHS Delivery budget.

W2 As W1 in respect to the NHS budget, and also protecting in real-terms that part of 'funding support for local government' that relates to education and social services.[25] Cuts are shared proportionately across other service areas, including the remainder of 'funding support for local government'.

W3 The core NHS budget receives 2% real terms increases each year – faster than it has in recent years, but less than half the pace it was increased during the 2000s. Any cuts required are shared proportionately across other service areas.

W4 As W3 in respect to the NHS budget, and also protecting in real-terms that part of 'funding support for local government' that relates to education and social services. Cuts are shared proportionately across other service areas, including the remainder of 'funding support for local government'.

This is clearly not an exhaustive set of options – there are literally an infinite number of ways to allocate the Welsh Government's budget. However, scenarios W1–W4 reflect some of the key issues the Welsh Government faces: the trade-off between health and other services, and a decision over whether local authorities should receive at least some budgetary protection given their funding of schools and social services. (In Appendix B we examine a number of additional scenarios related to EU funding, which may come to an end in its current form during the period in question).

Table 3.6, which shows the Welsh Government's budget allocations for 2016–17, shows that the core NHS budget (£6,329 million) accounts for 46% of the Welsh Government's overall resource DEL (£13,744 million).[26] Support for local government (£4,279 million) accounts for a further 30% of this budget. Protection or increases for these areas therefore significantly increases the scale of cuts needed in other areas to deliver overall spending cuts.

For instance, as set out in Section 3.2, in our baseline resource revenue scenario (R1), the Welsh block grant is forecast to be reduced by 3.8% in real terms and non–domestic rates revenues increase by 3.8% in real terms between 2016–17 and 2019–20. This means an overall cut to the Welsh Government's resource budget of 3.2%.

Figure 3.1 shows that under scenario W1, the modest increases in core NHS spending (46% of the Welsh Government's budget) that would follow from a decision to match increases in England would require a 7.4% real–terms cuts for all other areas of spending, over double the cut to the Welsh Government's budget as a whole (3.2%).

In W2, an additional £1.7billion of support to local government to fund education and £1.2 billion to fund social services is protected in real-terms, meaning that in total 67% of Welsh Government resource DEL spending would be protected. As a result, the requisite cuts to unprotected areas would increase to 11.9%.

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[25] The proportion of local authority spending going to particular service areas is based on the intended spending shares implied by the spending share assessment, and not on local authority revenue expenditure. This is based on the assumption that protection of funding would be done based on the intention of central government rather than the actual activity of local governments. However in practice it gives a very similar figure to similar to local authorities budgeted revenue expenditure.

[26] To be precise, £13,744 million is the sum of the Welsh Government's resource DEL (excluding depreciation) and spending funded by non–domestic rates (which is formally AME) as set out in the 1st Supplementary Budget for 2016–17.

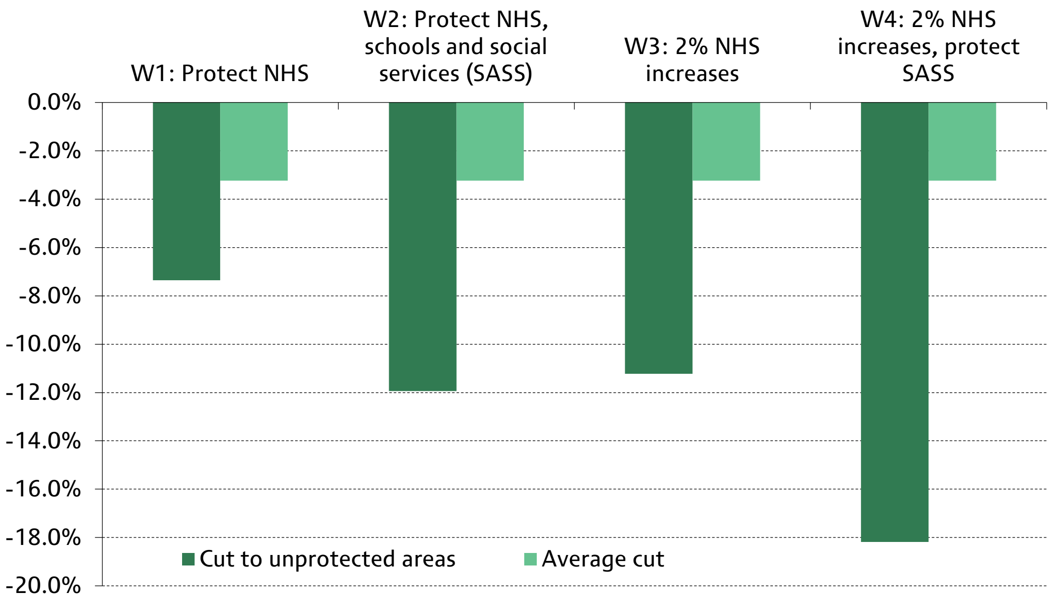
The pressure of increasing NHS spend by 2% each year as per scenario W3, would require cuts of 11.2% cuts to all other areas, including local government. If that part of central government support to local government to fund education and social services were also protected in such a scenario (W4), the remaining service areas would see cuts of 18.2%.

### Table 3.6 Welsh Government fiscal resource DEL, 2016–17, £millions

| **Main expenditure group** | **2016–17 budget** |
|---|---|
| Health, Well–being and Sport | 6,572 |
| *of which: Core NHS* | *6,329* |
| *of which: Public Health* | *177* |
| *of which: Social Services* | *66* |
| DEL funding support for Local Government | 3,302 |
| Other local government spend | 32 |
| Communities and Children | 358 |
| Economy and Infrastructure | 597 |
| Education | 1,339 |
| Environment and Rural Affairs | 275 |
| Central Services and Administration | 294 |
| **Total resource DEL allocated to departments** | **12,767** |
| AME support for Local Government (NDR) | 977 |
| **Total DEL + NDR allocated to departments** | **13,744** |

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).
Source: See Appendix A for sources.

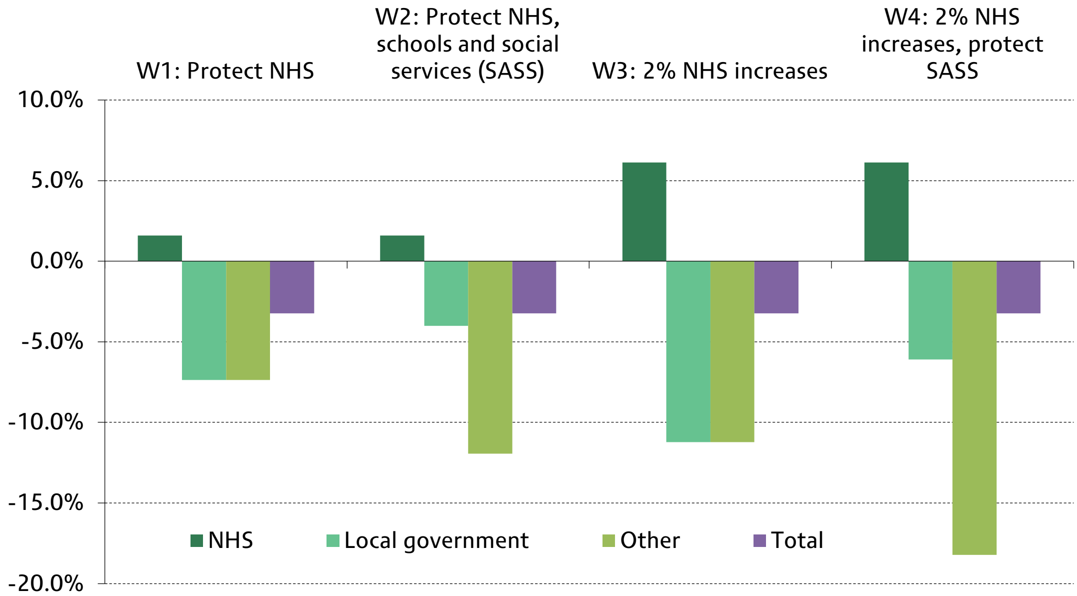
Figure 3.1. Cuts to Welsh Government spending (2016–17 to 2019–20) in baseline revenue scenario (R1–T1), by Welsh Government spending scenario




Source: Authors calculations using sources as described in Appendix A.

Figure 3.2 shows how these cuts would fall across the core NHS, local government and other main expenditure groups (MEGs) of the Welsh Government. In particular it shows that extending protection to the portion of local government funding for education and social services reduces the cut to the overall local government allocation from 7.4% in scenario W1 (where only health is protected) to 4.0% in scenario W2. Increasing the Welsh NHS budget by 2% a year in real terms would push cuts to local government back up to 6.1% though, even if funding to councils for education and social services were protected (W4).

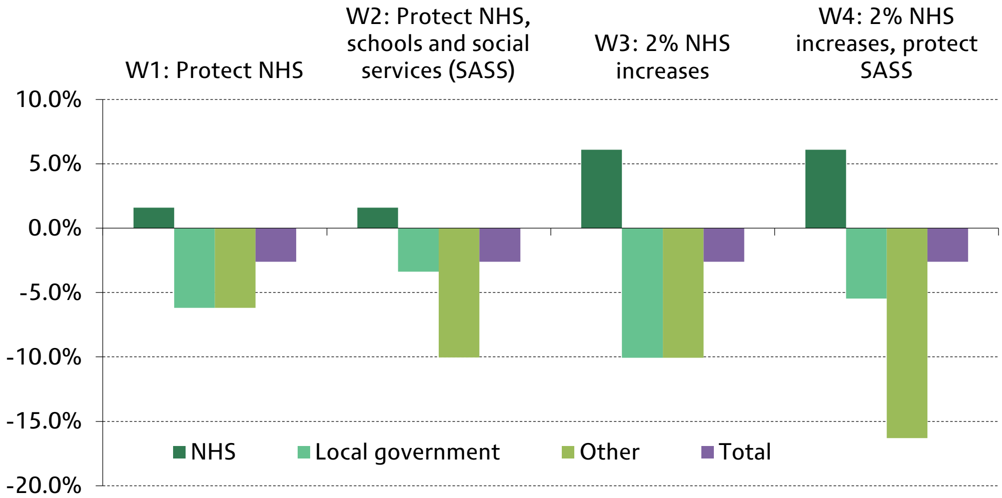
Figure 3.2. Cuts to Welsh Government spending by service area (2016–17 to 2019–20) in baseline revenue scenario (R1–T1), by Welsh Government spending scenario




Source: As Figure 3.1.

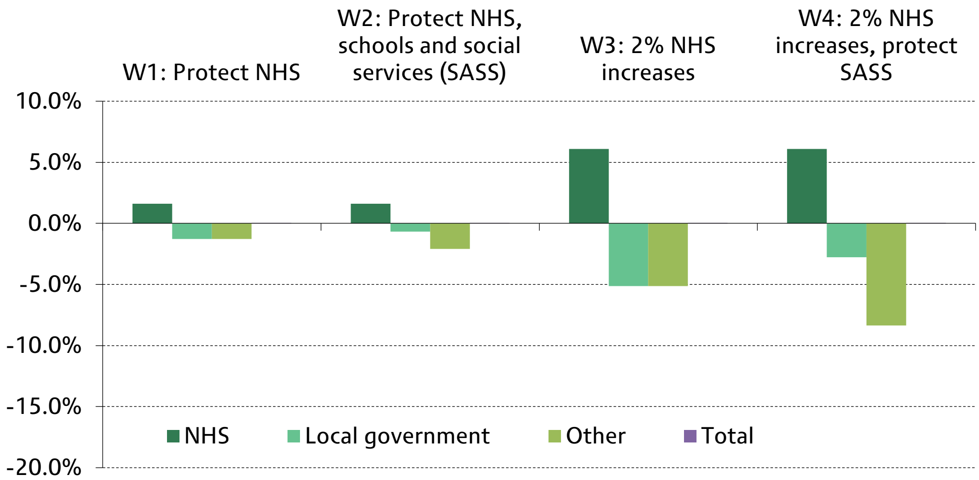
The same basic patterns hold if the overall budget of the Welsh Government is higher or lower than our baseline scenario, but the precise nature of the trade–offs differ. Figures 3.3 and 3.4 show the impacts of the same options for allocating the Welsh Government's budget (W1–W4) for revenue scenarios R2 and R3.

### Figure 3.3. Cuts to Welsh Government spending by service area (2016–17 to 2019–20) in baseline revenue scenario (R2–T1), by Welsh Government spending scenario




Source: As Figure 3.1.

### Figure 3.4. Cuts to Welsh Government spending by service area (2016–17 to 2019–20) in baseline revenue scenario (R3–T1), by Welsh Government spending scenario




Source: As Figure 3.1.

Under revenue scenario R2, overall budget cuts by 2019–20 would be reduced to 2.6%. Protecting the NHS (W1) would require cuts of 6.2% to other areas, including local government. Protecting education and social care funding for local government (W2) would increase the cuts to unprotected areas to 10%; overall funding support for local government – consisting of both protected and unprotected elements – would fall by 3.4%. Increasing the NHS budget and part-protecting grants to local authorities (W4) would again require large (16%) cuts to unprotected areas.

Under revenue scenario W3, the Welsh Government's budget would be virtually the same in 2019–20 as in 2016–17 in real terms. Even so, substantial cuts could still be required in certain areas. For instance, increasing the NHS budget by 2% a year and protecting local government's funding for education and social services would require cuts to unprotected areas of around 8% over the 3 years to 2019–20.

Table 3.7 shows the real–term budgets that would be available to different spending areas each year under each of the Welsh Government budget allocation scenarios (W1 – W4) if the Welsh Government's overall budget evolves in accordance with our baseline revenue scenario (R1–T1). Given the back–loading of the cuts to the overall budget under this revenue scenario, it is unsurprising that cuts to unprotected services would also be back–loaded.

The Table also shows the effects of the various Welsh Government budget allocation scenarios (W1 – W4) if income tax was devolved and the Welsh Government decreased (tax scenario T2) or increased (T3) the WRIT. Average cuts across all services would increase to 4.7% over the next 3 years if income tax were reduced by 1 percentage point (T2), or be reduced to 1.8% if income tax were increased by 1 percentage point (T3).

What about particular service areas? If the NHS were protected from cuts (W1), a 1 percentage point cut in the rates of income tax (T2) would increase the pace of cuts to unprotected services – including grants to local government – by over a third (from 7.4% to 10.1%). If protection were extended to funding support for education and social services (W2), cuts to local government as a whole would amount to 5.5% (as opposed to 4.0% with unchanged income tax) and other services to 16.3% (compared to 11.9%). Finally if NHS spending were increased by 2% in real terms per year and support for local government's education and social services spending were protected (W4), overall support for local government would see cuts of 7.6% (up from 6.1% with unchanged income tax) and other services cuts of 22.6% (up from 18.2%). A combination of income tax cuts and increases in the NHS budget would therefore entail substantial cuts to other service areas.

A 1 percentage point increase in the rates of income tax (T3) would, clearly, make the trade–offs between different service areas easier to manage. For instance, if only the NHS were protected (W1) the cuts to unprotected services would be 4.7%, around two-thirds the 7.4% required with unchanged income tax (although cuts would initially be greater than 4.7% and would be partly reversed in 2019–20 when we assume income tax powers would be available). But an increase in income tax rates of 1 percentage point could still leave unprotected services seeing substantial cuts if NHS spending were increased and education and social services spending protected (W4): 13.8% (down from 18.2% with unchanged income tax). A 1 percentage point increase in rates of income tax would therefore not be a panacea for the Welsh Government.

Table 3.8 repeats the analysis of Table 3.7 but under our scenario for the overall Welsh Government budget if inflation is 1 percentage points higher over the next few years and the UK government does not respond by loosening the purse strings (R1+). With the impact of inflation assumed to be felt in 2017–18 and 2018–19, this increases the pace of real–terms cuts in those years, as discussed in Section 3.1. Comparing the figures in Tables 3.7 and 3.8 shows that the additional real–terms cuts implied by inflation being 1 percentage point higher is about half as big as a 1 percentage point cut in income tax (although the timing of these additional cuts would be front–loaded as opposed to back–loaded). For instance, a 4.1% cut in the overall Welsh Government budget compares to 3.2% given March 2016 inflation forecasts, and 4.7% given those March forecasts and a 1 percentage point cut to the rates of income tax. With higher inflation, protecting or increasing favoured areas of spending like the NHS would require deeper cuts to unprotected areas. For instance, if the NHS were increased by 2 percent a year and protection offered to local government funding for education and social services (W4), cuts of 21% would be required to other areas of the budget, compared to 18% under existing inflation forecasts. An increase in the rate of income tax rates of 1 percentage point would bring cuts to unprotected services back down to 17%. That is, it would do little more than compensate for higher inflation.

Taken together, the scenarios analysed show that the Welsh Government will face difficult decisions, particular with regards to the trade-off between health, local government and other services. Increases in cash-terms budgets by the UK government could ease these trade-offs but higher inflation, or cuts to devolved taxes could make them more acute.

Table 3.7. Welsh DEL for current expenditure in different income tax scenarios, 2016–17 to 2019–20 (R1), real terms, £millions.

| **Spending scenario** | **Spend area** | **Annual % Change (T1)** | | | **Cumulative % Change 2016-17 to 2019-20 (T1)** | **Cumulative % Change 2016-17 to 2019-20 (T2)** | **Cumulative % Change 2016-17 to 2019-20 (T3)** |
|---|---|---|---|---|---|---|---|
| | | **2017–18** | **2018–19** | **2019–20** | | | |
| W1 | NHS | 1.0% | 0.2% | 0.5% | 1.6% | 1.6% | 1.6% |
| | Local government | -1.3% | -2.7% | -3.5% | -7.4% | -10.1% | -4.7% |
| | Other | -1.3% | -2.7% | -3.5% | -7.4% | -10.1% | -4.7% |
| | Total | -0.3% | -1.4% | -1.6% | -3.2% | -4.7% | -1.8% |
| W2 | NHS | 1.0% | 0.2% | 0.5% | 1.6% | 1.6% | 1.6% |
| | Local government | -0.7% | -1.4% | -1.9% | -4.0% | -5.5% | -2.5% |
| | Other | -2.2% | -4.4% | -5.9% | -11.9% | -16.3% | -7.6% |
| | Total | -0.3% | -1.4% | -1.6% | -3.2% | -4.7% | -1.8% |
| W3 | NHS | 2.0% | 2.0% | 2.0% | 6.1% | 6.1% | 6.1% |
| | Local government | -2.2% | -4.3% | -5.1% | -11.2% | -13.9% | -8.5% |
| | Other | -2.2% | -4.3% | -5.1% | -11.2% | -13.9% | -8.5% |
| | Total | -0.3% | -1.4% | -1.6% | -3.2% | -4.7% | -1.8% |
| W4 | NHS | 2.0% | 2.0% | 2.0% | 6.1% | 6.1% | 6.1% |
| | Local government | -1.2% | -2.3% | -2.7% | -6.1% | -7.6% | -4.6% |
| | Other | -3.6% | -7.1% | -8.6% | -18.2% | -22.6% | -13.8% |
| | Total | -0.3% | -1.4% | -1.6% | -3.2% | -4.7% | -1.8% |

Source: As Figure 3.1.

Table 3.8. Welsh DEL for current expenditure in different income tax scenarios, 2016–17 to 2019–20 (R1+), real terms, £millions.

| Spending scenario | Spend area | Annual % Change (T1) | | | Cumulative % Change 2016-17 to 2019-20 (T1) | Cumulative % Change 2016-17 to 2019-20 (T2) | Cumulative % Change 2016-17 to 2019-20 (T3) |
|---|---|---|---|---|---|---|---|
| | | 2017–18 | 2018–19 | 2019–20 | | | |
| W1 | NHS | 1.0% | 0.2% | 0.5% | 1.6% | 1.6% | 1.6% |
| | Local government | -2.2% | -3.5% | -3.5% | -9.0% | -11.7% | -6.3% |
| | Other | -2.2% | -3.5% | -3.5% | -9.0% | -11.7% | -6.3% |
| | Total | -0.7% | -1.8% | -1.6% | -4.1% | -5.6% | -2.7% |
| W2 | NHS | 1.0% | 0.2% | 0.5% | 1.6% | 1.6% | 1.6% |
| | Local government | -1.2% | -1.9% | -1.9% | -4.9% | -6.3% | -3.4% |
| | Other | -3.5% | -5.8% | -6.0% | -14.6% | -18.9% | -10.2% |
| | Total | -0.7% | -1.8% | -1.6% | -4.1% | -5.6% | -2.7% |
| W3 | NHS | 2.0% | 2.0% | 2.0% | 6.1% | 6.1% | 6.1% |
| | Local government | -3.1% | -5.2% | -5.1% | -12.8% | -15.5% | -10.1% |
| | Other | -3.1% | -5.2% | -5.1% | -12.8% | -15.5% | -10.1% |
| | Total | -0.7% | -1.8% | -1.6% | -4.1% | -5.6% | -2.7% |
| W4 | NHS | 2.0% | 2.0% | 2.0% | 6.1% | 6.1% | 6.1% |
| | Local government | -1.7% | -2.8% | -2.7% | -7.0% | -8.4% | -5.5% |
| | Other | -5.0% | -8.6% | -8.8% | -20.8% | -25.2% | -16.5% |
| | Total | -0.7% | -1.8% | -1.6% | -4.1% | -5.6% | -2.7% |

Source: As Figure 3.1.

# 4. Local government budgetary trade–offs: the picture to 2019–20

In this chapter of the report we examine in more detail the trade–offs facing Welsh councils as they set their budgets in the next few years. Overall, the combination of general revenue support grant (RSG, £3.2 billion), redistributed non–domestic rates (NDR, £0.9 billion), specific grants (£0.8 billion) and council tax (£1.1 billion) is forecast to provide approximately £6.1 billion of funding for Welsh councils in 2016–17. Draw–down of reserves is expected to provide a further £0.1 billion, giving a total budget of £6.2 billion.

The amount they receive from the Welsh Government (in general and specific grants and redistributed non–domestic rates) is out of councils' direct control and will reflect the type of higher–level decisions analysed in the last chapter. However councils do decide the rate of council tax they charge,[27] allowing them to influence the size of their budget at the margin. Thus in Section 4.1 we consider councils' overall budgets and the extent to which changes in council tax rates affect them. Section 4.2 then considers the trade-offs councils face when allocating their budgets to different service areas. In what follows we assume no further net draw–down from (or payment into) reserves from 2017–18 onwards. This is because drawing down reserves, while potentially a useful budgetary management tool in the short term, is not a sustainable solution in budgeting in the longer-term.

## 4.1 Council budget and council tax

Welsh councils receive funding from the revenue support grant, specific grants, redistributed non–domestic rates and their own council tax revenues. They can also operate reserves which they can add to or draw from in any particular year.[28]

Based on the earlier stages of this report there are a huge number of revenue scenarios we could set out for councils in Wales – varying the different total spending envelope at the UK level, changing Welsh Government spending decisions or varying the Welsh rate of income tax. However, these three all boil down to increasing or decreasing the generosity of central funding to councils (both through the main revenue support grant and through specific grants).

The key messages can be seen by holding the Welsh block grant fixed at the levels of our baseline scenario (R1) and the WRIT (if income tax is partially devolved during this period) fixed at 10% (T1) but varying the level of grants councils receive from the Welsh Government

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[27] More specifically, they decide on the "Band D" rate to charge. The multipliers for Bands A through I are fixed by the Welsh Government (for instance, council tax on a Band A property is 6/9$^{ths}$ the level of a Band D property, and on a Band I 21/9$^{ths}$ of the level).

[28] For the purpose of this analysis, we've excluded revenues accruing to police authorities and housing benefit which is sent directly to Welsh councils from DWP to match demand. In addition we have assumed that appropriations from reserves will be net 0 in every year from 2017–18 onwards.

as it chooses to allocate its budget differently (Welsh Government spending scenarios W1, W2, W3 and W4). This gives us 3 main scenarios for local government funding:

L1 Our baseline council revenue scenario, where the Welsh Government protects just core NHS spending (W1), general and specific grants to councils change at the same rate as other Welsh Government spending, and council tax revenues increase in line with the OBR's forecast.

L2 As L1, but the Welsh Government also protects that part of its general funding for councils that relates to councils' education and social services responsibilities (W2).

L3 As L1, but the Welsh government increases core NHS spending by 2% annually (W3).

L4 As L3, but the Welsh Government also protects that part of its general funding for councils that relates to councils' education and social services responsibilities (W4).

The OBR's council tax revenue forecasts assume council tax bills increase by an average of about 4% a year over the next 3 years and the council tax base (basically the number of residential properties) increases by 0.5% a year. But given council tax bills can be varied by councils, we also consider the impact on council budgets of increases in council tax above those forecast by the OBR:

L1+ As L1, but Welsh councils increase council tax by an additional 3.3 percentage points a year in 2017–18 to 2019–20, such that by 2019–20 council tax rates are 10 percentage points higher than they were otherwise forecast to be.

In our baseline scenario (L1), set out in Table 4.1, grants to local government receive no protection by the Welsh Government, and central funding and specific grants are assumed to fall by 7.4% in real-terms by 2019–20. In addition, rising business rates revenues mean the cost of discretionary non–domestic rate relief are assumed to increase 3.8% over the period. Furthermore, we assume that councils stop drawing down reserves in future years to fund their spending.

Under the OBR's forecasts, Welsh council tax revenues would increase by 8.3% in real terms by 2019–20. However, this only compensates for about 26% of the falls in grants, and 20% of the falls in other revenues, including draw-downs from reserves. Even account for council tax increases then, overall revenues would be down by 5.9% in real terms under such a scenario.[29]

[29] We have assumed that councils do not draw down any funds from their reserves over the remaining period. If we compare council's total revenues in 2019-20 with their revenues in 2016-17 excluding reserves, the cut is smaller, at 4.5%.

Table 4.1. Council revenues in scenario L1, 2016–17 to 2019–20, real terms, £millions

| Welsh council revenues, projection | 2016–17 | 2017–18 | 2018–19 | 2019–20 | % change 2016–17 to 2019–20 |
|---|---|---|---|---|---|
| Specific grants | 844 | 832 | 810 | 782 | -7.4% |
| Discretionary non–domestic rate relief | –4 | –4 | –4 | –4 | 3.8% |
| Central government funding (NDR + RSG) | 4,102 | 4,047 | 3,938 | 3,800 | -7.4% |
| Council tax (net of reduction scheme) | 1,123 | 1,155 | 1,185 | 1,217 | 8.3% |
| **Total grants and tax revenues** | 6,065 | 6,031 | 5,930 | 5,794 | -4.5% |
| Draw–down from reserves | 93 | 0 | 0 | 0 | N/A |
| **Total budget** | 6,158 | 6,031 | 5,930 | 5,794 | -5.9% |

Note: 2016–17 total includes £93million of funds drawn from reserves, assume to be zero in future years.
Source: Authors calculations using sources and methods as set out in Appendix C.

If the Welsh Government were to partially protect general funding for local government via the RSG and redistributed NDR revenues then cuts to overall central government funding would be smaller (5.4% under scenario L2, set out in Table 4.2), despite the fact this might put pressure on (unprotected) funding from specific grants. Smaller cuts to central government funding would mean forecast increases in council tax could do more to offset grant funding cuts (for instance, 35% of grant–funding cuts under scenario L2).

Table 4.2. Council revenues in scenario L2, 2016–17 to 2019–20, real terms, £millions.

| Welsh council revenues, projection | 2016–17 | 2017–18 | 2018–19 | 2019–20 | % change 2016–17 to 2019–20 |
|---|---|---|---|---|---|
| Specific grants | 844 | 825 | 789 | 743 | -11.9% |
| Discretionary non–domestic rate relief | –4 | –4 | –4 | –4 | 3.8% |
| Central government funding (NDR + RSG) | 4,102 | 4,072 | 4,013 | 3,937 | -4.0% |
| Council tax (net of reduction scheme) | 1,123 | 1,155 | 1,185 | 1,217 | 8.3% |
| **Total grants and tax revenues** | 6,065 | 6,049 | 5,984 | 5,893 | -2.8% |
| Draw–down from reserves | 93 | 0 | 0 | 0 | N/A |
| **Total budget** | 6,158 | 6,049 | 5,984 | 5,893 | -4.3% |

Note: See note to Table 4.1.
Source: See source to Table 4.1.

Table 4.3. Council revenues in scenario L3, 2016–17 to 2019–20, real terms, £millions.

| **Welsh council revenues, forecast** | **2016–17** | **2017–18** | **2018–19** | **2019–20** | **% change 2016–17 to 2019–20** |
|---|---|---|---|---|---|
| Specific grants | 844 | 825 | 789 | 749 | -11.2% |
| Discretionary non–domestic rate relief | –4 | –4 | –4 | –4 | 3.8% |
| Central government funding (NDR + RSG) | 4,102 | 4,010 | 3,836 | 3,641 | -11.2% |
| Council tax (net of reduction scheme) | 1,123 | 1,155 | 1,185 | 1,217 | 8.3% |
| **Total grants and tax revenues** | 6,065 | 5,987 | 5,806 | 5,603 | -7.6% |
| Draw–down from reserves | 93 | 0 | 0 | 0 | N/A |
| **Total budget** | 6,158 | 5,987 | 5,806 | 5,603 | -9.0% |

Note: See note to Table 4.1.
Source: See source to Table 4.1.

As we saw in Section 3.3, if the Welsh Government responds to demand pressures by increasing core health spend by 2% a year, large cuts are necessitated elsewhere. In our most pessimistic scenario from the perspective of local government (L3), no specific protection from these cuts is offered to grants to councils. As a result, any councils would face cuts to all central funding of 11.2%, resulting in an overall budget cut of 9.0%. Only 17% of this decline could be compensated for by forecast council tax revenues increases.

Table 4.4. Council revenues in scenario L4, 2016–17 to 2019–20, real terms, £millions.

| **Welsh council revenues, forecast** | **2016–17** | **2017–18** | **2018–19** | **2019–20** | **% change 2016–17 to 2019–20** |
|---|---|---|---|---|---|
| Specific grants | 844 | 813 | 755 | 690 | -18.2% |
| Discretionary non–domestic rate relief | –4 | –4 | –4 | –4 | 3.8% |
| Central government funding (NDR + RSG) | 4,102 | 4,052 | 3,957 | 3,851 | -6.1% |
| Council tax (net of reduction scheme) | 1,123 | 1,155 | 1,185 | 1,217 | 8.3% |
| **Total grants and tax revenues** | 6,065 | 6,017 | 5,894 | 5,754 | -5.1% |
| Draw–down from reserves | 93 | 0 | 0 | 0 | N/A |
| **Total budget** | 6,158 | 6,017 | 5,894 | 5,754 | -6.6% |

Note: See note to Table 4.1.
Source: See source to Table 4.1.

Even if funding for education and social services via the RSG and redistributed NDR revenues (around two thirds of all RSG and redistributed NDR revenues) were protected from cuts under such a scenario (L4), overall council grant cuts would amount to 8.2% (consisting of a 6.1% reduction in funding via the RSG and redistributed NDR revenues, and an 18.2% cut in specific grants). Forecast council tax revenue increases could only compensate for 23% of the decline, and overall funds available to councils would fall by 6.6% in real–terms by 2019–20.

Note that each of scenarios L1 to L4 (in Tables 4.1 to 4.4) are based on our baseline revenue scenario for the Welsh Government, where the UK Government makes as yet unallocated cuts to budgets in 2019–20 (resource block grant scenario R1) and the Welsh Government leaves income tax unchanged, if it were to be devolved (tax scenario T1). In reality if some spending cuts planned by the UK government were to be cancelled (e.g. scenarios R2 or R3) or Welsh Government taxes were to be increased (e.g. scenario T3) then more money would be available to the Welsh Government and hence, possibly, Welsh local government. On the other hand, if higher inflation were to increase the scale of cuts associated with any given budget (e.g. scenarios R1+ and R2+) or the Welsh Government were to cut taxes (e.g. scenario T2) then the spending squeeze could be tighter than in these scenarios.

### *Additional council tax increases*

Local councils may wish to offset cuts to grant funding by increasing council tax even more than forecast. If, rather than increase council tax bills at 4%, on average, in line with what the OBR assumes, councils increased council tax by (approximately) an additional 3.3 percentage points a year (so it would be 10 percentage points higher in 2019–20 than under current forecasts), real–terms budget cuts could be around a third smaller, at 3.9% (see Table 4.4), than under our baseline scenario for grants and council tax revenues (L1).

Table 4.5. Council revenues in scenario L1+ (council tax up an additional 3.3 percentage points a year), 2016–17 to 2019–20, real terms, £millions.

| Welsh council revenues, forecast | 2016–17 | 2017–18 | 2018–19 | 2019–20 | % cut |
|---|---|---|---|---|---|
| Specific grants | 844 | 832 | 810 | 782 | -7.4% |
| Discretionary non–domestic rate relief | –4 | –4 | –4 | –4 | 3.8% |
| Central government funding (NDR + RSG) | 4,102 | 4,047 | 3,938 | 3,800 | -7.4% |
| Council tax (net of reduction scheme) | 1,123 | 1,194 | 1,264 | 1,338 | 19.2% |
| *of which resulting from rate increase* | - | 39 | 79 | 122 | N/A |
| **Total grants and tax revenues** | 6,065 | 6,069 | 6,009 | 5,916 | -2.5% |
| Draw–down from reserves | 93 | 0 | 0 | 0 | N/A |
| **Total** | 6,158 | 6,069 | 6,009 | 5,916 | -3.9% |

Note: See note to Table 4.1.
Source: See source to Table 4.1.

If cuts to grants were relatively modest (as scenario L2), 10 percentage points of extra council tax increases over the next 3 years could allow local government, as a whole, to offset a little over 80% of the grant cuts facing it, but in our pessimistic scenario, this drops to only 39%.

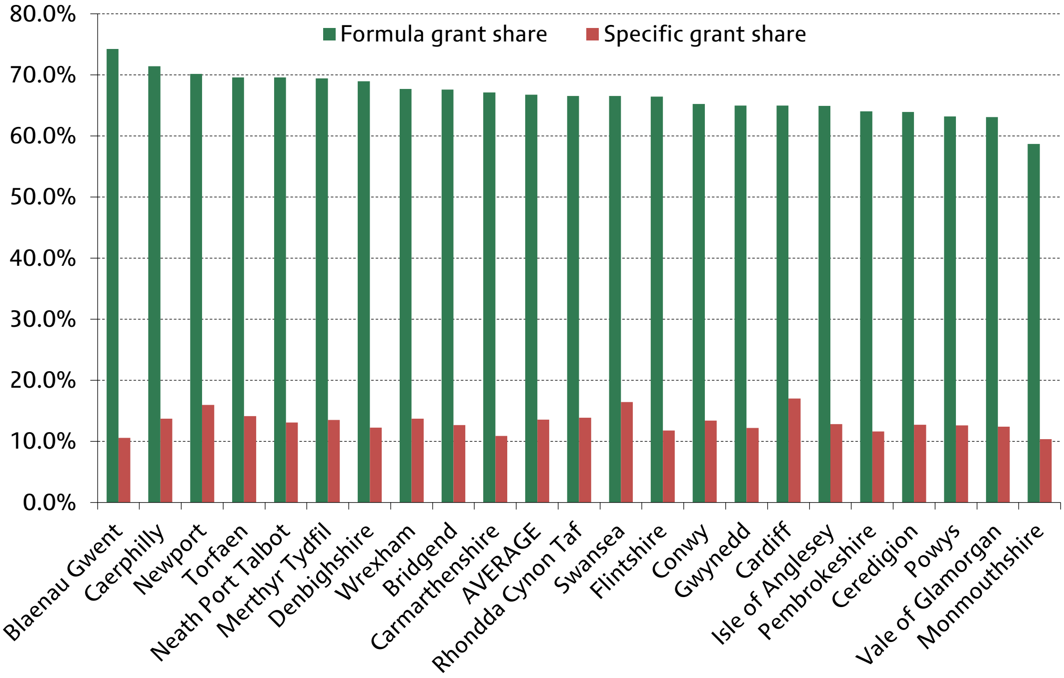
### Table 4.5. Percentage of the real-terms cuts to grant funding (NDR+RSG+SG) offset by real-terms increases in council tax revenues

| Council tax scenario | L1 | L2 | L3 | L4 |
|---|---|---|---|---|
| Council tax bills increase 4% a year, as forecast by the OBR | 26% | 35% | 17% | 23% |
| Council tax up additional 3.3 percentage points a year | 59% | 81% | 39% | 53% |
| *of which additional to baseline* | *33%* | *46%* | *22%* | *30%* |

Note: The real-terms increase in council tax revenues associated with the baseline scenario of 4% increases in council tax bills is 2.7%. This is the reason why the additional 3.3 percentage points of council tax increases (which equates to approximately an additional 3.3% real-terms increase in council tax revenues) offsets more of the real-terms council budget cuts than the baseline 4% increases in council tax.
Source: See source to Table 4.1.

The ability to offset cuts by increases to council tax would vary significantly across Wales though. This reflects the fact that there is significant variation amongst Welsh councils in their relative dependence on different sources of income. The proportion of council income coming from core central funding (RSG plus redistributed NDR revenues) across all authorities is 66.7%, but this ranges from 74.2% in Blaenau Gwent to 58.7% in Monmouthshire. This doesn't appear to correlate strongly with the allocation of specific grants, which vary from 10–17% of the income of councils.

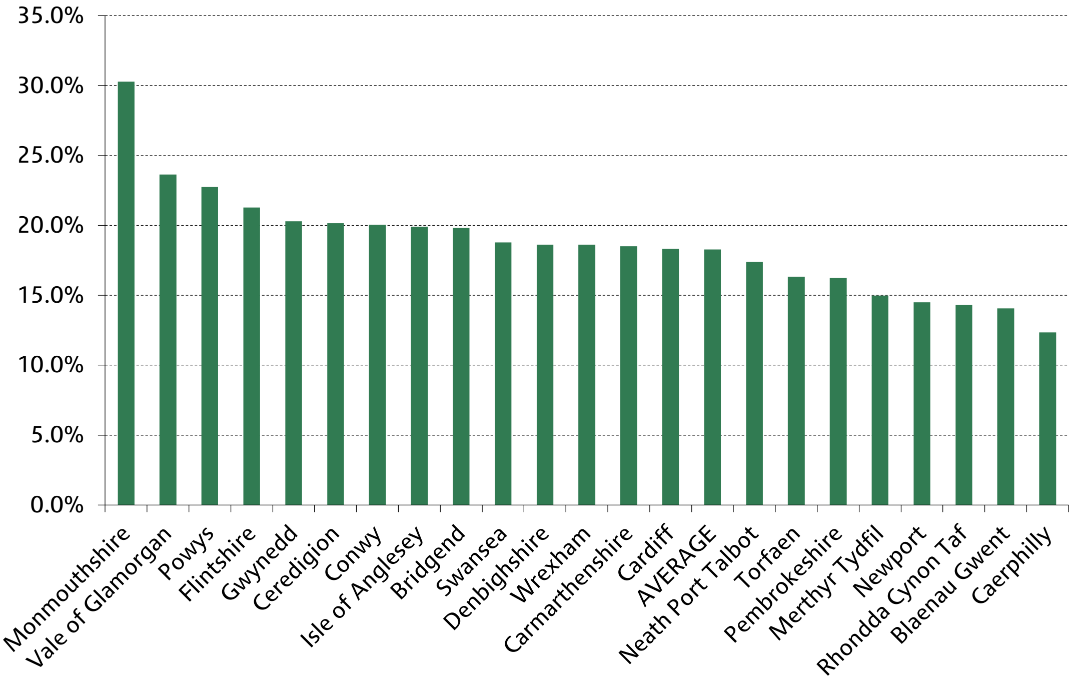
### Figure 4.1. Formula grant and specific grant revenue as a share of council revenue expenditure, 2016–17




Source: See source to Table 4.1.

Almost by definition, there is a correspondingly wide range in council's dependence on council tax – from 30% of their budget in Monmouthshire to 12% in Caerphilly.

Figure 4.2. Council tax revenues as a share of council revenue expenditure, 2016–17.




Source: See source to Table 4.1.

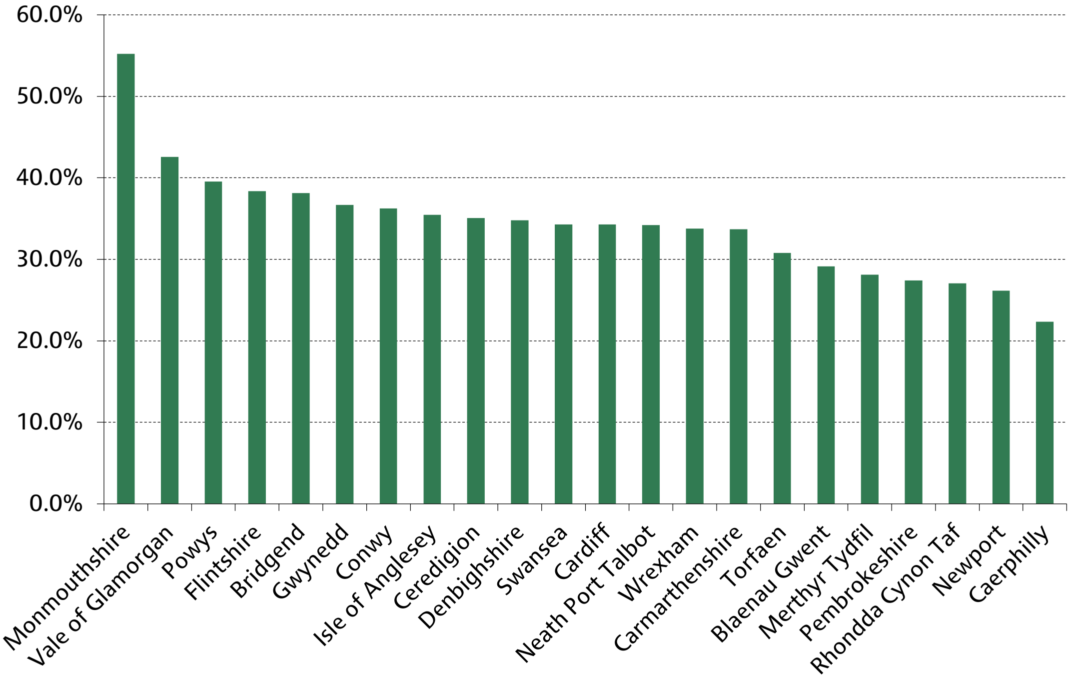
These differences in grant dependence and council tax yield reflect both differences in area characteristics (such as needs and the hypothetical local council tax base) and differences in the rates of council tax set by different authorities (for instance Pembrokeshire council charges a Band D rate of £841 while Blaenau Gwent charges £1,457). The funding formulae used to allocate funding to authorities can take into account the differences in characteristics so those more dependent on grant are not penalised for this when grants are cut. In particular, the cut in grant can be made smaller for such authorities and larger for authorities less dependent on grant, so that cuts to overall spending-power are evened out.

However, those authorities that obtain more (or less) of their funding from council tax than average, can still offset more (or less) of the cuts to their grants from additional increases in their council tax (i.e. increases on top of those taken into account by the funding formula): a given percentage increase in a funding stream that is already 30% of your budget is just *bigger* than the same percentage increase in a funding stream that is 10% of your budget.

Figure 4.3 shows the proportion of cuts to their overall funding under our baseline L1 scenario that different councils could offset by increasing their council tax by an additional 10 percentage points by 2019–20.[30] This proportion varies from 55% in Monmouthshire to 22% in Caerphilly, though for most authorities it is somewhere between 27% and 40% (with an average of 33%).

[30] The calculations assume that payments of council tax revenue support – the system by which the Welsh Government subsidises council tax payments of those on low incomes – increase in line with the additional increases in council tax, and that the cost of CTRS is funded by council tax revenues as a whole.

Figure 4.3. Percentage of funding cuts (2016–17 to 2019–20) under scenario L1 offset by an additional 10 percentage point council tax increase, by council.




Source: See source to Table 4.1.

## 4.2 Trade–offs between councils' service areas

Under the five local government revenue scenarios (L1, L2, L3, L4 and L1+) outlined in section 4.1, councils would face cuts to their real-terms spending power over the next 4 years. This means there would be a trade-off between spending on different service areas. As with the Welsh Government's budget, protections in certain areas would mean bigger cuts elsewhere.

Table 4.6 shows that over two-thirds of councils' spending goes to two areas: education and social services, which account for 42% and 27% of total budgeted revenue expenditure respectively in 2016–17. These are areas that can be considered particularly politically salient 'essential' services, with many major statutory responsibilities, and especially in the case of social services, rising costs and demands. Offering the protection that might be felt needed for such important services would require significantly larger cuts to the many other areas of council spending – which have generally already seen larger-than-average cuts.[31]

[31] A forthcoming IFS Report will examine changes to local government spending in Wales, Scotland and England, as well as look more broadly at recent and planned structural changes to the local government financing system.

Table 4.6. Welsh councils' budgeted revenue expenditure 2016–17, £m.

| Spending area | 2016–17 budget | Share of total |
| --- | --- | --- |
| Education | 2576.9 | 42% |
| Social Services | 1666.6 | 27% |
| Council fund housing (exc HB) | 111.8 | 2% |
| Local environmental services | 384.9 | 6% |
| Roads and transport | 283.3 | 5% |
| Libraries, culture, heritage, sport and recreation | 207.8 | 3% |
| Planning, economic and community development | 80.9 | 1% |
| Local tax collection | 30.2 | 0% |
| Law, order and protective services | 133.9 | 2% |
| Central administration | 166.3 | 3% |
| Other revenue expenditure | 182.8 | 3% |
| Debt financing costs | 332.5 | 5% |
| **Total revenue expenditure** | **6158.0** | **100%** |

Note: As with our analysis of revenues, these figures cover spending by Welsh unitary authorities, and therefore exclude spend by police authorities. They also exclude spend on housing benefit.
Source: See Appendix C.

In this analysis we consider 3 different spending decisions that could be made by local councils:

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 2016–17 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 (-0.5% 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 2016–17 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 2016–17 level. Debt financing costs are also assumed to maintain a constant share of the budget.

We also look at how the budget cuts to different areas of council spending vary across these scenarios depending in the revenues available to local councils set out in the scenarios (L1–L4 and L1+) in section 4.1.

In our baseline revenue scenario L1, the Welsh Government is assumed to protect health spending but no part of funding for local government. Under such a scenario, given existing OBR inflation forecasts, local councils would face an overall budget cut of 5.9% by 2019–20.

If no areas of council spending were protected (with the exception of debt financing costs, which we do not think councils have the power to 'cut' as other areas) and cuts were shared equally (S1), each spending area would face a 6.2% cut. Protecting education spending (S2) would result in an 11.0% cut to social services and other spending areas, whilst protecting education and social services spend would necessitate a 22.7% cut to other areas of council spending. Protecting Education (S2) close to doubles the cuts required to other areas, whilst protecting education and social services (S3) more than triples them relative to a no-protection scenario.

## Figure 4.4. Cuts to local government spending areas in revenue scenario L1, 2016–17 to 2019–20


Source: See Appendix C.

This pattern is consistent for our five different scenarios for local government revenue (L1 – L4 and L1+), as shown in Table 4.7. In revenue scenario L3, our least optimistic scenario from the perspective of local government, other areas of council spending would face cuts of 34.7% if councils choose to protect education and social services.

## Table 4.7. Real-terms cuts to different council spending areas, 2016–17 to 2019–20

| **Spend scenario** | **Spend area** | L1 | L2 | L3 | L4 | L1+ |
|---|---|---|---|---|---|---|
| S1 | Education | -6.2% | -4.5% | -9.4% | -6.8% | -4.1% |
| | Social services | -6.2% | -4.5% | -9.4% | -6.8% | -4.1% |
| | Other | -6.2% | -4.5% | -9.4% | -6.8% | -4.1% |
| | **Total** | **-5.9%** | **-4.3%** | **-9.0%** | **-6.6%** | **-3.9%** |
| S2 | Education | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| | Social services | -11.0% | -8.0% | -16.9% | -12.3% | -7.3% |
| | Other | -11.0% | -8.0% | -16.9% | -12.3% | -7.3% |
| | **Total** | **-5.9%** | **-4.3%** | **-9.0%** | **-6.6%** | **-3.9%** |
| S3 | Education | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| | Social services | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| | Other | -22.7% | -16.4% | -34.7% | -25.2% | -15.0% |
| | **Total** | **-5.9%** | **-4.3%** | **-9.0%** | **-6.6%** | **-3.9%** |

Source: See sources to Figure 4.4.

Delivering cuts of up to 35% to unprotected areas of council spending would represent a significant challenge as some of these areas have seen significant cuts over the last seven years already, as set out in Table 4.8. For instance highways and transport has been cut by 21%, housing by 26%, cultural services by 36 and planning by 52%, whilst education and social care have been relatively protected in real terms.

Table 4.8. Spending levels and real-terms changes in spending on different council service areas, 2009-10 to 2016-17 (£s millions, 2016–17prices)

| **Spend area** | 2009-10 | 2016-17 | Change |
|---|---|---|---|
| Education | 2,819.4 | 2,660.3 | -6% |
| Social care | 1,567.6 | 1,583.2 | 1% |
| Housing exc. Housing benefit | 151.6 | 111.8 | -26% |
| Environment and regulatory services | 445.7 | 373.3 | -16% |
| Highways and transport | 359.6 | 283.3 | -21% |
| Cultural and related | 327.2 | 207.8 | -36% |
| Planning and development | 168.4 | 80.9 | -52% |
| Fire | 158.3 | 133.9 | -15% |
| Central services | 223.2 | 194.8 | -13% |
| **Total service expenditure** | **6,221.0** | **5,629.3** | **-10%** |
| Debt financing costs | 354.5 | 332.5 | -6% |
| Other revenue expenditure | 61.5 | 196.2 | 219% |
| **Total revenue expenditure** | **6,637.0** | **6,158.0** | **-7%** |

Notes: Housing service spend (and total service expenditure) excludes spending on housing benefit and housing benefit administration. Classification of different items of spending differs a little in table 4.8 to the current local government budgets in order that they are consistent over time. Large increases in 'other revenue expenditure' are explained in part by charging capital expenditure to the revenue account and unallocated contingencies.
Source: See sources to Figure 4.4.

# 5. Conclusions

This report has examined the outlook for the short to medium-term outlook for the Welsh Government's budget, and the trade-offs the Welsh finance minister will face when allocating the budget to particular service areas. It has also looked in more detail at local government spending.

This task has been made more difficult by the uncertainty surrounding the UK's economic and fiscal outlook: the recent decision by voters to leave the EU is likely to affect tax and spending plans in the coming years, but we are not yet sure to what extent. In our scenarios for the amount of block grant funding the Welsh Government receives from HM Treasury, we have looked at two main short-to-medium term impacts from 'Brexit': higher inflation as a result of the depreciation of the pound, reducing the real-terms value of any given block grant; and the cancellation of at least some planned cuts to departmental spending. These scenarios show that higher inflation would make the trade-offs facing the Welsh Government as it allocates its funding across services more stark, but that a loosening of spending plans as part of a fiscal stimulus could, on the other hand, give the Welsh Government more room to manoeuvre in the short term. It is worth noting that in the longer-term, if as expected, the decision to leave the EU reduces national income relative to pre-referendum forecasts, the UK's public finances would be weaker. Thus, if the UK government wanted eventually to generate a budget surplus, larger rather than smaller cuts (or tax rises or some combination of the two) would eventually be needed. Wales Public Services 2025 will look at this issue in a follow-up report to be published early in 2017.

After considering the block grant, our attention turned to devolved tax revenues. Our view is that while powers over landfill tax and stamp duty land tax may offer important environmental and property market policy levers, changes in them are unlikely to have major budgetary implications: they are small relative to the block grant. Business rates are a more substantial source of revenues but are constrained by legislation from increasing by more than RPI inflation each year. That means income tax, if it is devolved, is likely the only tax to provide significant levers for increasing or reducing the amount of resources available to the Welsh Government.

Our work has highlighted that even if income tax were increased though, the Welsh Government is still likely to face difficult trade-offs in allocating its budget over the next few years. For instance, if the Welsh Government were to protect funding for the NHS and decided that the portion of its general grants to councils that relates to funding for education and social services also required protection, cuts to other areas (such as higher education) would need to average 11.9% by 2019–20. Increasing income tax rates by 1p in the pound would reduce this to 7.6%.

Councils will also face difficult choices in allocating their budgets – particularly in relation to education and social services. Council tax bills are already forecast to increase by 4% a year by the OBR. Increasing them even faster could offset some but not all of the budget cuts expected, but could mean cuts bite differently across Wales. Some areas like Monmouthshire can raise relatively more from higher council tax than others like many councils in the South Wales Valleys.

# Appendix A. Modelling the Welsh Government's budget

Chapter 3 provides detail about the main assumptions underlying the various scenarios for the Welsh block grant and the allocation of the Welsh budget between now and 2019–20 However, in addition to these assumptions, a number of adjustments have had to be made in other to utilise our projection methodology.

## Alternative scenarios for total UK–wide DEL

Budget 2016 sets out the most recent spending plans for UK departmental expenditure limits (DELs), including the Welsh block grant, for each year until 2019–20. However, these plans seem likely to be amended in the coming years, so we model alternative scenarios.

First, there are £3.5 billion of planned but unallocated cuts, which form part of our baseline scenario (based on current policy). We allocate these cuts to all departments with the exception of Health and International Development, in proportion to the planned resource DELs for those departments in 2019–20.

Second, the UK government could decide to delay cuts planned for the period to 2019–20 in response to the anticipated economic slowdown following the recent decision to leave the EU. On the resource side, include a scenario where we hold constant in real–terms any DEL forecast to fall below its 2016–17 real–terms level on current plans. On the capital side we include scenarios where capital spending is either brought forward or increased, where any changes in given years are spread across DELs in proportion to their contribution to the total capital DEL.

## Projecting the Welsh 'block grant'

We project the Welsh 'block grant' using our projections for the total UK DEL, our assumptions for how this will be allocated between Whitehall departments, and the Barnett formula. 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 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% of spending relates to functions devolved to the Welsh Government. Thus 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% (Wales' population share) multiplied by 80.9% (the departmental comparability factor).

Note that when the Department for Transport allocates its budget, it may not allocate them 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 usual 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 practise, the precise impact of any changes to existing spending plans on the Welsh block grant may differ somewhat from what we model.

## Projecting Welsh Taxes

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 (2016x).
- Non domestic rates revenues are taken from Table 7.1 of HM Treasury's 2016 PESA (HM Treasury (2016y). These are referred to as 'locally financed support in Wales'.

When simulating changes a 1 percentage point change in income tax rates (scenarios T1 and T2), we scale income tax revenues up or down by 10% (a 1 percentage point increase on the proposed 10 percentage point WRIT is a 10% change). This is akin to assuming there is no behavioural response to the change in tax rate. In reality one may expect a 10% increase in tax rates to raise somewhat less than 10% more revenues as individuals respond to higher tax rates by reducing their work effort or increasing their tax avoidance and evasion effort (and vice versa for a tax rate cut).

## 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 2017–18 the Welsh block grant is due to reduced by 0.4% in real terms relative to the 2016–17 figure. We therefore assume a 0.4% fall in the Welsh Government's total DEL in 2017–18 too.

## Modelling Welsh Government budget choices

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.

1) 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.

2) 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 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).

# Appendix B. EU funding and the Welsh Government's budget

In addition to its funding from the block grant and devolved taxes, the Welsh Government manages and spends EU funds in Wales. These funds sit outside the Welsh Government's normal budget but are significant: approximately £547 million a year, with perhaps a further £23 million bypassing the Welsh Government entirely and going straight to universities and the private sector. Table B.1 breaks this spending down.

Table B.1. Forecast EU funds in Wales managed by the Welsh Government, 2016–17 to 2019–20, £millions.

| EU funded programme | 2016–17 | 2017–18 | 2018–19 | 2019–20 |
|---|---|---|---|---|
| EU structural funds | 255 | 255 | 255 | 255 |
| Ireland–Wales programme | 4 | 4 | 4 | 4 |
| Direct payments to farmers | 207 | 207 | 207 | 207 |
| Rural development programme | 79 | 79 | 79 | 79 |
| Fisheries | 2 | 2 | 2 | 2 |

Source: Authors' calculations based on Welsh Government estimates provided to the authors.

Once the UK leaves the EU, it is likely that most existing EU programmes in Wales will come to an end. The UK and Welsh Governments thus have to decide what will take their place. In the short–term, the UK Government has confirmed that funding for direct payments to farmers and Horizon 2020 will be guaranteed until 2020. For other major areas, including rural development and structural funds, funding will be guaranteed for projects committed to prior to the forthcoming 2016 Autumn Statement. However, funds that are in principle already allocated but are unspent by the time we leave the EU and are not committed to by this autumn will not be guaranteed (such projects will be assessed on a case–by–case basis). No statements have been made regarding longer–term funding post–2020.

In order to model the impact of the loss of EU funds on the Welsh Government budget we have assumed that EU funding will cease at the end of (calendar year) 2018, and that from this point onwards that the UK and Welsh Government must decide how to respond. The UK government can choose whether it will provide replacement funding for previously–EU funded programmes, and whether this will be ring fenced for the devolved administrations.

EU funds are worth £547million a year to the Welsh Government. If the UK government were to fully reimburse these funds, then the Welsh Government would face cuts of 3.1% to its spending power (consisting of its own budget, which would be reduced by 3.2% in our baseline R1–T1 scenario, and the protected EU funds). If the UK government chooses not to replace the lost EU funds, then these cuts more than double, to 6.9%. For the main body of this report, our implicit baseline assumption is that the UK government fully funds EU schemes through a ring–fenced pot, or that these schemes simply cease to exist when the EU funds are withdrawn and there is no knock on effect on the Welsh Government budget.

If any funding received to replace EU funds is not ring–fenced by the UK government, the Welsh Government could decide whether it will use this funding to protect spending on EU schemes, or whether it will roll this funding into its overall budget and cut EU schemes along with other areas of spending.

In this annex we consider four scenarios which vary the proportion of funding reimbursed by the UK government (always assumed to be non-ring fenced) and the Welsh government's spending priorities (whether it wishes to protect EU schemes or is happy to see their budgets cut.)

E1 The Welsh Government's main budget is given by our baseline scenario (R1T1). UK government fully reimburses the Welsh government for all the EU funds foregone, and does not ring-fence them. The Welsh Government protects its core NHS budget (in line with NHS funding in England) and cuts all other areas (including the schemes formerly funded by the EU) proportionately.

E2 As E1, except that the UK government provides funding to fully cover direct payments to farmers but only 50% of other EU funds foregone (for instance, if it decided not to approve all the rural and regional development schemes that would have been approved under the EU schemes).

E3 As E1, except the UK Government does not reimburse the Welsh Government for any EU funds. The Welsh Government protects health (in line with NHS funding in England) and cuts all other areas proportionately.

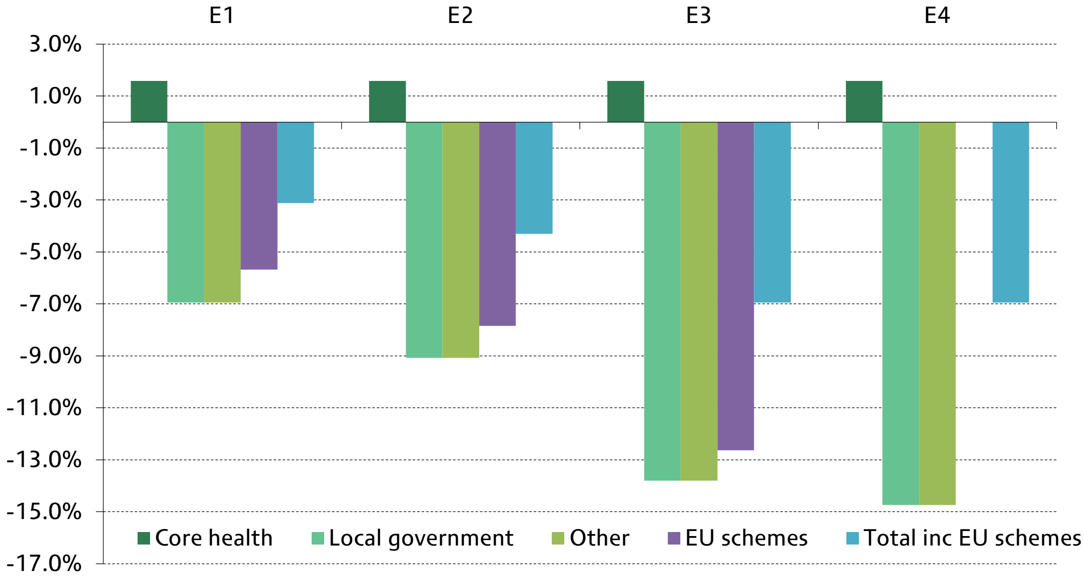
E4 As E3, except that the Welsh Government also chooses to protect spending on EU schemes.

Under our first scenario, E1, the Welsh Government faces cuts of 3.1% to its total funding (including current EU funds). As figure B.1 shows, as a result of protecting core health spending, the cuts required of all other spending areas (including schemes formerly funded by the EU) would be 6.9% by 2019-20.

If the UK government chooses to only partially replace lost EU funds, in line with scenario E2, then the cut to the Welsh Government's total funding would increase to 4.3%, and cuts to unprotected areas, including EU schemes, would average 9.1%.

Without replacement funds, the Welsh Government would face more than double the cut to its total budget (including current EU funds) at 6.9% by 2019–20. If it chose to cut funds for schemes currently funded by the EU in line with unprotected services like environment and local government, cut to these areas of 13.8% would be required, over double that would be required if the cost of EU schemes were fully covered by the UK government. Full protection of the budgets for EU schemes would increase the cuts to unprotected services (E4) to 14.7%.

## Figure B.1. Cuts to Welsh Government spending under alternative EU funding scenarios, by spending area (2016–17 to 2019–20)




Source: Here.

The timing of these cuts are entirely dependent on when the Welsh Government stops receiving money from the European Union for established programmes. We assume here that this happens during the final quarter of 2018–19. If this were the case, the full financial impact of decisions relating to EU funding would become evident the following fiscal year, 2019–20.

Taken together, this demonstrates that the short-to-medium term impact on the Welsh Government budget of leaving the EU depends on the general fiscal response by the UK government (considered in Section 3.1 of the main report), the timing of our exit, and any decision made by the UK Government to protect or guarantee spending on pre–existing EU schemes (considered in this Appendix). In the longer run, the UK and Welsh governments will have to decide whether the programmes started with EU funding match their own priorities and how to fund any replacement schemes from national (and perhaps smaller) budgets in a world where we have left the EU.

# Appendix C. Modelling local government budgets in Wales

Chapter 4 provides detail about 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 2019–20. 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 2016–17 and subtract any revenues accruing to Police authorities.[32]

This forms our 2016–17 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'.[33] 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

[32] Available at: https://statswales.gov.wales/Catalogue/Local-Government/Finance/Revenue.

[33] 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.

Government's 'Funding Support for Local Government' (the DEL 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 2016–17 baseline) in line with the OBR's latest forecast (from the March Economic and Fiscal Outlook.) For example between 2016–17 and 2017–8 revenues in cash-terms are forecast to increase by 4.7% 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 2017–18, 6.7% in 2018–19 and 10% in 2019–20.

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 2016–17

Changes in local government spending by service area are calculated using outturns from 2009–10 and budgets from 2016–17.[34] Adjustments were made to the figures for education and social services for the shift of funding for some early years provision (such as Sure Start centres) from education to social services, and expenditure by national parks was moved to 'other revenue expenditure' in 2016–17 for consistency with 2009–10.

[34] Available at: https://statswales.gov.wales/Catalogue/Local-Government/Finance/Revenue.

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