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Business rates in Wales, local retention and regional
growth deals
Policy Report

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Business rates in Wales, local retention and regional growth deals

Nikos Kapitsinis and Daria Luchinskaya

Wales Public Services 2025

For further information please contact:

Nikos Kapitsinis

Wales Public Services 2025

Tel: 029 2087 0913

Email: info@wps2025.org.uk

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Executive summary

As a contribution to a UK-wide programme on the future shape of local government finance being led by the Institute for Fiscal Studies, this paper considers the issue of local retention of business rates by local authorities in Wales, and highlights important questions that should be asked. In particular, it looks at the argument for retention in the context of the new and emerging regional growth partnerships in Wales (City Regions¹) and their role in promoting regional economic development. In doing so, the paper recognises the new economic and financial circumstances which are anticipated following Brexit, and takes into account the devolution of fiscal powers to Wales and the impact of the UK Government's 'austerity' policy on public spending in Wales and local authority budgets.

This report describes existing business rates arrangements in Wales, summarises the current approaches to business rate retention in England and Scotland, and discusses existing proposals for NDR change in Wales. It then explores a conceptual city-region shared-gain business rates incentivisation model which would enable regional growth partnerships to retain a portion of the business rates they generate and incentivise them to grow their business rate tax base.

Importantly, it should be emphasised that the report does not claim that business rates retention itself would necessarily lead to a significant growth in total NDR revenues beyond what would happen in the absence of retention. Instead, the report shows how business rates retention would lead to gains for the Welsh Government and the councils resulting from any extra rates growth due to City Region deals. This provides incentives for councils and Welsh Government to support projects related to the City Region and Growth Deals (and more broadly) to encourage regional development.

Underlying the discussion is the trade-off between redistribution on the one hand and incentives to grow the tax base on the other, which raises questions of what is a 'fair' business rate retention system. Is too much business rate revenue divergence detrimental to regional cohesion? Is it equitable for some councils to do better and others – much worse? Or are differential outcomes appropriate and justified given councils' differential performance? It would be up to policymakers to take a stance on these questions, while keeping in mind the economic implications of their decisions.

¹ The term City Regions in this report refers to both the City Region and Growth Deals.

Key messages and findings

The existing NDR scheme in Wales

- Non-domestic rates constitute a significant element in the local government finance system, generating annual revenues of £1 billion in Wales, about 10-15% of total net local authority income, and have gained prominence as a source of income as Welsh government grants to local government have been cut under austerity.
- Responsibility for business rates was devolved to the Welsh Government with effect from 2015-16. The rates are collected by the councils, put into a Welsh Government pool, and then redistributed across local authorities. This means that there is a redistributive element in the current system that benefits councils which are poorer and have a smaller tax base.
- Local retention of business rates by local authorities has not historically been a high-profile issue in Wales, where instead the focus has been on relief schemes to mitigate the impact of business rates on small businesses.
- Two key reports raised the possibility of retention but did not set out specific proposals. The argument for retention is that it could incentivise councils to generate new developments to increase their local tax base. However, business rate retention, without the corresponding adjustment of Revenue Support Grant, also has the potential to benefit councils where business rate revenues are rising relative to need – these may be the more economically developed councils with higher property values and biggest increases in the local tax base. This could therefore negatively affect the revenues of poorer councils with less buoyant property markets.

NDR scheme in England and Scotland

- Changes to business rates introduced in England and Scotland in recent years reflect different policy choices. Since 2011, in practical terms, the councils in Scotland retain the whole amount of business rates income they generate. In 2012-13, the Scottish Government introduced an incentive scheme under which a local authority retains 50 per cent of any business rates receipts above a set target. There is no penalty for councils which fail to meet their target, with the Scottish Government meeting any shortfall through the Revenue Support Grant.
- The approach in England, part of the far-reaching local financing agenda, started in 2012-13, with a 50 per cent NDR retention scheme and has developed since, with 75% retention by 2020 and a number of 100 per cent retention pilots already in

operation. The 100% retention pilots in effect break the link between business rates and the Revenue Support Grant. The England schemes are more complex than those in Scotland, among other things reflecting the two-tier Local Government in parts of the country and a ‘tariff and top-ups’ approach to equalisation between poorer and richer authorities.

- A key difference between the two approaches is the incentive structure facing councils. Under the Scottish system, councils are asymmetrically exposed to risk of not meeting their targets. They are rewarded for doing well, but are protected against performing poorly, thus weakening the incentives to grow their revenues. Under the English system, authorities are exposed to losses as well as gains, which may create a stronger incentive for councils to grow their revenues but also exposes them to more risk.
- Evidence shows that the English scheme has exposed the council budgets to additional variability on both the upside and the downside, leading to winners and losers. In Scotland, the incentive scheme has resulted in relatively modest level of funds retained by local authorities who have exceeded their target (average of £6 million a year). However, it is important to keep the counterfactual policy outcome in mind when evaluating the effects of the business rates retention reforms: even if some councils gain from retained NDR, they may still lose relative to what they would have received if that revenue had been redistributed across councils in the absence of retention.

The City Regions in Wales

- The establishment of the City Regions (Cardiff Capital and Swansea Bay) has reignited the interest in business rate retention.
- City Region deals in Wales have been established as drivers of economic growth, based on major projects that stimulate regional investment. However, the City Region deals also raise the risk of deepening the inequalities between councils, since the benefits could be unevenly distributed across Wales based on enhanced regional competition.
- Both Cardiff Capital and Swansea Bay City Regions are proposing some degree of business rate retention, arguing that retention could help incentivise the City Regions to grow their economies and increase their local tax base, generating funds for further investment, thus creating a virtuous circle. It is therefore timely to consider how a business rate retention scheme in Wales might work.

The hypothetical case of 100% NDR retention

- A simple reform of the existing NDR scheme in Wales could be a 100% business rates revenue retention at the local level. In a hypothetical simple case where councils retain 100% of business rates and no corresponding adjustment from the Revenue Support Grant is made, the retention would likely impact adversely on most councils and positively on only a few.
- With a hypothetical 100% retention, some councils would see their revenue falling relative to a fully pooled system while others would record higher revenues. Councils with vibrant property markets, higher numbers of companies and higher property values, as well as bigger increases in local tax base, would be more likely to secure higher NDR revenue. By contrast, councils with less vibrant rental structures, lower numbers of enterprises and lower RV, as well as smaller increases in the local tax base, would likely experience reduced revenues, irrespective of need for local services.

A city-region shared-gain business rates incentivisation scheme in Wales

- Instead of retention at council level, a reform which incentivises business rate revenue growth resulting from successful local economic development might be more attractive for Wales. This is all the more so in a context where Welsh local authority revenue funding for economic development fell by 74 per cent over the period 2009-10 to 2016-17, as austerity took effect and local authorities sought to protect funding for schools and social services. The loss of EU funding in the event of Brexit, if not replaced through the UK Government's proposed Shared Prosperity Fund or equivalent, would also mean a significant loss of economic development funding.
- As a starting point, this report discusses two possible ways of organising such a shared-gain scheme at the city region footprint. In each case the objective would be to incentivise the drive for economic development and strengthen the bond between local authorities within the City Region in pursuing shared regional goals.
- The first option is to apply the Scottish model at the City Regional level. One way in which this could be done is to set a city region baseline business rate target, for instance on the basis of the growth trend in business rate revenue, and each regional partnership would in effect retain the agreed portion of the revenues in excess of the target. This 'Scottish approach' would focus on the overall growth in economic activity as reflected in business rate growth, so not just confined to individual capital projects.

- An alternative option, an example of which has been advocated by the Swansea Bay City Region, would involve the retention of half of the business rates revenues yielded by the developments resulting from the city region investment. Such a scheme would focus on the business rates yielded by specific projects (e.g. new buildings or other tangible assets) created through the growth deals, over and above what the City Region would have received in the absence of those projects.
- The 'project-based' approach may skew City Regional incentives in favour of developing capital projects over other development projects, and it may be difficult to attribute which projects are part of the City Deal and which are not.
- Retained funds in both schemes could be made available to the regional partnerships to help finance their activities, taking account of the need for economically disadvantaged councils to benefit, with the balance going into the national business rates pool for redistribution.
- Both schemes would provide incentives to increase local economic growth and the local tax base, while mitigating the potential negative regional inequality effects of the City Regions.
- As an illustration, under a city regional NDR incentivisation approach, and assuming that business rate revenues grow at 1% per year due to the operation of the City Regions, Cardiff Capital Region would retain £2.57 million in 2019-20 (the next possible financial year of the scheme's implementation), the Swansea Bay City Region would retain £1.14 million, and the North Wales Growth Deal £1.14 million.

Key issues to note and questions to ask when considering business rates retention in Wales

- The issue of risk and detriment is crucial – a commitment to ensuring that no local authority loses out compared to what it would have received in the absence of retention suggests that any scheme has to be a) relatively modest in scope, and b) authorities have to be adequately protected while trading off that protection against the incentives to take on some risk and to grow their tax bases.
- There is limited evidence across the UK to date concerning the impact of such NDR schemes on the local economy, but it is worth noting that the mainstream political parties are all committed to regional economic strategies. Therefore, a thorough investigation of the potential impacts of business rates is required.
- Some operational issues, such as the impact of appeals on business rate income, should also be considered; this report notes such issues, but they lie outside the scope of the analysis.

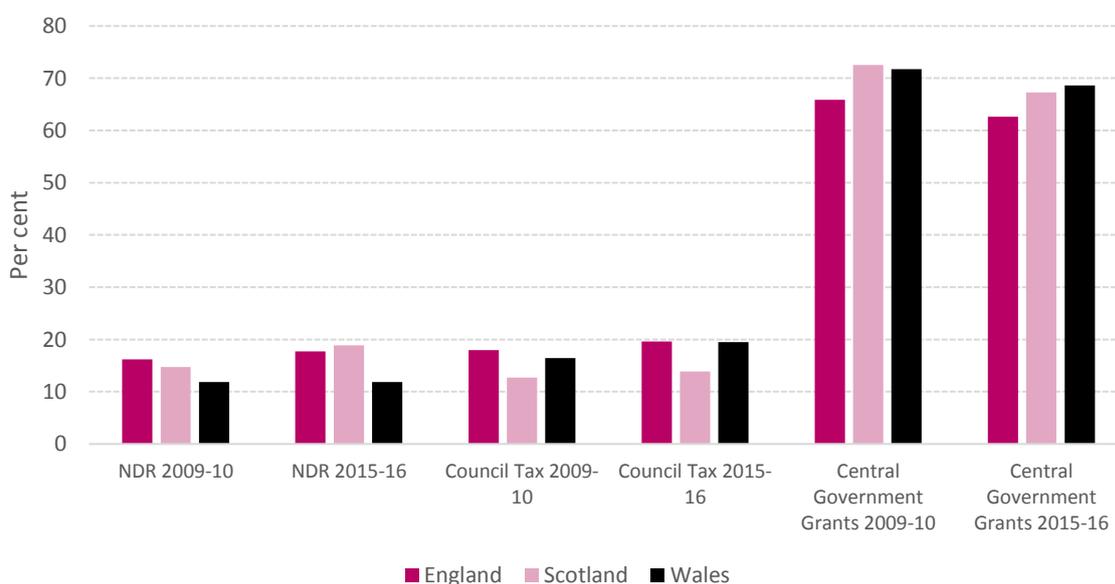
- Policymakers should aim at striking an appropriate balance between incentives to grow the tax base and regional economic performance on the one hand, and redistribution to minimise regional inequality on the other.

Introduction

Overview

In the context of austerity applied by the UK Government in the wake of the 2007 global economic crisis and the evolving devolution settlement for Wales, there has been a marked divergence in policy for local government finance between London and Cardiff. This has included very different approaches to central government funding for local authorities (with bigger cuts and a strong push towards self-financing in England as part of a 'localism' agenda), council tax (more flexibility over increases in Wales) and Non-Domestic Rates (NDR).² Broadly, local authority revenue stems from three main sources: central government grants (general and specific), council tax, and NDR. While local government finance experienced overall revenue cuts since 2009-10, its shape has been diverging among the devolved areas (Figure 1). For instance, the contribution of council tax income to the total local government revenues has slightly increased in Scotland between 2009-10 and 2015-16, whereas in Wales and England it recorded a much greater rise. Indeed, several Welsh councils increased their local tax rates to compensate for the reduced Revenue Support Grant (Ogle et al., 2017).

Figure 1: Sources of Local Government revenues as a percentage of total Local Government finance



Source: ONS (2011; 2016), Scottish Government (2011; 2017a), and for Wales: Financing of gross revenue expenditure (available here: <https://statswales.gov.wales/Catalogue/Local-Government/Finance/Revenue>) and in-year council tax collection (available here: <https://statswales.gov.wales/Catalogue/Local-Government/Finance/CouncilTax/Collection>).

Note: Central Government Grant includes the Council Tax Benefit before 2013-14, and Council Tax Reduction after 2013-14.

² In the rest of this paper, business rates are generally referred to by their more formal term, Non-Domestic Rates.

Although there has not been a fundamental shift in the approach to local government finance in Wales since devolution, various reviews and studies have discussed the issue (Business Rates Task and Finish Group, 2012; Welsh Government, 2012a; Independent Commission on Local Government Finance Wales, 2016; Wales Audit Office, 2016; Welsh Government, 2017a). Specifically, the local retention of NDR revenues was discussed and proposed by the Business Rates Task and Finish Group (TFG) in 2012. The Independent Commission on Local Government Finance Wales, established by the Welsh Local Government Association (WLGA) and the Chartered Institute for Public Finance and Accountancy (CIPFA), suggested a 100% retention of NDR revenue. The Welsh Government has not agreed to any retention scheme since NDR was devolved with effect from 2015-16 but the debate has been reignited by the establishment of the Cardiff Capital Region City and Swansea Bay City Region in the mid-2010s. These have advocated the retention of NDR revenues above a growth baseline to provide extra income to the City Regions (Cardiff Capital Region, 2016; Swansea Bay City, 2017).

Scope and structure

This report analyses the current NDR scheme in Wales and forms part of the wider efforts exploring different approaches to local government finance. Based on the evidence of the existing schemes in Wales, England, and Scotland, the basic goal of this report is to provide careful considerations for changes in the Welsh NDR scheme at the city regional level that the Welsh Government could take into account in the direction of providing incentives for economic growth, while protecting the budget of all the councils. It should be noted that some operational issues, such as the impact of appeals, and the impact of Brexit on business rate revenues, lie outside the scope of this analysis.

By examining the interrelationships between local governance, regional finance and public policy across space, this report provides a rigorous review of the existing NDR scheme in Wales and its proposed reforms.

First, it analyses the existing NDR model in Wales and the net difference between NDR settlements and contributions across individual local authorities. Second, it presents evidence about the NDR schemes in England and Scotland, and reviews the policy discussion to date on reforming the NDR scheme in Wales. Third, the report presents suggestions for how a City-Region shared-gain business rates incentivisation scheme could operate in Wales, and what the financial implications of such a scheme might be.

Wales: the existing NDR scheme and its contribution to local government finance

NDR constitute a tax on non-domestic properties (NDP). Total NDR revenues for a council are equal to the sum of the NDR that all the users of NDP pay. The business rate for a property is calculated by multiplying its Rateable Value (RV) by the NDR multiplier ('poundage'), minus any reliefs for which the property is eligible (Amin-Smith and Phillips, 2017). The RV is assigned by the Valuation Office Agency (VOA) and is equal to the floor area of the premises multiplied by the rental value per m². Starting from 2018-19, the poundage, which is the same for all the 22 Welsh councils, is set by the Welsh Government each year in line with the Consumer Price Index (CPI)³ according to its level in September of the previous financial year to which the poundage refers. The reliefs, which are funded by the Welsh Government, are set to reduce the business rates for small businesses, unoccupied properties, and charities.

Before 2015, NDR, after removing the appeals, used to be pooled with revenues generated in England;⁴ NDR were devolved to the Welsh Government in 2015. Since then, all NDR revenues are collected by the councils and are provided to the Welsh Government, which then redistributes them to the Local Authorities (LAs), based on their proportion of the population aged 18 and over, regardless of the income raised by each LA. The distributable amount of NDR revenues is used, alongside the Revenue Support Grant (RSG) and council tax, to finance the Local Government budget. NDR revenues are non-hypothecated, being spent by the councils to finance their local services and priorities, such as schools and social care.

The significance of the NDR in Wales has grown since 2009-10, in the context of budget cuts implemented by the UK Government to resolve the 2007 global economic crisis. Since then, NDR revenue contribution to the Welsh local government annual budgeted income has been steadily increasing from 10.9% in 2011-12 to above 12% in 2016-17, at a value of £1 billion (Luchinskaya et al., 2017).

The net difference between the NDR revenues distributed to each LA from the Welsh Government pool and the contribution each LA made to the pool was estimated in the period between 2000-01 and 2015-16⁵ (from now on, this will be referred to as 'difference'), using outturn data (see Annex 1). Some LAs receive more business rates income than they

³ The switch from RPI to CPI for indexation purposes was announced in the Welsh Budget for 2018-19.

⁴ Councils collected the NDR and transferred them to the Welsh Government. The latter would pay the business rates to the UK Government which would return them to the Welsh Government through the Welsh Block Grant. Therefore, NDR used to contribute to the Welsh Block Grant.

⁵ The 2015-16 financial year was chosen since it was the latest year that all data for NDR generation and its determinants was available.

contribute (positive difference), whereas for other councils the contributions exceed the settlements (negative difference). Ten LAs have never contributed more NDR revenues than they received, whereas seven councils have received less NDR revenue than they contributed for more than half of the 16 financial years between 2000-01 and 2015-16 (Table 1).

In order to paint a detailed picture of the existing NDR scheme in Wales, local authority characteristics were examined in relation to the NDR difference. Specifically, the analysis looked at the relationship between NDR difference and: gross value-added (GVA), property market (rateable value and number of non-domestic properties), unemployment rate, population, population density and average earnings, at the LA level.

According to the results of correlation and regression statistical analysis,⁶ the councils which tend to receive more NDR revenue than they contribute are likely to be the more economically underdeveloped, sparsely populated and rural councils, with relatively weak property markets. It is likely that these councils have a small tax base and low property prices, recording high unemployment, as well as low average earnings of citizens. In contrast, the councils that have a negative average NDR difference are likely to be the more economically developed, highly populated and urbanised councils. They are likely to have a buoyant property market, comparatively large tax base and higher property values, lower unemployment, as well as higher average earnings, compared to councils with a positive NDR difference. On balance, the existing NDR scheme financially supports the councils which are economically disadvantaged. Table 2 summarises the findings, showing a clear split between councils with positive and negative NDR difference.

⁶ The results and detailed analysis can be found in the full report which will be published on the website of Wales Public Services 2025 by May 2018.

Table 1: Summary of the net difference settlements-contributions for each LA

	No. of times NDR contributions exceeded settlements (2000-01 to 2015-16)	Average net difference in cash terms (£ million)	Average net difference per capita (£)
Isle of Anglesey	1	2.49	73.75
Gwynedd	8	0.04	0.36
Conwy	0	2.52	45.61
Denbighshire	0	2.82	61.70
Flintshire	16	-5.81	-78.93
Wrexham	10	0.05	0.64
Powys	0	5.28	82.93
Ceredigion	0	3.06	83.75
Pembrokeshire	6	-1.26	-20.49
Carmarthenshire	0	4.87	55.57
Swansea	9	-0.71	-6.24
Neath Port Talbot	2	1.32	19.71
Bridgend	11	-0.33	-5.09
Vale of Glamorgan	10	-0.65	-11.13
Rhondda Cynon Taf	0	7.33	64.33
Merthyr Tydfil	5	0.42	15.35
Caerphilly	0	6.71	78.48
Blaenau Gwent	0	3.34	99.04
Torfaen	0	1.81	40.83
Monmouthshire	0	2.01	45.87
Newport	16	-6.93	-99.7
Cardiff	16	-29.79	-182

Notes: Average net difference is calculated as average settlements less average contributions, 2000-01 to 2015-16. Figures are in cash terms. Source: Stats Wales (2018) and authors' calculations.

Table 2: A classification of the councils according to the NDR difference

	Councils with positive NDR difference	Councils with negative NDR difference
Features	Economically less strong	Economically more strong
	Weak property market	Vibrant property market
	Small tax base	Big tax base
	Rural councils	Urbanised councils
	Low property prices	High property prices
	Low populated	Highly populated
	Low average earnings	High average earnings
	High unemployment	Low unemployment

Government policy on business rates in England and Scotland

UK government policy on business rates in England

Until 2012-13, NDR revenues in England were collected by the councils, paid to the UK Government and then redistributed back to the councils, forming part of their funding from the UK Government. According to the report of the Department for Communities and Local Government (DCLG) in 2011, English councils did not have the sufficient certainty to structure long-term investment plans as they had no control of the locally raised revenues. Therefore, in 2013 the business rates retention scheme (BRRS) was adopted in England in order to incentivise local economic and business growth (UK Government, 2012). The provision of incentives for local economic growth through the BRRS assumed that the new scheme incentivises investment to new developments, buildings and premises, which would bring about a rise in the local tax base.

In 2013-14, the first year of the scheme, a baseline level of funding related to overall NDR was estimated for each council. NDR revenue baselines were created for each council, based on what councils got through reallocation. This baseline level of funding ensured that each council's revenues did not change as compared to the year of BRRS implementation (Amin-Smith and Phillips, 2017). In 2013-14, the business rates baseline was estimated, based on the gross NDR raised under the retention scheme in 2012-13, the first year of the implementation of the scheme, before tariffs and top-ups. Since 2012-13, local government retained 50% of the NDR revenues with the remaining 50% paid to the UK Government (DCLG, 2012; UK Government, 2012). According to the new regulations accompanying the retention scheme, councils whose NDR baselines were higher than their baseline funding level had to pay the difference (tariff) to the UK Government (CIPFA, 2013). The UK Government then reallocated this tariff as a top-up to those councils whose business rates baseline was lower than the baseline funding level (DCLG, 2012).

Therefore, councils that experience an increase in NDR revenues retain part of the extra revenue, while councils that record a decline of NDR revenues keep a proportion of the losses (Amin-Smith and Phillips, 2017). The amount of gains or losses that each council retains depends on two factors: the type of council, and the relative difference between business rates baseline and the baseline funding. First, the type of council determines how much of the NDR revenue can be kept: metropolitan boroughs and unitary authorities retain 49% (1% is provided to the fire authorities), in two-tier local government areas the districts keep up to 40% and counties up to 10%, while London boroughs keep up to 30%, and the Greater London Authority

– up to 20%. Second, how the business rates baseline level compares to the baseline funding also matters: if the business rates baseline is lower than baseline funding, the council retains the share (depending on the type of council as explained above). If the business rates baseline is higher, the council pays a levy, and the share that it keeps is gradually reduced down to 50% of the maximum level that a council of that type can retain (Amin-Smith et al., 2016). The levies are used to fund a safety net to protect only the councils recording a significant decline in NDR revenues – 7.5% below the baseline funding level (CIPFA, 2013).

Turning to its implications, the BRRS in England has given strong incentives to the councils to grow revenues and constrain spending needs (Amin-Smith et al., 2018). However, it has also increased the variability and unevenness of the local funding and regional development (Muldoon-Smith and Greenhalgh, 2015; Greenhalgh et al., 2016). The BRRS has the potential to benefit the budget of the councils with vibrant property markets and negatively affect the income of the LAs with less developed rental structures (Muldoon-Smith and Greenhalgh, 2015). Moreover, it could benefit the councils with the biggest increases in their tax base in cash terms (Amin-Smith et al., 2018). Another problem arises when considering that tariffs and top-ups are dependent on inflation,⁷ whereas non-domestic rates are not, thus strengthening the possibility of local funding divergence across England, even if the NDR revenues record the same growth rate in all the councils (Amin-Smith et al., 2016). Indeed, under the new regulations only the cash baseline level of funding is protected.

Amin-Smith et al. (2016) have estimated that 52 councils, mainly district councils with a small budget, have increased their income by more than 5%, whereas 119 councils, particularly the large county councils with a large budget, have recorded losses. Even councils with a noticeable commercial tax base were found to lose from the new scheme, due to certain impediments that negatively affected NDR revenues, such as backdated appeals which vary significantly across space (Amin-Smith and Phillips, 2017). The 75% and 100% retention schemes are projected to cause important divergence of funding available to the English councils (Amin-Smith et al., 2018). While under the previous system, the liability for appeals and mandatory reliefs was pooled by the UK Government, under the new scheme, based on the principle of sharing some costs and some benefits, English councils must internalise 50% of the liability in mandatory reliefs and 50% of the liability for outstanding appeals (Amin-Smith et al., 2016). Therefore, the National Audit Office (2017) has highlighted the risks that many English councils face regarding their ability to fund the local services, and that potential BRRS

⁷ Under the new regulations only the cash baseline level of funding is protected.

effects on local economic growth have not been formally assessed prior to BRRS implementation.

Scottish Government policy on business rates in Scotland

The NDR scheme in Scotland has seen several changes in the last decade. Since 2011, in practical terms, the councils retain the whole amount of business rates income they generate (Scottish Parliament, 2015). In 2012, the business rates incentivisation scheme (BRIS) was established to provide the councils with incentives to increase their NDR revenues (Scottish Government, 2012).

Since 2012, 'each local authority that exceeds its individual non-domestic rate income target will retain a half share of the additional rates income generated. Those local authorities that do not reach their target will continue to be compensated by the Scottish Government' (Scottish Government, 2012: 25). The local target is calculated based on the growth of RV, and subsequently of NDR. That is, if the RV rises above the target in a local authority, the council retains 50% of the additional NDR revenue and provides the rest to the Scottish Government (Amin-Smith et al., 2016). By contrast, if RV is lower than the target, then the amount provided by the Scottish Government increases to compensate the loss (Scottish Parliament, 2015).

Under the Scottish system, the budgets of all the councils are protected as the Scottish Government adjusts the RSG in a way that councils receive at least the same amount of funds with the initial year of retention implementation (Amin-Smith et al., 2016). Councils are asymmetrically exposed to risk of not meeting their targets: they are rewarded for doing well, and are protected against performing poorly, thus weakening the marginal incentives for councils performing just under their target to grow their revenues.

This incentivisation scheme has not generated large amounts of retained NDR revenue (Amin-Smith et al., 2016). In 2012-13, out of the £2,346 million NDR generated, only £9 million (0.38%) was retained by 12 out of the 32 councils (Scottish Government, 2014). This amount declined to only £2.5 million for 2014-15 retained by 7 councils (Scottish Government, 2016). In 2015-16, the latest year that outturn data is available, £6.3 million was retained by 8 councils (Scottish Government, 2017b).

Comparison of the English and Scottish NDR retention schemes

Overall, local NDR revenue retention schemes in England and Scotland had different internal mechanics, yet both aimed at incentivising the growth of the local tax base. However, the

retention scheme in England has also created winners and losers, increased the vulnerability of many councils' budgets, and split the councils between 'premium' and 'redundant' locations (Muldoon-Smith and Greenhalgh, 2015). The key features and implications of the two retention schemes are summarised in Table 3.

Table 3: The NDR system and its implications in England and Scotland

	Regulations	Implications
England (BRRS)	<ul style="list-style-type: none"> • 50% NDR retention, tariffs, top-ups and levies • Retention of potential growth or loss of NDR • 75% retention in 2020 • Pilot implementation of 100% NDR retention in 10 counties, including Surrey and London in 2018-19 	<ul style="list-style-type: none"> • Exposure to upward and downward NDR revenue risk creates strong marginal incentives to grow tax base • Benefits for the councils with the biggest increases in their tax base in cash terms • Risk of uneven local funding (depending on which areas are more able to take advantage of the incentives created by business rates)
Scotland (BRIS)	<ul style="list-style-type: none"> • Councils receive back the whole amount of business rates income they generate • Councils are protected against underperformance • NDR growth incentivisation scheme 	<ul style="list-style-type: none"> • Protection against downward NDR revenue risk has not provided strong incentives to increase the tax base – marginal incentives exist for councils performing above target, but not for those performing below target • The scheme has not yet led to big amounts of revenues retained

The underlying factor is that LAs record crucial differences in terms of the property market: various levels of non-domestic properties across space, spatially differentiated rateable values, and geographically varied reliefs (Greenhalgh et al., 2016). This implies that any localisation of a centrally managed local tax could entail a divergence of councils' funding.

A hypothetical scheme of NDR retention at council level in Wales

In 2011, before NDR were devolved, the Welsh Government tasked the Business Rates Task and Finish Group (TFG) to examine the way the NDR scheme could be configured in order to encourage and boost local economic growth. The report recommended, among other actions, the devolution and retention of NDR revenues and the adjustment of RSG to each council, in such a way that total funds available for each LA would not change (TFG, 2012). The Group proposed a 100% retention of NDR revenues for two years, which would then drop to 50%. It is worth noting that the TFG did not model the impact on individual LAs. The response of the Welsh Government was unenthusiastic. Although it highlighted that its priority is to create jobs and boost economic growth, recognising the economic significance of the link between the funds raised and spent by the councils, it postponed any decision about local retention of NDR revenues until the decision for NDR devolution to Wales was made (Welsh Government, 2012b).

In 2016, the WLGA and CIPFA tasked the Independent Commission on Local Government Finance in Wales (ICLGFW) to make recommendations for the reform of local government funding, taking account of the evolving devolution settlement for Wales (the Travers review). The ICLGFW (2016) suggested a 100% retention of NDR revenues from the 22 councils in order to facilitate more flexibility in local decision-making, promote self-reliance and entrepreneurship. Alongside the retention, the Commission suggested adjusting the RSG of each council in such a way that total funds available for each LA would not change. This RSG adjustment would be just for the initial year. After Year 1, councils could either gain or lose revenues according to the level of NDR they raised. With such a BRRS, councils would be incentivised to grow their local tax base income and achieve economic growth by investing funds to increase their number of NDP. The response of the Welsh Government was again negative as it 'would benefit only a small number of authorities and would result in significant cuts to the budgets of the majority' (Welsh Government, 2017a: 14). Overall, proposals of both reports were not specific in the sense that formulae were not brought forward and the schemes were not described in a systematic way.

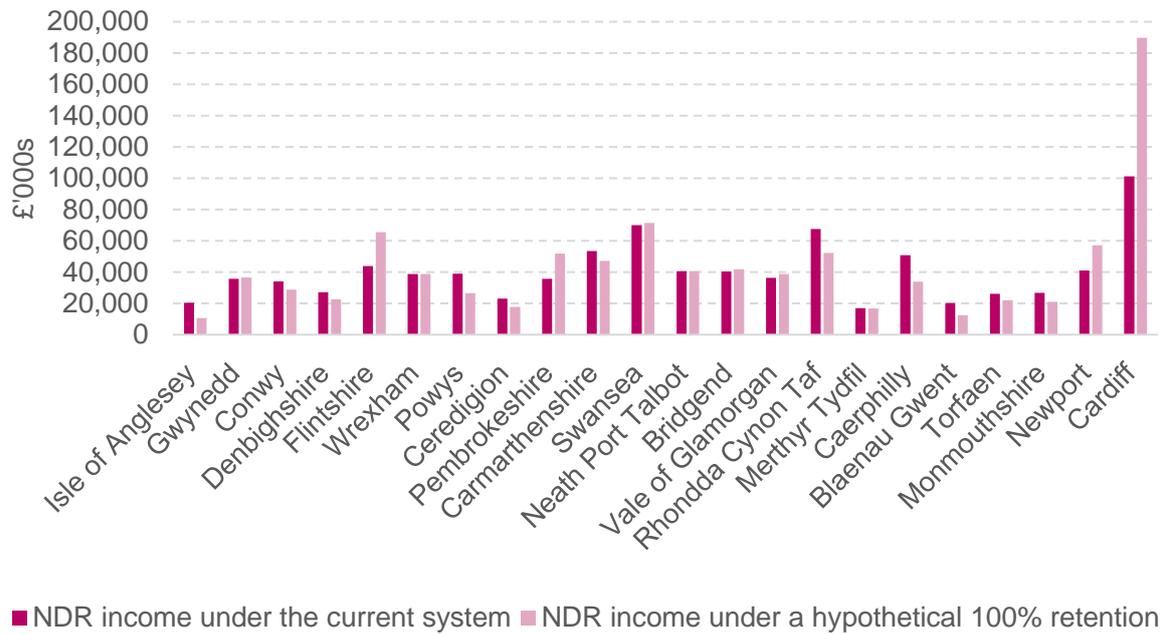
As a benchmark, we compute a simple NDR retention scheme, a hypothetical 100% retention of NDR without RSG adjustment. Under this simple scheme, some councils would see their revenue falling relative to a fully pooled system while others would record higher revenues. Such a hypothetical system could result in an increasing divergence between councils in their

relative income and spending (geographical impact). Councils with vibrant property markets, higher numbers of companies and higher property values, as well as bigger increases in local tax base, would be more likely to secure higher NDR revenue. By contrast, councils with less vibrant rental structures, lower numbers of enterprises and lower RV, as well as smaller increases in local tax base, would likely experience reduced revenues, irrespective of need for local services. Therefore, a simple 100% NDR retention scheme could increase the financial pressure on these councils regarding the delivery of basic social services provided at the local level across Wales (sectoral effect).

The impact of a simple 100% NDR retention scheme without redistributive elements can be summarised as follows. Based on the average difference between the revenues under a simple 100% NDR retention and the NDR revenues under the existing Welsh scheme for each council over 2009-10 and 2015-16, eighteen councils would have seen their revenue falling, while only four would have seen a rise in their revenues. If the NDR retention had been applied since 2009-10, eleven councils would have seen their revenues falling drastically in all financial years (the average fall per head of population in these councils would be £79), seven LAs would have had mixed results (some years with positive and some years with negative difference) and only four councils would have recorded increased revenues at each year over the period. Figure 2 compares LA incomes under the existing NDR regime with the estimated revenues under the simple 100% NDR retention benchmark for each LA in 2015-16.

It is important to note that this estimation does not model the NDR retention in Wales by councils and thus does not account any tariffs or top-ups, as the English system does. The aim of the calculation, demonstrated in Figure 2, is to highlight the redistributive mechanism of the current NDR system. In the actual application of a 100% retention to the Welsh councils, either the RSG should be adjusted or a mechanism of tariffs and top-ups should be established.

Figure 2: NDR revenue with and without simple 100% retention for each council, 2015-16, £ thousands, cash terms



Source: Stats Wales (2018) and authors' calculations

The City Regions and Growth Deals in Wales

Two developments have put the question of NDR retention back on the policy agenda. The full devolution of NDR to Wales from 2015-16 has given the Welsh Government the powers to make such reforms as it wishes. The encouragement of a more systematic approach to regional collaborations across local authorities for the purposes of economic development and delivery of some public services as a cornerstone for local government reform in Wales is creating a fresh context for thinking about NDR.

Two recent economic development policy documents from the Welsh Government have both emphasised the importance of regional economic collaborations (Welsh Government 2017b & c). The UK and Welsh Governments have both responded positively to the establishment by local authorities and partners of City Regions in Wales in order to achieve sustainable, inclusive, and fair economic growth (Welsh Government, 2017b). There are two existing city region and growth deals, involving 14 councils in south and west Wales, a third is under negotiation for north Wales, involving 6 councils, and a final one is in prospect in Mid Wales (UK Government, 2017a).

The Cardiff Capital Region City Deal (CCR) was signed in 2016 and is a partnership between the Welsh Government, the UK Government, and the councils for Cardiff, Vale of Glamorgan, Caerphilly, Blaenau Gwent, Newport, Monmouth, Torfaen, Bridgend, Rhondda Cynon Taf, and Merthyr Tydfil (Cardiff Capital Region, 2016). It has secured £1.3 billion of public investment and covers a period of 20 years, aiming at stimulating regional economic growth, reducing unemployment, upgrading people's skills, and improving transportation (Economy, Infrastructure and Skills Committee, 2017). It is expected to deliver 25,000 jobs and attract £4 billion of private sector investment. The projects included in the deal are funded by the Welsh Government (£500 million, provided from 2016-17 to 2022-23), the UK Government (£500 million) and the ten local authorities (£120 million). The councils will contribute to the Investment Fund in proportion to their population. The projects of the CCR have not been set out in detail and are currently being specified. They are dominated by the South East Wales Metro (£725 million), involving the delivery of the Metro Central transport hub in Cardiff, a new coach and tram station, and four new train stations (Wentloog, Splott, Llanwern, and Roath). Moreover, CCR invested £37.9 million to build a factory for compound semiconductors in Newport (Cardiff Capital Region, 2017). Finally, the CCR is expected to invest in the development of a skilled workforce through actions that involve, among others, the establishment of the CCR Skills and Employment Board.

The Swansea Bay City Region (SBCR) deal was signed in 2017 and is a partnership between the Welsh Government, the UK Government, and the councils for Swansea, Neath Port Talbot, Carmarthenshire, and Pembrokeshire (Swansea Bay City, 2017). It has secured £600 million of public investment, and covers a period of 15 years, aiming at accelerating regional economic prosperity, developing jobs of high value and technology, and addressing the transformational economic power of digital networks (Economy, Infrastructure and Skills Committee, 2017). It is expected to increase the regional GVA by £1.8 billion and deliver 10,000 new jobs. The Welsh Government and the UK Government will contribute up to £125.4 and £115.6 million respectively, while the four councils, two universities and two health boards are expected to contribute £396 million to the Deal (Swansea Bay City, 2017). Specifically, the councils will contribute £240 million, through borrowing. The design of the projects is at a more advanced stage than the CCR, since SBCR and North Wales Growth Deal (NWGD) are growth deals. Therefore, their boards needed to present specific projects before the agreement with the UK and Welsh Government. The SBCR Deal involves eleven projects (total cost £1.274 billion), such as the Swansea City and Waterfront Digital District that will create incubation space for start-ups and small companies at the Swansea Waterfront development. Another project is the Skills and Talent Initiative, to improve people's skills.

Finally, the North Wales Growth Deal (NWGD) is currently under negotiation involving the councils for Flintshire, Wrexham, Denbighshire, Gwynedd, Isle of Anglesey, and Conwy. It seeks to secure £380 million of public capital investment from the UK and Welsh Governments, attract £1 billion of private sector investment, and create 5,300 jobs by 2035 (UK government, 2017b). The suggested projects include, among other actions, the expansion of Wrexham's industrial estate and the redevelopment of Holyhead Port (Gwynedd Council, 2017).

It is clear that the city region and growth deals are a significant pillar of the regional economic development policy of the Welsh Government which has pre-allocated funding for these deals. However, the allocation of funding from the UK Government is guaranteed only for the first five years of the deals, with subsequent assessments (every five years) for unlocking further funding. These five-year windows mean that there is some uncertainty about future UK government funding over the longer term. However, the income that the City Regions are expected to generate, based on regional economic growth, could be seen as a long term funding stream. The rest of finance will be provided by the councils through borrowing (Cardiff Capital Region, 2016; Swansea Bay City, 2017). Finally, economic issues, such as Brexit, could imply unpredicted changes in funding allocation (Economy, Infrastructure and Skills Committee, 2017). Thus, the need for extra funding to carry out the city region deals becomes apparent.

The National Assembly for Wales Economy, Infrastructure and Skills Committee (2017) has identified three issues for the city region and growth deals in Wales. First, the positive impact of the city region schemes could be unevenly distributed across the Welsh regions, thus deepening the inequality within and among them. Second, there is a question about the risk of competition between the Welsh regions leading to a ‘race to the bottom’ in terms of business incentives, including NDR, with negative consequences for the economically disadvantaged regions (Bevan Foundation and Joseph Rowntree Foundation, 2017). Finally, it expressed concerns about the quality of collaboration within the regions, which could influence the impact the regions might have.

Box 1: Main risks to City Regions in Wales

1. Rising regional inequalities
2. High regional competition
3. Possibility of lack of funds
4. Quality of collaboration

Source: Bevan Foundation and Joseph Rowntree Foundation (2017) and Economy, Infrastructure and Skills Committee (2017)

Options for a city-region shared-gain business rates incentivisation scheme in Wales

This section discusses NDR retention that could be implemented in Wales, focusing on incentivisation schemes (partial retention) rather than a blanket retention. Two different models of incentivisation schemes are discussed at a city regional level: an application of the Scottish NDR incentivisation scheme and a project-based NDR incentivisation scheme. Suggestions for key issues to be considered to ensure that the incentivisation schemes are implemented effectively are discussed.

Both City Regions in the south of Wales are advocating the retention of NDR revenues at city region level above a growth baseline to provide income for implementing the deals (Cardiff Capital Region, 2016; Swansea Bay City, 2017). In other words, they refer to a business rates growth incentivisation model. Specifically, the CCR seeks ‘the devolution of business rate income above an agreed growth baseline’ (Cardiff Capital Region, 2016: 6). The SBCR refers to a scheme based on business rates yields from projects financed through the city region deals. Specifically, it states that ‘there will be an opportunity for the additional business rate income to be utilised to support part of the revenue implications of these projects’ (Carmarthenshire County Council, 2017: 7). However, only loose details about the type of NDR retention suggested by the City Regions are available.

If the Welsh Government were to introduce an NDR incentivisation scheme that protected the budget of all the councils and incentivised growth at the city regional level, then the mechanics and the implications of this scheme should be described and evaluated in detail, in order to avoid a situation similar to that in England where the reform of NDR model has not been formally assessed before its implementation (National Audit Office, 2017).

The rationale for a city regional rather than a council-based NDR incentivisation approach is 1) that in the city region case, the NDR raised is based on a number of selected councils, rather than individual councils, 2) that the scheme would still be local enough to take local variation into account, and 3) that it would build on the regional development aim of the city regions, as well as help mitigate potential increases in regional inequality as a consequence of the city regions. However, this approach also raises the question related to the way that the nature of the trade-offs between incentivising tax base growth and preventing widening regional inequality changes when moving from a council-based NDR incentivisation scheme to a regional NDR incentivisation scheme.

Option 1: Applying the Scottish NDR model to City Regions

One simple option of an NDR retention scheme would be to take the Scottish model and apply it at the city regional level. The projects of the City Regions and the growth deals per se are expected to entail a significant uplift of the local tax base alongside a growth in economic activity, which would imply a rise in NDR revenue. Overall, this approach would take account of the overall growth in economic activity as reflected in business rate growth, so not just confined to capital projects.

The suggested mechanics of applying a Scottish BRIS-type scheme to the Welsh City Regions are as follows:

- In seeking to frame a policy scheme that does not disadvantage any council, there would be no change to the existing model of NDR revenue. In other words, the existing NDR scheme at the council level remains unchanged, and on top of this, a city regional BRIS is implemented.
- The Welsh Government would set targets for the expected NDR revenue generation in the City Regions, aggregating the respective business rates generated in the councils of each city region. The NDR revenue target would be estimated using the historical average growth rate of business rates contribution in the councils of each city region: 3.16% for CCR, 3.94% for SBCR, and 2.78% for NWGD.
- At the end of the financial year, the Welsh Government would assess whether the NDR revenue generation in a city region (based on outturn data) reached its target. If it exceeded the target, the city region would be allocated 50% of the revenues in excess of the target. The remaining 50% would be pooled by the Welsh Government with the NDR revenues from the existing scheme for redistribution through the existing population-based formula.
- There are options for how the city region retained funds could be handled. One would be for the city region boards to allocate, on a collective basis, the retained NDR revenue towards the shared priorities, taking account of the need for economically disadvantaged councils to benefit. An alternative might be for the funds to be distributed to the participating councils as an incentive to them to approve the planning permission and facilitate wider development around city deal projects.
- The city-region-driven NDR revenue, redistributed to the 22 councils, would be non-ring-fenced. Councils could, for example, spend this revenue to increase the funding for the social services, or on other priorities.

- The fact that two councils are not included at the moment in city region deals at the moment, i.e. Powys and Ceredigion, should be considered. Thus, specific attention should be paid to the financial support of these two councils.

Option 2: The project-based scheme

Another option for a scheme would be a shared-gain approach to the growth of business rates at a city regional level based on the projects promoted by the city region which are related to non-domestic property use. These projects are expected to generate significant business rates revenues which will be additional to the existing NDR revenue.

A scheme such as this might take the following broad shape:

- The City Regions would retain the 50% of the NDR revenues that will be generated by the city region and growth deal projects. The remaining 50% is provided to the Welsh Government.
- A scheme would need to clarify what properties are included in the scheme:
 - a. non-domestic properties that are clearly included in the projects of the City Regions, such as the factory for compound semiconductors in Newport and the new train stations of the South East Wales Metro;
 - b. companies that will be located in new premises funded by the City Regions, such as a store in one of the new train stations and a company in the Swansea Waterfront development;
 - c. businesses attracted to premises not funded by the City Regions but close to the projects that were funded by them. For example, the Cardiff Metro Central transport hub is likely to attract new enterprises in the perimeteric area. Whether these new companies would be included in the scheme, and for how long, or not would need to be clarified.
- A scheme would need to include provisions for a number of situations summarised below (further detail is included in Annex 2):
 - a. if aggregate baseline NDR revenue of the councils involved in a city region registered decline (say by more than -5% in a financial year);
 - b. where city deal projects involve relocation, for example of an existing NDR-generating business within the region;
 - c. where buildings related to the city deal projects remain empty.
- Each project, related to non-domestic use, that is approved in the city region deals, after the beginning of the incentivisation scheme, will be treated similarly to the projects that were present at the outset of the city region scheme.

- Two conditions related to the city region functioning could boost the efficiency of the scheme. First, the new developments, introduced in the new NDR retention model, could address basic social needs, satisfy sustainable economic growth conditions, and respect the environmental footprint. Second, the City Regions should minimise the risk of overbuilding, by not focusing only on new and speculative developments (Economy, Infrastructure and Skills Committee, 2017). Indeed, the retention of NDR and the subsequent efforts to increase non-domestic income through new floor space development could entail overbuilding (Muldoon-Smith and Greenhalgh, 2015).
- The city regions would bear 50% of the liability for appeals related to NDP stemming from the projects included in the city region deals. Therefore, the councils in the city regions would face two different types of appeals. First, appeals arising from the current system, whereby the liability for appeals is pooled by the Welsh Government. Second, the appeals related to the projects of the suggested system, whereby the city regions have the 50% of the liability. This accounts for the benefits of the shared-gain scheme, based on a sharing financial risks principle. Similarly, the city regions would bear 50% of the liability for reliefs relating to SMEs, charities, and empty properties.
- The rest of the suggestions regarding the use of the retained NDR revenue by the City Regions and the Welsh Government are the same as the first version of the scheme discussed above.

Comparing the two options

Summarily, in the Scottish-type scheme applied at the City Regions level, a target for NDR revenue based on historic (pre-City Region) growth would be applied. If the total City Region NDR revenue were to exceed this target, the City Region would retain 50% of the difference between the revenue collected and the target set.

In the project-based scheme, half of the NDR revenue generated through the City Region projects would be retained at the City Region level. The implementation of the Scottish-type scheme might seem more straight-forward, due to the simpler model setup. Both the Scottish-type and the project-based schemes are expected to have similar financial implications for Welsh councils.

In the case of the project-based system, it should also be considered that a direct link between City Region capital projects and retention of the city-region-driven NDR may provide incentives for the City Regions to invest in property investment (potentially crowding out private investment and/or seeing resources diverted from investments that have higher returns but no

direct business rates revenues – e.g. investment in skills, transport, etc.), and skew City Region spending. Conversely, if the link between City Region projects and NDR retention were less direct, it may be difficult to police the boundaries between what counts as a City Region project, and what does not.

Both Scottish-type and project-based approaches to NDR retention at the City Region level could also help mitigate the potential negative effects of the City Regions in terms of the potential widening of regional disparities.

The implications of the city-region shared-gain NDR incentivisation scheme for Wales

Both the incentivisation schemes at city regional level discussed above have positive financial implications. In all cases, the city regions bring projects and revenues. This report argues that these projects and subsequent growth could be accompanied by NDR retention in order to boost the economic efficiency of the City Regions.

Based on this, the NDR incentivisation scheme seeks to achieve five specific goals. First, to boost the chances of achieving the city region deals' goals. Second, to overcome weaknesses of the city-regional planning, such as rising regional inequalities. Third, to incentivise economic growth. Fourth, to provide more flexibility to the regions to adapt to local funding challenges. Finally, to support the funding for local services.

Importantly, in this report we do not argue whether the City Region NDR incentivisation scheme would result in extra NDR revenue, or whether the same NDR revenue would have been obtained through the City Regions but in the absence of incentivisation. If the City Regions developments are driving the NDR revenue growth, then retention may make little difference to the NDR revenues gained. The NDR revenues that would have been raised in the absence of retention could have been used to increase spending on local council services via the RSG, or on public services provided by the Welsh government.

The funds from the incentivisation scheme could be used to support councils' funding for city region deals projects in the short term, and, thus, to bring economic development to the city regions. In the long term, the retained NDR revenues could stimulate regional investment, for creating jobs, building infrastructure based on local needs, and, overall, promoting regional economic growth, which are the basic targets of the Welsh Government post-Brexit regional policy and of the city region deals (Welsh Government, 2017c). These benefits would be important considering that the local economic development spending has seen the highest percentage of local government spending cuts: it fell from £86 million in 2009-10 to £23 million in 2015-16, recording a 74% decline (Ogle et al., 2017). On these grounds, a city-region shared-gain model could increase the capability of the councils to respond creatively and flexibly to local issues. The financial benefits are multiplied when considering that the larger projects of the city region deals are expected to raise the property value of the local area, thus additionally increasing NDR revenues, from both the existing scheme and the proposed incentivisation scheme.

The city-region-driven NDR revenue is also important considering the possible loss of EU regional financing post-Brexit. While the UK Government has promised a Shared Prosperity Fund, only limited information about this fund is available, and it is not clear whether all of the funding that Wales currently receives from European Structural and Investment Funds would be covered.

The city-region-driven funds from the proposed NDR incentivisation scheme could also be used to reduce councils' debts and/or to finance the interest. This would be helpful because councils finance the current projects of the city region deals through borrowing (Cardiff Capital Region, 2016).

The proposed NDR incentivisation scheme has further important positive implications. First, the budgets of all the 22 Welsh councils would be protected against a reduction in NDR revenues, and the city-region-driven income that would be redistributed from the proposed NDR scheme would increase the funding to local services and improve people's lives across Wales. Second, the proposed scheme could provide incentives to city regions to increase the NDR revenue that they generate and retain, as each extra project would imply an increase in the councils' local tax base. All the councils are expected to benefit. On one hand, councils with less buoyant property markets would benefit because the scheme suggests that the 50% of the city-region-driven NDR revenue be retained at the city regional level and then used in a way that benefits all the councils. On the other hand, the incentivisation scheme could also improve the likelihood that even councils with less buoyant property markets would attract new and big developments as the city region deal should involve projects in all the councils. In the absence of this scheme, the funds and projects would predominantly be directed to councils that are wealthy and attractive to investors. Third, the proposed scheme could boost growth in economically disadvantaged Welsh councils, as recommended by the Bevan Foundation and the Joseph Rowntree Foundation (2017). In fact, the scheme seeks to strengthen the case for the spatially equal distribution of economic growth stemming from city regions and their projects.

However, under a City Region NDR retention, a trade-off arises between how much redistribution is made and the incentive for individual councils to approve developments. How stark this trade-off is would depend on where the nexus of decision on development making lies (council level, more regional planning, or at the Welsh Government level, and how decisions about development are negotiated), and how much individual councils care about each other's outcomes.

Two factors strengthen the argument for a positive impact of the scheme on equality across the Welsh regions. First, the NDR multiplier should be the same for all the city regions in order

to minimise the risk of increasing regional competition, which has been identified as a basic concern with regard to the city regions deals. Second, the scheme suggests that the retained NDR revenues are allocated by the City Region boards towards the shared priorities, on a collective basis, taking account of the need for economically disadvantaged councils to benefit. Therefore, the incentivisation scheme aims at restricting regional inequalities, based on close working collaboration between the local councils, the city region boards, and the Welsh Government.

Box 2: Main implications of the city-region shared-gain business rates incentivisation scheme

- Funding for City Regions: investments, reduction of councils' debt
- Raising the property value of the local area, thus additionally increasing NDR revenue
- Increasing the capability of the councils to respond creatively and flexibly to local issues
- Incentivisation of local tax base and NDR revenue increase in all the councils
- Mitigation of potential rise of regional inequalities
- Minimising the risk of increasing regional competition
- Avoiding the negative effects of NDR retention at the local level
- Financial support for the local public services

Scenarios for the financial implications of the shared-gain scheme for the three City Regions in Wales

This section discusses three scenarios that consider the financial implications of a shared-gain NDR incentivisation (partial retention) scheme for the three city regions in Wales (CCR, SBCR, and NWGD). The scenarios show how much City Regions might expect to retain in NDR revenue under a shared-gains incentivisation scheme (a Scottish-type scheme or a project-based scheme, or any such scheme) depending on the increase of NDR income stemming from the establishment of the City Regions. Moreover, this report calculates the NDR revenue, resulting from the City Regions, that would be provided to the Welsh Government for redistribution.

We do not use the scenarios to show who would lose or gain from the incentivisation scheme for the following reason. Councils and the Welsh Government would both gain from the scheme only if it is the incentivisation scheme itself that is driving overall NDR revenue growth through faster growth in the City Region tax base. But, if the City Region developments themselves (and not rates retention) are driving the NDR revenue growth, then the Welsh government would have also received that revenue growth in the absence of rates retention. In that counterfactual, the Welsh Government could have used that NDR revenue stemming from City Regions developments to increase the Revenue Support Grant to councils, leading to a redistribution between councils and the Welsh Government and resulting in winners and losers. In this report we do not model this counterfactual, and do not seek to estimate the net impact of the incentivisation scheme at the City Region level.

The scenarios calculate the amount of city-region-driven NDR revenues retained by the City Regions for financing the needs of each City Region, and the city-region-driven NDR revenues provided to the Welsh Government, for redistribution among the 22 councils. The NDR revenue growth in Box 3 is assumed to stem from the City Region developments (not in addition to City Region developments). The scenarios demonstrate how the City Regions and the Welsh Government split the NDR revenues resulting from the City Regions.

It should also be noted that these scenarios are not forecasts or predictions of what will happen after the establishment of the City Regions and after considering the top-up impact of the incentivisation. Instead, they are 'what-if' projections based on the existing knowledge and trends about NDR revenue generation.

Box 3: Scenarios for the NDR incentivisation scheme

City Regions retain 50% of the city-region-driven NDR revenues, assuming that either:

- NDR revenue increases by 1% for every year in the three city regions, after removing the reliefs and appeals, or;
- NDR revenue increases by 3% per year, other conditions as above, or;
- NDR revenue increases by 5% per year, other conditions as above.

The Welsh Government collects the remaining 50% of the city-region-driven NDR revenues and pools them alongside other NDR collected. These NDR are then redistributed to the 22 councils alongside the RSG.

The increase in NDR revenues comes in from 2019-20, and is modelled to 2021-22.

The first scenario refers to a growth in NDR revenues of 1% in cash terms for every year in the three city regions, after removing the reliefs and appeals, the second scenario assumes a 3% growth in business rates generated in the CCR, SBCR, and NWGD, and the third scenario refers to a 5% growth in NDR revenues.^{8, 9, 10, 11} The scenario-making process begins from the next possible financial year of the scheme's implementation, 2019-20, and extends to 2021-22. The latest available data for NDR at the council level is for the financial year 2017-18 (estimates, rather than outturns).

Unfortunately, forecasts for future NDR revenue generation for each council are not available. Therefore, the numbers used in this report for future NDR revenue generation for each city region are based on the average NDR revenue growth rate for those regions¹² from 2000-01 to 2015-16.¹³ Figure 3 compares the three scenarios with the status quo: no operation of the City Regions and no retention at the city regional level. In other words, the baseline trend is the projected NDR generation in the councils comprising the three City Regions, and the three

⁸ The 1%, 3%, and 5% growth rate in each scenario was based on the average growth rate of NDR in each city region between 2000-01 and 2017-18: 3.16% for CCR, 3.94% for SBCR, and 2.78% for NWGD.

⁹ The specific levels if NDR rise are above CPI.

¹⁰ This income becomes more important considering that the Welsh Government has not accounted for NDR income from the city region projects in its projections for NDR revenues in the short-term future, as these projects are at an initial stage.

¹¹ Brexit and its possible implications should be considered when calculating NDR revenue projections. However, at present, the uncertainty surrounding possible Brexit implications is too high to include in the modelling and is therefore beyond the scope of this report.

¹² It should be mentioned that NDR growth in Wales overall and in the three city regions is rather volatile with high standard deviation and coefficient of variation values.

¹³ The projections for the NDR income generated in each council were double-checked by employing the linear trend line projection method (Black, 2012). The results were very similar to the method based on average growth rate used in this report.

scenarios show how much of the NDR revenues stemming from the City Regions the City Regions and the Welsh Government would retain, depending on the NDR revenue growth rate.

In all three scenarios, the retained NDR income ranges from £1 million to £13 million, for all city regions (see Annex 23 for details).¹⁴ Under scenario 1, CCR would retain £2.7 million in 2021,¹⁵ while the SBCR would retain £1.2 million, and the NWGC – £1.176 million. Under scenario 2, CCR would retain £8.2 million in retained NDR revenues, SBCR – £3.7 million, and NWGD – £3.6 million in 2021-22. The cumulative impact of the city-region-driven NDR revenues should also be considered. For instance, scenario 3 would result in the retention of £40 million of NDR revenues for the CCR between 2019-20 and 2021-22. Considering that the agreed total amount of the 20-year borrowing for the 10 CCR councils is £120 million, the £40 million could cover a third of the cost of this borrowing, in just the first three years of implementation of the incentivisation scheme (2019-20 to 2021-22), if the conditions for scenario 3 were to hold. Recall that these retained revenues do not take into account what the same regions would have received if the City Regions developments had gone forward but rates retention was not introduced.

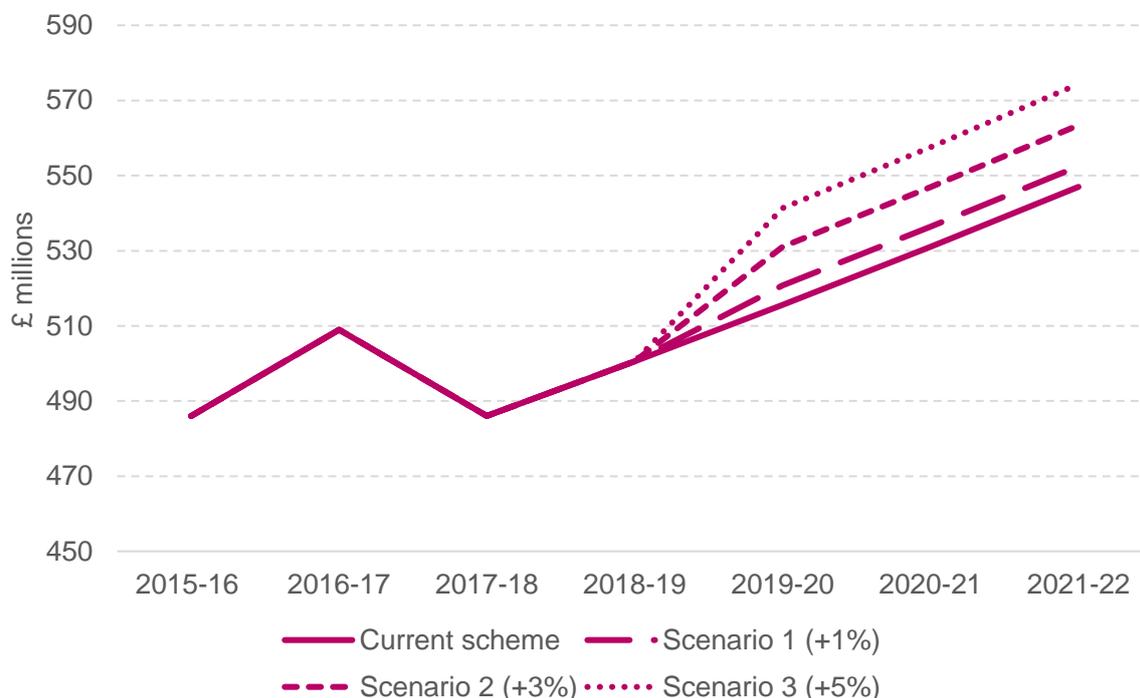
¹⁴ In order to estimate the retained NDR revenue generated in the region, the model that was used is the following:

$$Y_{r,t} = aX_{r,t} * 0.5$$

Where $Y_{r,t}$ is the city-region-driven business rates generated in region r in year t , $X_{r,t}$ is the projected NDR income generated in region r in year t without the city-regional retention scheme, and a is the rate of increase of NDR income in each scenario.

¹⁵ For instance, the semiconductor factory is expected to contribute £172,000 of NDR revenues for CCR in one year, based on the poundage for 2018-19.

Figure 3: Projected NDR generation in the CCR based on the three scenarios, £ millions, cash terms



Source: Stats Wales (2018) and authors' calculations

The Welsh Government would add the city-region-driven NDR revenue to the pooled NDR revenue from the existing scheme and redistribute total NDR revenues to all councils to fund local services. Table 4 shows the amount of city-region-driven NDR revenue that would be provided to the Welsh Government under each of the three scenarios. For example, under scenario 1, the Welsh Government would receive £4.7 million in 2019-20, while under scenario 3 it could collect £24.3 million in the same year. Cumulatively, the Welsh Government could receive £75 million in NDR revenue under scenario 3 over 2019-20 to 2021-2022. It is worth noting that this city-region-driven NDR revenue would not be sufficient to reverse the trend of underfunding of local government in Wales, which has faced significant budget cuts and pressures over the last few years (Ogle et al., 2017). Again, we reiterate that the city-region-driven NDR income received by the Welsh Government does not take into account what the Welsh Government would have received if the City Regions developments had gone forward but rates retention was not introduced.

Table 4: City-region-driven NDR income received by the Welsh Government based on the three scenarios, in £ millions, cash terms

	2019-20	2020-21	2021-22
Scenario 1 (1% annual NDR revenue growth)	4.9	5.0	5.2
Scenario 2 (3% annual NDR revenue growth)	14.6	15.1	15.5
Scenario 3 (5% annual NDR revenue growth)	24.3	25.1	25.9

Source: Stats Wales (2018) and authors' calculations

Conclusion

The aim of this report was to examine the current model of business rates in Wales and to explore possible NDR retention and incentivisation schemes, thus participating in the policy debate around local and regional finance in Wales. It analysed existing research on NDR retention in England and Scotland, considered the potential impact of an NDR retention scheme on Welsh NDR revenues, and discussed how a regional approach to a possible shared-gain business rates incentivisation scheme in Wales might be introduced.

This report has shown that the current NDR scheme in Wales, where councils' NDR revenues are pooled and redistributed by the Welsh Government alongside the Revenue Support Grant, financially supports disadvantaged councils. The councils that receive more revenues than they contribute tend to be the less developed and rural LAs, with higher levels unemployment and lower levels of average earnings. By contrast, the wealthy and urbanised councils contribute higher amounts of business rates than they receive.

However, there is a crucial trade-off between redistribution and incentives to grow a region's (and council's) tax base. The more the NDR retention system results in redistribution, the higher the chance of keeping widening regional disparity under control, but the lower the incentives to grow the tax base. The more the NDR retention system encourages incentives to grow the tax base, the more it opens councils (and regions) to risk, and may come at the cost of increased regional disparity. Policymakers will need to make a decision about the optimal mix between redistribution and incentives in designing an NDR retention system. Furthermore, introducing a new regional level between individual councils and the Welsh Government, may address some of the risks of NDR retention at the council level, but introduces questions about at which level decisions about regional development lie.

The discussion of changes to the business rates system in Wales has focused on how business rates are calculated, the NDR appeals system, and the NDR relief schemes. Two reports published in the mid-2010s recommended that NDR revenue should be retained in Wales, during a period that NDR retention was implemented in Scotland and England. In Scotland, NDR retention was accompanied by an incentivisation scheme at the local level, which has so far had limited effects on NDR revenues. The BRRS in England has the potential to benefit the budgets of the developed councils with vibrant property markets and the biggest increases in the local tax base, thus exacerbating the risk of regional development polarisation. Therefore, if Wales were to implement an NDR revenue retention scheme at the council level similar to the English system, it could suffer from similar detrimental effects on local finance from a geographical and sectoral perspective. A council-level NDR revenue

retention scheme would likely result in less income for councils with underdeveloped property markets and more revenues for the councils with buoyant rental structure (geographical impact). It would also increase the financial pressure to councils with reduced income regarding the delivery of basic social services, while also raising the risk of overbuilding (sectoral impact).

The emergence of city regions in Wales has put NDR retention schemes back on the policy agenda, but from a different perspective: retention of the city-region-driven NDR income at the city-regional level. The city regions were established in Wales as important investment initiatives aiming at improving regional economic development and employment growth. However, city regions also have the potential to lead to deeper intra- and inter-regional inequalities, based on fierce regional competition.

If the city region schemes are anticipated to be a major driver of future economic activity in Wales and if the Welsh Government decides to promote an NDR incentivisation model, then a city-region shared-gain business rates incentivisation scheme, discussed in this report, could help the city regions to achieve their aims and boost local finance. The central suggestion made in this report takes account of the overall growth in economic activity as reflected in business rate growth. The Welsh Government would set targets for the expected NDR income generation in each city region, and the city region would retain 50% of the revenues in excess of the target. An alternative version of the partial NDR retention model is that 50% of NDR revenues generated by the non-domestic properties stemming from the city regions deals projects, over and above the NDR revenues that would have been raised in the regions in the absence of the city region projects, should be retained at the city region level.

The retained NDR income by city regions in both models would be allocated, on a collective basis, towards the shared priorities of the City Regions, such as funding city region investments or reducing councils' level of debt, taking account of the need for economically disadvantaged councils to benefit. The calculation of the city-region-driven NDR revenues is based on the assumption of the same poundage for all the city regions. It is important to mention that the projects, introduced in the city regions, should address basic social needs, while the city region boards should minimise the risk of overbuilding and ensure that all councils comprising the city regions gain from the proposed projects. The city regions would send the other 50% of the city-region-driven NDR income to the Welsh Government, which would in turn redistribute these revenues alongside the existing NDR revenues, to the Welsh councils. This NDR income could, for example, financially support social services provided by the councils. This scheme has the potential to support local and regional economic growth, mitigate regional inequalities, restrict the negative impacts of regional competition, and back

the provision of local services, especially in the case that the incentives actually generate faster growth in the tax base.

Overall, this report does not offer easy solutions to the problems of reduced local finance and regional economic development. However, its key messages raise important issues to consider to avoid the potential negative effects of local NDR retention and seek to mitigate regional disparities. Following the spirit of the suggestions made in this report, a well-implemented NDR incentivisation model could improve the distribution of city regions gains across Wales and share city regional strategy benefits among all the Welsh councils and their citizens.

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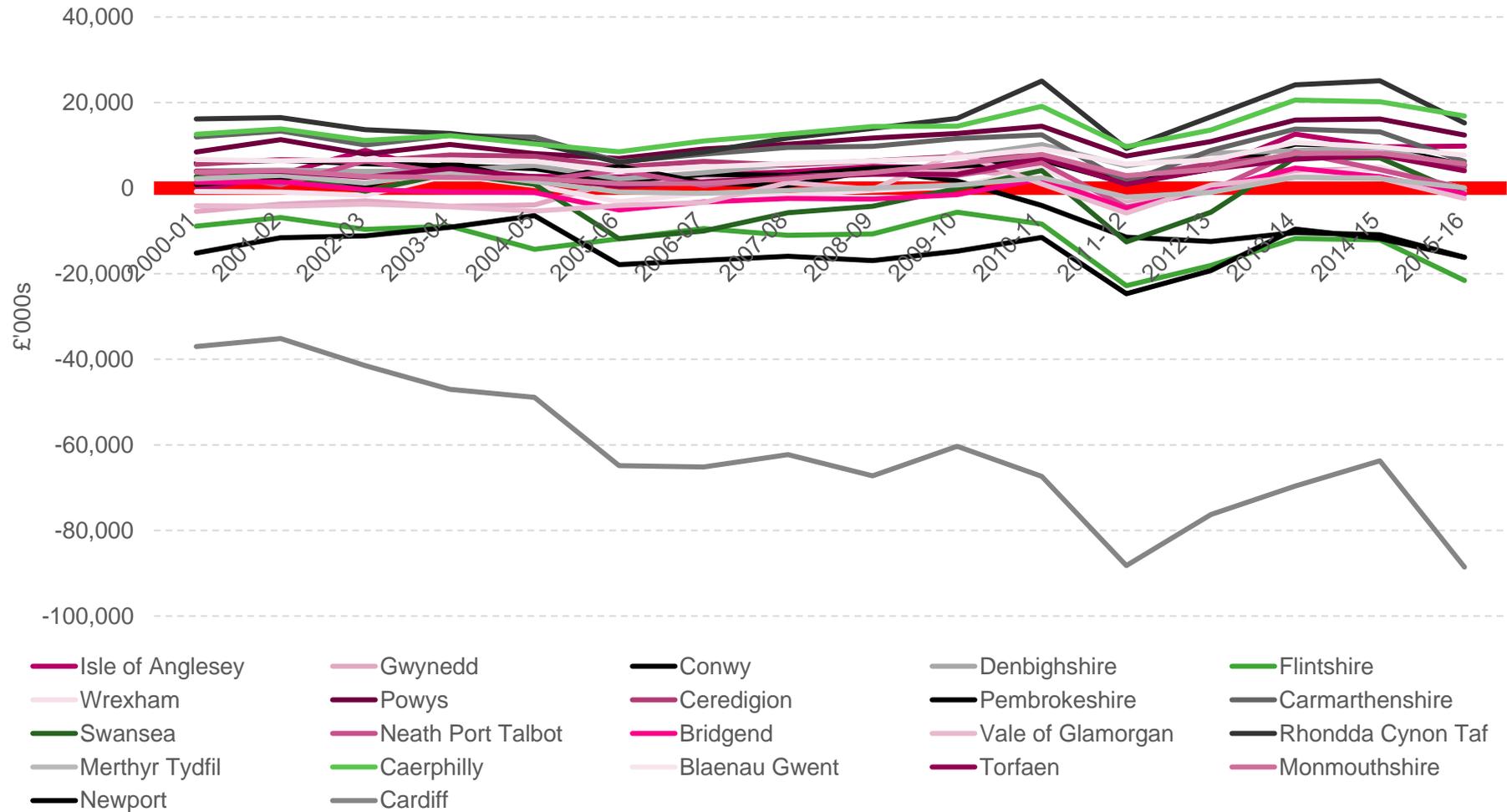
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Annex 1

Figure 4: Difference of NDR settlements-contributions for the 22 Welsh LAs, 2000-01 to 2015-16, £ thousands, cash terms



Annex 2

- If aggregate NDR revenue under the existing scheme of the councils involved in a city region records a decline by more than -5% in a financial year, then in that year the city regions could not retain the 50% of business rates revenue from the city region projects; by contrast 100% of this City-Region-raised NDR could be provided to the Welsh Government for redistribution.
- In case of relocation of a company from an NDP that arises from a named City Region project to another NDP that may still be in the City Region but not part of the project, the NDP could end to be part of the incentivisation scheme.
- In the case of delocalisation, whereby a company moves from a location of the city region to premises of a city region project: this NDP could then become part of the incentivisation scheme.
- In the case that buildings related to the city regions projects remain empty: this NDP could not be part of the incentivisation scheme, since the City Regions will be under financial pressure to finance the relief.

Annex 3

Table 5: Three scenarios for the generation and retention of business rates revenues under the suggested NDR scheme, based on NDR average growth rate projections

	NDR generation (£ millions)							Retained NDR income (£ millions)				Retained NDR income as % of average GVA growth (1998-2016)		
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2019-20	2020-21	2021-22	Total	2019-20	2020-21	2021-22
CCR (current scheme)	486	509	486	501	516	531	547							
<i>Scenario 1</i>	486	509	486	501	521	536	552	2.57	2.65	2.73	7.96	0.33	0.34	0.35
<i>Scenario 2</i>	486	509	486	501	531	547	563	7.73	7.96	8.20	23.90	0.98	1.01	1.04
<i>Scenario 3</i>	486	509	486	501	541	558	574	12.89	13.27	13.67	39.84	1.64	1.69	1.74
SBCR (current scheme)	211	218	212	220	229	238	248							
<i>Scenario 1</i>	211	218	212	220	231	240	250	1.14	1.19	1.23	3.57	0.37	0.39	0.40
<i>Scenario 2</i>	211	218	212	220	236	245	255	3.43	3.57	3.71	10.71	1.11	1.16	1.21
<i>Scenario 3</i>	211	218	212	220	240	250	260	5.72	5.95	6.18	17.86	1.86	1.93	2.01
NWGD (current scheme)	203	211	217	223	229	235	242							
<i>Scenario 1</i>	203	211	217	223	231	238	244	1.14	1.17	1.2	3.53	0.35	0.36	0.37
<i>Scenario 2</i>	203	211	217	223	236	242	249	3.43	3.52	3.62	10.59	1.04	1.07	1.10
<i>Scenario 3</i>	203	211	217	223	240	247	254	5.72	5.88	6.04	17.64	1.73	1.78	1.83

Wales Public Services 2025

The Wales Public Services 2025 Programme is investigating the long-term financial, demographic and demand pressures confronting public services in Wales and possible responses. Hosted by Cardiff Business School and independent, the Programme is a unique partnership between Cardiff University and five national bodies in Wales: the Welsh Local Government Association, SOLACE Wales, the Welsh NHS Confederation, the Wales Council for Voluntary Action and Community Housing Cymru.

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Authors' Details

Dr Nikos Kapitsinis (principal author) is a Research Assistant at Wales Public Services 2025, hosted by Cardiff Business School.

Dr Daria Luchinskaya is a Research Associate at Wales Public Services 2025 and a Research Fellow at the Institute for Employment Research, University of Warwick